



REMUNERATION REFORM

How does the '2 strikes' rule affect your Company and your Board?

The New Reforms

On 20 June 2011, the Senate approved the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* and the legislation will take effect from 1 July 2011.

Although this article primarily focuses on the impact of the '2 strikes' remuneration report vote and the potential for a board spill, the new law has wide reaching impact on remuneration practices and corporate governance in Australia, including (in addition to the '2 strikes'):

- prohibiting key management personnel (and closely related parties of such personnel) from hedging their incentive remuneration (such as shares and options);
- imposing rules about disclosing entities (which include ASX listed companies) using remuneration consultants including the consultant's role and the method of communication of the consultant's recommendations;
- prohibiting key management personnel and their closely related parties voting (or voting undirected proxies) on remuneration matters and any motion to require a board spill;
- preventing proxy holders from 'cherry picking' the proxies they exercise (directed proxies not voted will now default to the Chairman who must exercise those proxies as directed);
- requiring that shareholder approval be obtained for board 'no vacancy' declarations where a company has not exceeded the maximum director limit set in its constitution; and
- requiring remuneration disclosure in the remuneration report to be confined to key management personnel (instead of the five highest paid company or group executives).

'2 strikes' board spill

Under the new law, a '2 strikes' re-election process will apply to the non-binding shareholder vote on the remuneration report. Namely, where a company's remuneration report receives a 'no' vote of 25% or more of all votes cast at two consecutive annual general meetings (that is, '2 strikes'), a resolution (the 'spill resolution') must be put to the second AGM requiring shareholders to vote on whether the company must hold another general meeting (known as the 'spill meeting') to consider spilling the board. If the spill resolution is approved by a simple majority of 50% or more of the eligible votes cast, the 'spill meeting' must be held within 90 days.

At the spill meeting, those individuals who were directors when the remuneration report was considered at the most recent AGM will be required to stand for re-election (other than the managing director). If, at the spill meeting all of the directors are removed (other than the managing director) there is a mechanism to ensure that there are a minimum of three directors remaining on the board. Namely, the remaining positions (other than that of the managing director) will be filled by those with the highest percentages of votes favouring their appointment cast at the spill meeting on the resolution for their appointment (even if less than half the votes cast on the resolution were in favour of their appointment). If two or more individuals have the same percentage of votes, the remaining director or directors can choose which individual is appointed as a director, and this appointment must be confirmed at the company's next AGM.

In the case where none of the individuals who were directors when the remuneration report was considered at the most recent AGM remain as directors of the company, the company will not be required to hold the spill meeting. This is the case whether or not those directors have been replaced by new directors.

This new law applies to resolutions on the remuneration report put to annual general meetings held after 1 July 2011. Therefore, the earliest spill meetings could be held in late 2012.

Practical implications

The new reforms have a number of practical implications for ASX listed companies. Namely:

- **AGM Disclosure:** Notices of annual general meeting will need to disclose the impact of the '2 strikes'. This will not simply be the case for the notice of meeting for the subsequent AGM after a company has received a no vote of more than 25% on the remuneration report. Companies should be proactive in explaining the significant ramifications of the new reforms in their next notice of meeting to ensure that shareholders consider the significant impact of the '2 strikes' rule before voting against the remuneration report.

Clearly, significant disclosure regarding the impact of a second 'no' vote of more than 25% at the 'second AGM' will be required. The notice of meeting will need to explain the different potential outcomes and different resolutions (which may or may not be put to shareholders). More importantly, companies will need to set out the impact on the company of losing most of the directors from its board and the significant interruption this will have on the company's strategy, and potentially value, should the board be removed at the spill meeting.

The proxy form for the second AGM will need to allow shareholders to cast a vote on the spill resolution.

- **Annual report disclosure:** Where a company's remuneration report receives a 'no' vote of 25 per cent or more, the company's subsequent remuneration report must explain the board's proposed action in response or, if the board does not propose any action, the board's reasons for not making any changes.
- **Spill resolution at the second AGM and the spill meeting:** At the 'second AGM' the Chairman of the company will need to adjourn the meeting while the votes on the remuneration report are tallied. Otherwise, the Chairman would need to put the 'spill resolution' to shareholders on a contingent basis prior to the determination of whether there is a second strike. To do so, would be inappropriate and, legally, the spill resolution, being a contingent resolution, may not be valid.

Should there be a board spill for an ASX 300 company, it will not be possible for it to comply with the ASX Listing Rules regarding the composition of the audit committee. Namely, the audit committee will need to have at least three non-executive directors, a majority of whom are independent. Accordingly, these companies may need to seek a conditional waiver from the ASX in advance of any spill meeting.

Additionally, the directors who fill the vacant positions on the board after the spill meeting (assuming there is a spill), will need to stand for election at the next AGM along with one of the remaining directors, who will need to stand for re-election. In short, the reforms have the potential to impact not only at the ‘second AGM’ but at the following AGM.

- **Major shareholders and proxy voting services:** Given that the average number of votes cast at AGMs is currently a little over 50% of all issued shares, a ‘no vote’ of 25% or more will, on average, require shareholders holding approximately 13% to vote against the remuneration report. Although the spill meeting may only be held if the spill resolution is approved by a majority (that is, 50% or more), this still puts the emphasis on companies to liaise with major shareholders on the issue of remuneration. In addition, companies may need to engage with proxy voting services, such as RiskMetrics, to explain the rationale behind the remuneration structure and practices.
- **Dissatisfied shareholders and corporate opportunists:** The new laws give dissatisfied shareholders and corporate opportunists a new weapon in their arsenal. A company which has received a ‘no vote’ at the last AGM may become susceptible to dissatisfied substantial shareholders forcing a board spill or opportunistic advances from corporate raiders and board requisitioners. If such market participants are able to sway the vote at the ‘second AGM’ to require the company to call a spill meeting, it may allow dissatisfied substantial shareholders to nominate, and have voted in, their own representatives to the board or allow the raiders to launch aggressive control transactions whilst the board is in flux or has been reduced to three directors. Companies should liaise with their substantial shareholders, particularly those who have voiced any dissatisfaction, and should carefully monitor share register movements prior to the ‘second AGM’ as well as prepare themselves for any potential hostile approaches.

Conclusion

The new remuneration reforms, especially the ‘2 strikes’ rule, are arguably the most significant corporate governance reforms that corporate Australia has seen since the ASX Corporate Governance Principles were first published and the “if not, why not” regime was implemented. Shareholders and stakeholders, such as RiskMetrics and the Australian Shareholders Association, have been equipped with a large axe that they will be able to wield against boards who disregard shareholder unhappiness with respect to remuneration practices. Companies and boards, especially those facing the potential of a no vote at a subsequent AGM, will need to carefully consider their strategy regarding meeting disclosure and changes to remuneration and will need to liaise with key shareholders and stakeholders whilst being wary of opportunistic approaches at a time when the board may have its back against the wall.

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