



BRIEFING PAPER: A SECOND STRIKE WORLD

The 2012 Australian AGM season will be the first where listed companies that received a vote of 25 percent against their 2011 remuneration reports may encounter a 'second strike'. Under the 'two strikes' changes to the Corporations Act in 2011, effective for AGMs after 1 July 2011:

- A vote against a remuneration report of 25 percent or more counts as a 'first strike'.
- At the next AGM, a company with a first strike will be required to put to shareholders a resolution seeking approval to convene a meeting where all directors will be required to seek reelection with this 'spill resolution' requiring a **majority** to be effective.
- This spill resolution will be a **conditional resolution** and will only be put to the meeting if a 'second strike' occurs: If the remuneration report at the AGM receives a vote against of 25 percent or more.
- For institutional investors who typically vote long before the meeting, this means they will be required to vote on the spill resolution without knowing whether a second strike will occur.

A board spill can only occur therefore if two consecutive remuneration report votes receive a vote against of more than 25 percent AND the spill resolution at the second AGM receives a majority of votes in favour. Members of key management personnel – senior executives and directors – and their related parties are prohibited from voting on remuneration report and spill resolutions but would be able to vote at a spill meeting should the spill resolution be passed.

Approaching the second strike

The introduction of two strikes prompted an outcry from groups representing company directors and management that the potential for a board spill arising from a remuneration report vote would destabilise companies and lead to remuneration report votes being abused by shareholders seeking board control.

Institutional investors when weighing up how to vote on the remuneration report of a first strike company in 2012 are likely to face significant pressure from company management and groups working for management and funded by shareholders. These management teams will urge investors to vote in favour of the remuneration report regardless of any concerns over remuneration they may have. In deciding how to vote on the remuneration report at a first strike company, institutions should remember that it is not possible to inadvertently spill the board – a board spill will require a majority of votes in favour on a specific resolution seeking a board spill.

There are a range of options for investors on how to treat the second strike remuneration report vote and the spill resolution:

- **Business as usual:** The easiest option for an institutional investor is to evaluate the remuneration report at a first strike company on the same basis as they would evaluate any other remuneration report and simply ignore the spill resolution. In this scenario an investor would vote against the spill resolution (or abstain) unless they had serious concerns over company performance.
- **Treat the spill and remuneration report resolution as linked:** Some institutions may wish to regard the decision as to whether or not to support the remuneration report at a first strike company as connected with the decision on whether to support the spill resolution. In this situation unless an investor feels strongly that substantial change in management is required they will feel compelled to back the remuneration report regardless of its content. In this scenario, which is likely to be emphasised by company representatives and proxy solicitors, the remuneration report vote at a first strike company will be treated as a de facto vote of confidence – regardless of whether or not the spill resolution is passed.
- **A tactical approach:** Some investors may wish to use their remuneration report vote and the spill resolution tactically in order to extract governance concessions from a company (given the near-hysteria with which the two strikes regime has been regarded by many company boards and advisors). In this case investors may wish to threaten to vote against the remuneration report and/or the spill resolution unless a particular feature of the company's pay or governance practices is changed or, in an extreme case, the company commits to board or executive renewal.
- **Obligation:** Some investors may regard themselves as having an obligation to use the spill resolution and evaluate the remuneration report of a first strike company differently given the Parliament's creation of the two strike regime. This strategy carries high reputational risks for an investor especially if the first strike company concerned has made a concerted effort to address investor concerns identified during the first strike.

How OM will approach the second strike

OM's approach to making recommendations on the spill resolution and the remuneration report at a first strike company will reflect the 'business as usual' view outlined above. Analysis and advice of the remuneration report resolution will be done on the same basis as for any other remuneration report resolution while the spill resolution will be evaluated on the basis of whether the performance of the company justifies seeking the removal of a majority of the present board. This will mean:

- **OM will be unlikely** to support a spill resolution even if it recommends against a first strike company's remuneration report **unless the company has a track record of underperformance, unresponsiveness to shareholder concerns over its performance and no stated plans for board or executive renewal.**

This reluctance stems from the fact that shareholders in the ordinary course of business are able to signal concern over board performance by voting against

incumbent directors seeking election at an AGM. It also recognises that a board spill is likely to be disruptive and unlikely to lead to substantive change in the board especially given the difficulty shareholders will face in nominating candidates to stand at the spill meeting should one be convened. This is because the spill meeting must be held within 90 days of the spill resolution being passed; many company constitutions require non-board endorsed director nominations to be received 45 business days – 63 days – prior to a meeting. Listed companies are required to provide 28 days' notice of a general meeting.

- **Pay issues will not play a part in deciding how to recommend on the spill resolution outside of extreme cases.** Even in these cases pay for executives is most likely to be a minor factor which is symptomatic of problems at the company rather than **the** problem at the company.
- **OM will disregard** assertions by company representatives that a vote against the remuneration report at a first strike company will have destabilising consequences **in the absence of compelling evidence and in light of the fact no board spill can occur unless a majority of votes cast on the spill resolution are in favour – in addition to a 25 percent vote against the remuneration report.**

Strategic shareholders and the second strike

Many company directors and advisors to companies have asserted that the two strikes regime will be used to effect de facto changes of control at listed companies. These assertions have continued despite the fact that for a board spill to occur a majority of votes cast must be in favour of the board spill resolution in addition to 25 percent of votes being against the second remuneration report. Under the Corporations Act **prior** to the introduction of the two strikes regime, a strategic shareholder with a substantial shareholding has been able to seek to nominate friendly candidates and remove hostile ones through the right of shareholders with 5 percent of shares able to be voted being able to requisition a general meeting or put resolutions to a general meeting (ss. 249D & 249N).

Of the 21 S&P/ASX 300 entities that received a first strike between 1 July 2011 and 31 December 2011, one – Tassal Group – has a strategic shareholder which nominated a candidate who was elected to the board and is understood to have opposed not only the remuneration report but also the reelection of a board endorsed director. It is also possible that the strike at Aspen Group was also in part due to disgruntled major shareholders given the company's former executive director together with a group of other shareholders had requisitioned a general meeting to remove the incumbent board earlier in 2011. Among the additional three first strike companies that were constituents of the FTSE ASFA 300 Index but not the S&P/ASX 300, one, Sirtex Medical, incurred a first strike apparently because of the votes of a major shareholder with a history of disputes with the company.

Shareholders in these companies should be aware of the potential for disgruntled strategic holders to use the two strikes regime to create mischief although as the Aspen and Tassal examples show, there are more direct means of achieving a particular set of goals for a dissatisfied shareholder. In any case, these strategic holders to engender a board spill will require the support of other shareholders given the board spill resolution requires majority support.

Appendix 1: First strike companies in the S&P/ASX 300

Company	Against vote (%)	Company	Against vote (%)
Crown Limited	55.7	Nexus Energy Limited	35.8
Pacific Brands Limited	53.1	Integra Mining Limited	35.7
Bandanna Energy Limited	44.1	Silex Systems Limited	34.2
GUD Holdings Limited	44.1	Watpac Limited	34.2
Cabcharge Limited	40.6	UGL Limited	30.1
Linc Energy Limited	40.1	Gryphon Minerals Limited	29
Bluescope Steel Limited	39.2	Dexus Property Group*	28.2
NRW Holdings Limited	39.1	Austin Engineering Limited	27.1
Fleetwood Corp.	38.9	Perpetual Limited	26.2
Tassal Group Limited	37.3	Focus Minerals Limited	25.4
Aspen Group	35.9		

Source: Company announcements of meeting results; between 31 December 2011 to 31 May 2012 Roc Oil, Mirabela Nickel and Beadell Resources have also incurred first strikes.

***Note:** Dexus Property Group is not subject to the two strike regime as the listed group consists only of trusts. It voluntarily submits itself to the same governance regime as a listed company and views itself as having incurred a first strike.