GRG Remuneration Insight 132

Reasonable Remuneration

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INTRODUCTION

This Insight canvasses the Corporations Act requirement that the remuneration of directors (and their spouses, parents and children) of public companies must be reasonable or it must be approved by shareholders, and those provisions that are relevant to seeking such shareholder approval.

The responsibility for ensuring that remuneration of directors is reasonable rests with the Board and breaches of this requirement can lead to fines and disqualification of directors, let alone the reputational damage that may be incurred.

The trigger for writing this Insight is that there were a number of examples of remuneration practices that did not seem to be reasonable and did not meet the requirements for shareholder approval, which were publicly debated during 2020.

CORPORATIONS ACT REQUIREMENTS AND CONSIDERATIONS

Legal Provisions

Section 208 of the Corporations Act requires, amongst other things, that the remuneration of directors (related parties) of public companies must either:

a) be approved by shareholders in the way set out in sections 217 to 227,

b) be provided pursuant to a contract that was approved by shareholders and satisfied specific requirements, or

c) fall within one of the exemptions set out in sections 210 to 216.

The most relevant exemption is contained in section 211 and relates to reasonable remuneration which is defined as:

> "-to give the *remuneration* would be reasonable given:
>
> *(i) the circumstances of* the public company or entity *giving the remuneration; and*
>
> (ii) the related party's circumstances (including the responsibilities involved in the office or employment)."

While s208 covers both executive and non-executive director (NED) roles this Insight focuses mainly on remuneration for executive director roles (Managing Director and sometimes others) which tends to be the focus of these debates, noting that NED remuneration tends to be simpler and of a lesser quantum.

The starting point for considering reasonableness will usually be whether the remuneration is consistent with the normal/market reward for any comparable director roles for the work performed or duties that are involved. Although not specifically mentioned in the definition it would seem to be self-evident that when considering the reasonableness of remuneration both the quantum and the mix of elements of remuneration will need to be considered.

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Company Circumstances and Considerations

To state the obvious, not all companies are exactly alike; they operate in different industry sectors, they are of different sizes, they operate in different geographies, they generate different levels of profit, they carry different levels of risk and debt, they are in different stages of their evolution, they have different future prospects, some have proven commercial offerings and others are developing new commercial offerings or are testing the market to see if they have a viable commercial offering.

There are so many variations that it is impossible to set guideless for directors when considering the company's circumstances. However, there are some company circumstances that clearly restrict the quantum and structure of remuneration; for example, in the case of cash flow stress it seems obvious that company circumstances would warrant the use of equity to deliver part of Fixed Pay and deferred short term variable remuneration awards as well as long term variable remuneration grants, thereby conserving cash. To pay all of these amounts in cash only could compromise the Company's ability to meet its financial obligations.

Director's Circumstances and Considerations

As indicated in the legislation it is important to consider the nature of the role being filled by the director. Clearly, some roles like Finance Director and Executive Director would warrant lower levels of remuneration than the role of Managing Director of the same company. In addition, how the role is designed and fits into the larger organisation structure is also key. For example, where there are multiple roles fulfilling the same function (e.g. part time Finance Director and a Chief Financial Officer) it may not be reasonable to pay both roles at the full market rate.

As indicated above, the key consideration is what comparable roles are being paid in the market. Generally, for Australian companies the market will be composed of comparable roles located in Australia. To identify comparable roles, it will be necessary to consider the size of the company as measured by relevant factors such as market capitalisation, profitability and possibly revenue. In Australia, the quantum of total remuneration and incentive award opportunities tend to grow when company size increases. It will also be necessary to consider the remuneration practices of companies operating in the same industry and/or facing similar operational challenges. The outcome of such an analysis will usually be ranges of market remuneration practices for total remuneration and incentive award opportunities for the director role being considered. Independent external remuneration consultants, such as Godfrey Remuneration Group, should be well placed to conduct the analysis required to advise on market remuneration practices for director roles and opine on the reasonableness of the proposed or current remuneration package.

The level of experience and competence exhibited by the director would then need to be considered to determine where in the ranges the director's total remuneration and incentive award opportunities should be set.

Other circumstances of the director that could be considered include the individual's wealth or shareholding in the company. This aspect needs to be approached with caution. A widely held view is that income earned by way of remuneration and income from investment should be treated separately. An exception may arise when a company founder has undertaken an initial public offering (IPO) of the company's shares. When doing so it is usual for the founder's shares to be escrowed for a period when forecasts made in the prospectus for the IPO need to be delivered to justify the purchase of shares by investors. Perhaps during this period, it may be reasonable for a director who was the founder to be remunerated at a lower level than the top of market practice because the value derived by the founder through the IPO relates partly to performance leading up to the IPO and partly to promised performance immediately following the IPO. In this regard it should be noted that remuneration that is not reasonable may be too low or too high or inappropriately structured in terms of the mix of the elements of remuneration.

SHAREHOLDER APPROVAL

The Provisions

There are several provisions that are relevant to shareholder approval of remuneration. These include:

1. Sections 217 to 227 of the Corporations Act which relate to financial benefits provided to directors, and
2. ASX Listing Rules Guidance Note 19 which is relevant when performance securities are to be issued to directors as part of their remuneration.

Corporations Act Provisions

Sections 217 to 227 of the Corporations Act cover a range of procedural matters that need to be complied with when seeking shareholder approval of proposed remuneration arrangements. Of these s218(1) is particularly important as it states that the required explanatory statement set out:

> *"(e) all other information that:*
>
> *(i) is reasonably required by members in order to decide whether or not it is in the company's interests to pass the proposed resolution; and*
>
> *(ii) is known to the company or to any of its directors.*
>
> *(2) An example of the kind of information referred to in paragraph (1)(e) is information about what, from an economic and commercial point of view, are the true potential costs and detriments of, or resulting from, giving financial benefits as permitted by the proposed resolution, including (without limitation):*
>
> *(a) opportunity costs; and*
>
> *(b) taxation consequences (such as liability to fringe benefits tax); and*
>
> *(c) benefits forgone by whoever would give the benefits."*

ASX Listing Rules Guidance Note 19

Guidance Note 19 relates to ASX Listing Rules:

- LR 1.1 condition 1, covering requirements for admission to the official ASX list as an ASX listing – "*The entity's structure and operations must be appropriate for a listed entity.*",
- LR 6.1 – "The terms that apply to each "class of' security must, in ASX's opinion, be appropriate and equitable."
- LR 12.5 – "An entity's structure and operations must be appropriate for a listed entity".

It also addresses "performance securities" which are broadly defined as a security that converts into a given number of ordinary shares with the usual rights attached if and when a nominated performance milestone is achieved but has limited rights before then".

This definition clearly covers performance rights and options typically granted as the long term variable remuneration component of remuneration packages for executive directors, and often IPO equity arrangements. However, there are two important carve-outs relevant to director remuneration and they mean that most performance rights and options granted to executive directors are not subject to the Guidance Note. These are:

- cash-settled performance rights because they are not "equity securities" for the purposes of the Listing Rules (note: this does not apply to indeterminate rights that may be settled in cash, it only applies to rights that may only be settled in cash); and

- "an issue of performance shares, performance options or deliverable performance rights by an entity under an employee incentive scheme or as part of the remuneration package of a director or employee, where the issue has been made in the ordinary course of business of the entity and not in connection with a new or re-compliance listing and has been approved" as required under the ASX Listing Rules. (underlining inserted)

Under United States law, the term "**ordinary course of business"** covers the usual transactions, customs and practices of a certain business and of a certain firm. In Australia, much has been written by legal practitioners about the meaning of this phrase. However, from the author's point of view it would:

a) Include directors' remuneration when the quantum and structure is consistent with relevant market practices, i.e. when the remuneration is reasonable; and

b) Not include remuneration which is significantly large and out of line with relevant market practices, i.e. when the remuneration is not reasonable.

If proposed grants of performance securities do not fall within these exemptions, then sections 8 to 15 of the Guidance Note need to be complied with. Briefly, the requirements of sections 8 to 15 are as follows:

- Generally, shareholder approval of the grants of performance securities is required (section 12) – this is consistent with the Corporations Act which requires remuneration that is not demonstrably reasonable to be approved by shareholders, if it is provided,
- The ASX recommends in principle advice be sought from the ASX before making any announcement about the proposed grant of performance securities (section 8),
- The performance securities need to satisfy specified base requirements in relation to a range of aspects including transferability, voting, dividend entitlements, winding up entitlements, bonus issues and change of control (section 9),
- The number of shares into which performance right may convert needs to be equitable and clearly communicated to shareholders (section 10),
- Performance milestones need to be appropriate and equitable (section 11),
- A report from an independent expert may be required in some circumstances such as when the aggregate number of shares into which performance securities may be converted is greater than 10% of issued shares at the time the performance securities are to be issued (section 13),
- The notice seeking shareholder approval must include such material as will fully and fairly inform shareholders and enable them to make a properly informed judgement (section14), and
- A voting exclusion statement is required (section 15).

WHEN REMUNERATION IS NOT REASONABLE AND CONCLUSION

It is generally advisable for Boards of Public companies and particularly those that are listed on the ASX to obtain independent expert advice on whether proposed remuneration packages for directors are reasonable, so as to manage the outlined compliance requirements, and risks associated with falling foul of the requirements. Remuneration may not be considered reasonable when it falls outside the range of comparable market practices, in terms of either quantum or structure, or the quantum or structure may be viewed as compromising the Company's viability or obligations. If however the independent advice confirms that the proposed remuneration packages are reasonable then the Board may proceed with confidence to implement the remuneration, but of course after obtaining shareholder approval of proposed grants of equity when required under ASX Listing Rule 10.14.

If the advice is that a proposed remuneration package is not reasonable then the Board has two choices:

1. Modify the remuneration package so that it is reasonable, or
2. Seek shareholder approval for the proposed remuneration package observing the requirements of the Corporations Act and, if relevant, Guidance Note 19.