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No. 79 2002–03

Corporations Amendment (Repayment of Directors' Bonuses) Bill 2002

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I N F O R M A T I O N A N D R E S E A R C H S E R V I C E S

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Corporations Amendment (Repayment of Directors'
Bonuses) Bill 2002

Mark Tapley
Law and Bills Digest Group
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Corporations Amendment (Repayment of Director's Bonuses) Bill 2002

Date Introduced: 16 October 2002

House: House of Representatives

Portfolio: Treasury

Commencement: On Royal Assent

Purpose

To amend the *Corporations Act 2001* to permit liquidators to reclaim unreasonable payments made to the directors of insolvent companies and their close associates.

Background

Basis of policy commitment

For some years there has been considerable public concern about the remuneration levels of company directors and senior executives. Criticism has focused on a number of aspects namely the quantum of remuneration, the level of disclosure to shareholders and the market generally and in some cases, the apparent lack of a relationship between reward and performance. This Bill is intended to address the latter aspect of the controversy.

The origin of this Bill lies in the collapse of telecommunications carrier One.Tel in May 2001. Shortly after One.Tel went into administration it was revealed that the company's co-managing directors Mr Keeling and Mr Rich had each received \$7.5 million in bonuses in a year where the company had lost \$291 million.¹ The bonuses were paid on the basis of market capitalisation which in November 1999 reached over \$5 billion at the height of the telecommunications boom.

In response to the public outcry, the Prime Minister announced on 4 June 2001 that:

The Commonwealth intends to amend the law so that in future, where bonuses are paid in the circumstances where those bonuses were paid to the bosses of One.Tel, that money will be refundable and can be used to meet the lawful and legitimate entitlements of workers and also the other creditors of the company.²

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Following the Prime Minister's announcement it was reported that Mr Rich and Mr Keeling agreed to repay the bonuses.³

The role of bonuses in executive remuneration

Bonuses have come to represent an increasing proportion of total amounts paid to company directors and senior executives. A 2002 survey of 183 listed companies published by the *Australian Financial Review* stated that average pay of Chief Executive Officers (CEOs)⁴ was \$1.68 million and that 56 per cent of that amount was comprised of bonuses and other performance based incentives.⁵ Defenders of remuneration levels argue that boards obtain independent advice on the market value of executives and that Australian CEOs receive modest compensation by international standards.⁶ Others have stated however that Australian CEOs are the third highest paid in the world behind the US and Britain.⁷

Data from Mercer's *Top Management Remuneration Review Survey* covers a wider range of entities including private companies and state owned enterprises and senior executives as well as directors. The survey indicates that incentive or bonus payments become an increasing important part of remuneration as the value of the total employment package increases.

Employment Cost (EC)	2002 Average Incentive	As a % of EC
100-125	11 703	10
125-150	15 088	11
150-200	20 373	12
200-250	34 393	15
250-300	49 180	18
300-350	66 648	21
350-400	81 604	22
400+	171 180	34

Source: Mercer Human Resource Consulting.

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Senate Amendments in 2001

In September 2001, the Opposition supported a Democrat amendment to the *Corporations Act* that was moved during debate on the Bankruptcy Legislation Amendment Bill 2001. The amendment inserted a definition of 'performance-related bonus' and added a new subsection to the list of voidable transactions contained in section 588FE of the *Corporations Act 2001*. While the amendment passed the Senate, it was not considered by the House of Representatives prior to the General Election.

If the amendment had been enacted, a company's liquidator would have been able to apply to the Court under section 588FF for an order that a director or executive officer⁸ repay to the company the amount of any performance-related bonus received in the 12 months before the winding up of the company began. The money would then have been available for distribution to the company's employees, creditors and shareholders if there were sufficient funds. Under the proposed provisions, the payment would only have been voidable if the amount of the bonus exceeded \$40 000 and the remuneration paid to the director or executive officer exceeded \$100 000 excluding bonuses. The Senate amendments were expressed to have a retrospective effect applying from the date of the Prime Minister's announcement of policy intention on 4 June 2001.

Main Provisions

Section 588FE of the *Corporations Act* lists a number of transactions that are voidable. These include insolvent transactions, uncommercial transactions and unfair loans to the company.⁹ If a transaction is voidable a company's liquidator may apply to the court under section 588FF for an order that the financial benefit be returned the company so that it can be distributed to all creditors.

The Bill adds the category 'unreasonable director-related transactions' to the list of voidable transactions in section 588FE (**items 4 and 5**).

This new category is defined by **proposed section 588FDA** as a transaction where the company:

- makes a payment or
- a conveyance, transfer or other disposition of property or
- issues securities or
- incurs an obligation to make a payment, disposition or issue.¹⁰

to a director of the company; or a close associate; or to someone else on their behalf or for their benefit in circumstances where a reasonable person would not have entered into the

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transaction having regard to the benefit and detriment accruing to the company of entering into the transaction, the benefit accruing to other parties and other relevant matters.

While the title of the Bill refers to 'directors' bonuses' in fact the scope of section 588FDA is much broader and would capture other transactions such as base salary payments and retirement benefits.

The term 'close associate of a director' is defined to mean a director's relatives or spouse or relatives of the director's spouse or de facto (**item 1**).

Subsection 588FDA(2) requires that the reasonableness of the transaction should be assessed at the time the transaction is entered into rather than when the obligation accrued. In other words, the reasonableness of a payment is to be assessed at the time it was made rather than when the company agreed to make the payment as a matter of contract.

Unreasonable directed-related transactions will only be voidable if:

- they were entered into on or after this Bill receives Royal Assent, and
- they were entered into, or an act was done to give effect to the transaction, within 4 years of the company beginning to be wound up (**proposed subsections 588FE(1), (6A)**).

Thus payments can only be challenged under this section if a company goes into liquidation within 4 years of the transaction. Large payments to directors of companies that are poorly performing but solvent are not voidable under the provisions proposed by this Bill.

If the court finds a transaction to be voidable solely on the ground that it is an unreasonable director-related transaction, it may only make an order for the recovery of the difference between the value of the benefits and the amount that would have been paid by a reasonable person in the company's circumstances (**proposed subsection 588FF(4)**). Consequently, the court will *not* be able to order the repayment of an entire bonus unless a reasonable person in the company's circumstances would not have made any bonus payment.

This provision also has implications for the treatment of options granted to directors. Under the Bill, a director could be forced to repay the value of options that were granted in unreasonable circumstances however any profits that may have been made on the trading of those options would seem to be beyond the scope of a court order under section 588FF. In some cases, the initial value of the option granted by the company may be a small fraction of the profits made on sale.¹¹

Section 588FG provides defences against claims that a transaction is voidable. Under subsection 588FG(2) a court must not make an order under section 588FF (unless the transaction is an unfair loan) prejudicing the interests of a person who:

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- became a party to the transaction in good faith
- had no reasonable basis for suspecting that the company was insolvent, and
- had provided valuable consideration or changed their position in reliance on the transaction.

Item 7 amends the subsection to ensure that the defence is not available in the case of unreasonable director-related transactions. As the Explanatory Memorandum notes 'the insolvency of the company at the time of an unreasonable director-related transaction is not a relevant consideration under the proposed amendments.'¹²

Concluding Comments

What is an 'unreasonable' director-related transaction?

The Bill does not define in detail the circumstances in which a director-related transaction would be 'unreasonable'. Rather, it requires a case by case analysis of the benefit and detriment accruing to various parties to the transaction.

While there are other provisions of the *Corporations Act* which require the Court to examine whether remuneration is reasonable¹³ there is little useful case law on how this matter is to be assessed. To comply with the requirements of the law it is common practice for directors to establish compensation committees and employ external pay consultants to advise on the appropriate level of remuneration. Of course, the use of consultants of itself is not a guarantee that remuneration will be reasonable. Highlighting concerns about the independence of consultants, one US academic has stated that:

'it is a very dim compensation consultant who does not recognise that he has actually been hired by the corporate CEO and that his role is to find a way to justify a sizeable increase in compensation for the CEO'¹⁴

Academics have suggested that Australian courts may draw some guidance from the US courts in assessing whether a payment is reasonable.¹⁵ As far back as 1933 the United States Supreme Court held that bonus payments to directors must bear some relation to the value of services that they have given to the company.¹⁶ Many cases in the US have arisen due to tax law requirements that a company can only claim a deduction for salaries of personal services rendered when the amount is 'reasonable'.¹⁷ Some factors identified by US Courts as relevant in adjudicating on these tax cases include:

- compensation for executives in like positions
- the executive's skills and qualifications and experience
- the nature, extent and scope of the executive's work

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- comparison of salaries with distributions to shareholders
- prevailing general economic conditions, and
- a comparison of salaries paid with the gross income and net income of the company.

In the context of the current Bill, if the Parliament is concerned that the test of unreasonableness is too uncertain it may wish to give the courts some guidance on what it considers to be relevant factors in making this assessment.

A more radical approach would be to specify a dollar amount¹⁸ or multiple of salary as the reference point for determining whether a payment is reasonable. This approach could have unintended effects. For example, if a specified amount is given legislative recognition as being unreasonable, the effect may be to bring all bonus payments up to just under that amount regardless of whether the payment bears any relation to services rendered. It may be worth noting however that some in the business community have expressed support for pay caps in some circumstances. Prominent investment banker Bill Beerworth has argued that retirement payments to executives should be limited to 3 times base pay.¹⁹

Key differences between the Government's Bill and the Amendments passed by the Senate in 2001

As mentioned above, in September 2001 the Senate passed amendments moved by the Australian Democrats (the Senate Amendments) which sought to enable the liquidator to claw back performance related bonuses. There are a number of points of difference between the approach taken by the Senate amendments and that contained in this Bill.

Who is caught?

The Bill allows transactions to be voided only if they involve payments to a director or their close associate –eg relative, de facto, spouse. The Senate amendments did not apply to payments made to 'close associates' of directors as defined in the Bill. However they were broader in that they permitted a liquidator to attempt to claw back bonuses paid to executive officers of the company as well as directors. Section 9 of the Corporations Act defines an 'executive officer' as a person who is concerned in, or takes part in, the management of the body (regardless of the person's designation and whether or not the person is a director of the body).

In several recent collapses it has been revealed that senior executives have been the beneficiaries of large bonuses. In 2000-01 HIH paid executive bonuses of \$4.6 million, and Ansett Airlines paid \$3.3 million in bonuses to various employees shortly before the airline collapsed in September 2001.²⁰

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What transactions are captured?

Under the Bill 'unreasonable director-related transactions' are not defined in any degree of detail, the issue is left for the courts to determine. The Senate amendments were more proscriptive and may be seen as proposing an implied definition of reasonable 'performance related bonus' for directors and executives. The amendments stated that the payment would only have been voidable if the amount of the bonus exceeded \$40 000 and the remuneration paid to the director or executive officer exceeded \$100 000 excluding bonuses. As discussed earlier, setting such thresholds could result in the perverse outcome of encouraging the payment of bonuses up to \$40 000 in belief that they will not come under scrutiny.

Application

The Bill allows a company's liquidator to apply to the court to recover 'unreasonable director-related transactions' that were made up to 4 years before the company became insolvent. The Senate amendments provided that performance related bonuses could only be clawed back by the liquidator if they were made within 12 months of the commencement of a wind up.

The Senate amendments were to apply retrospectively to performance related bonuses paid after 4 June 2001. In contrast, the Bill will only apply to unreasonable director-related transactions that take place after Royal Assent.

The question of retrospectivity

As noted above, the new powers given to liquidators by this Bill will only apply to transactions entered into after the legislation receives Royal Assent. The Government has stated that it has concerns about whether retrospective provisions would be constitutionally valid.²¹ It has not elaborated in detail about the nature of those concerns.

Generally speaking, while there is undoubtedly great potential for retrospective laws to operate unfairly, High Court authority indicates that there is nothing in the Australian Constitution which specifically prevents the Parliament from enacting retrospective laws.²² Indeed it is not uncommon for the Parliament to pass Laws which contain provisions which operate retrospectively.²³ A recent example in the current Parliament is the Criminal Code Amendment (Anti-hoax and Other Measures) Act 2002. The commencement of the offence created by that Act was backdated to 2pm on 16 October 2001—the date on which the Prime Minister announced the Government's intention to legislate on the matter. On that occasion the Government defended the retrospective provision on the basis that the impugned behaviour could never be regarded as a legitimate right or entitlement.²⁴

One possible ground of challenge may be an argument that a law enabling the liquidator to claw back payments that were not voidable at the time they were made is a law with respect to 'acquisition of property' for the purposes of section 51(xxxi) of the

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Constitution.²⁵ If this were established then the law would be invalid, as it does not provide for 'just terms'. The success of this claim would probably turn on whether the High Court considered that the legislation was properly characterised as one 'with respect to the acquisition of property'. The High Court has stated that section 51(xxxi) does not apply in cases where providing just terms would be 'irrelevant or incongruous',²⁶ such as where a law provides for the forfeiture of prohibited imports²⁷, the compulsory payment of provisional tax²⁸ or sequestering the property of a bankrupt.²⁹ It is open to doubt whether this legislation would be characterised in that context, the interpretation of section 51(xxxi) remains subject to considerable uncertainty.³⁰

Comparison to uncommercial transactions provisions

It may be argued that payments of the kind targeted by the new provisions will often be 'uncommercial transactions' thus already voidable under existing law.³¹ Section 588FB defines an uncommercial transaction as one where a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:

- the benefits (if any) to the company of entering into the transaction
- the detriment to the company of entering into the transaction
- the respective benefits to other parties to the transaction of entering into it, and
- any other relevant matter.

While these criteria are echoed in the proposed section 588FDA, uncommercial transactions are only voidable if they are also an insolvent transaction entered into within 2 years before the commencement of a wind up. In contrast, 'unreasonable director-related transactions' are much broader. It is not necessary to prove that the company was insolvent when the transaction was made and the transaction may occur up to 4 years before an application is made to wind up the company.

Endnotes

- 1 Neil Chenoweth, 'Gang of Four paved the way', *Australian Financial Review*, 17 October 2002.
- 2 The Hon. John Howard MP, House of Representatives, *Hansard*, 4 June 2001, p. 27 127.
- 3 Damon Kitney, 'Bonus may have breached One.Tel rules' *Australian Financial Review*, 18 July 2001.
- 4 It is typical for the CEO to also be a director of the company.
- 5 Lachlan Johnston and Damon Kitney, 'Executive salaries under pressure' *Australian Financial Review*, 6 November 2002.

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- 6 Qantas Chair Margaret Jackson quoted in Lachlan Johnston and Damon Kitney, 'Executive salaries under pressure' *Australian Financial Review*, 6 November 2002.
- 7 Miriam Cosic, 'CEO Overkill' *Weekend Australian*, 27 April 2002.
- 8 An executive officer is defined in section 9 of the *Corporations Act 2001* as a person who is concerned in, or takes part in, the management of the body (regardless of the person's designation and whether or not the person is a director of the body).
- 9 These concepts are defined in sections 588FB, 588FC and 588FF.
- 10 A note to subsection 588FDA(1) makes clear that this is intended to cover the granting of options over shares.
- 11 In certain circumstances US law will require trading profits to be repaid. The recently enacted Sarbanes Oxley Act ([section 304](#)) requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to repay any bonus they received if they make an accounting restatement due to a failure to comply with reporting requirements. The law also requires the CEO and CFO to repay any profits they have made on the sale of the company's securities during the 12 month period following the public release of the financial statement containing the error.
- 12 Explanatory Memorandum p.5.
- 13 See for example the uncommercial transactions provisions in section 588FB and the related party transaction provisions in Part 2E of the Corporations Act. Part 2E requires that financial benefits paid to related parties (including directors) should be disclosed to shareholders and approved at a general meeting before being paid. Financial benefits which constitute 'reasonable remuneration' are exempt from these requirements (section 211).
- 14 Yablon, 'Overcompensating: the Corporate Lawyer and Executive Pay', 92 *Columbia Law Review* 1867-1884 at 1878 (1992).
- 15 Andrew Defina, Thomas Harris and Ian Ramsay 'What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation Into the Relationship Between Pay and Performance in the largest Australian Companies' *Companies and Securities Law Journal*, Vol 12 1994, p341-356.
- 16 *Rogers v Hill* [289 US 582](#) at 591.
- 17 26 USC 162(a)(1).
- 18 As, for example, set out in the Senate amendments of 2001 discussed above.
- 19 Fiona Buffini, 'Executive excess bill soft on options, pay', *Australian Financial Review*, 1 November 2002.
- 20 Neil Chenoweth, 'Gang of Four paved the way', *Australian Financial Review*, 17 October 2002.
- 21 The Hon. Peter Costello MP, Second Reading Speech, House of Representatives, *Hansard*, 16 October 2002, p. 7625.

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- 22 See *R v Kidman* (1915) 20 CLR 425 and *Polyukhovich v Commonwealth* (1991) 101 ALR 545. Nevertheless it is a principle of statutory interpretation that in the absence of a clear statement to the contrary an Act will be assumed not to have retrospective application.

In contrast, Article 1 Section 9 of the US Constitution prohibits the Congress from passing 'bill of attainder or ex post facto Law'.

- 23 The report of the Senate Scrutiny of Bills Committee 39th Parliament lists a number of pieces of legislation where retrospective provisions attracted the committee's concern. The Committee's report can be found at the following link:

http://www.aph.gov.au/senate/committee/scrutiny/39_parlreport/39_parlreport.pdf

- 24 Explanatory Memorandum, Criminal Code Amendment (Anti-hoax and Other Measures) Bill 2002, p. 2.

- 25 Section 51(xxxi) states

The Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to:-

(xxx) The acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has the power to make laws.

26. *Mutual Pools & Staff Pty Limited v Commonwealth* (1994) 179 CLR 155 at 221/222.

- 27 *Burton v Honan* (1952) 86 C.L.R. 169.

- 28 *FCT v Clyne* (1958) 100 C.L.R. 246.

- 29 *Attorney-General (Cth) v Schmidt* (1961) 105 C.L.R. 361,372.

- 30 See Simon Evans, 'When Is an Acquisition of Property Not an Acquisition of Property?: The Search for a Principled Approach to Section 51(xxxi)', *Public Law Review*, Vol.11(3), September 2000, p. 183–204.

- 31 See subsection 588FE(3).

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