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In hearing the case the Court of Chancery has held that the shareholders of a Delaware corporation can contract with the company's board of directors to vest the shareholders with powers that would otherwise reside with the board, and that such agreements can be binding even if not set forth in the company's certificate of incorporation.

**This decision is an important victory for shareholder rights under Delaware law, because the Court of Chancery has expressly recognised that shareholders, not the board, are the ultimate holders of power in a Delaware corporation, and that the shareholders can contract with the board to give themselves (the shareholders) the right to vote on matters that would otherwise fall within the board's purview.**

The defendants took the position that, although they had promised to adopt a board policy requiring shareholder approval for extension of poison pills, they had the right to rescind that policy at any time because it only had the effect of a board resolution.

The court rejected the defendants' argument that board policies are per se revocable by the board, and recognise that they are not revocable if they are the product of contractual bargaining:

*"If the board had the power to adopt resolutions (or policies), then the power to rescind resolutions (policies) must reside with the board as well. An equally strong principle is that: If a board enters into a contract to adopt and keep in place a resolution (or a policy) that other justifiably rely upon to their detriment, that contract may be enforceable, without regard to whether resolutions (or policies) are typically revocable by the board at will."*

The Court also rejected the defendants' argument that their agreement to submit extensions of poison pills for shareholder approval was unenforceable as a matter of law.

**DIARY DATE**

**ACSI LUNCHEON SEMINAR**

**Time:** 12.00pm – 2.00pm  
**Date:** Monday 1 May 2006  
**Venue:** Grace Hotel, 77 York Street, Sydney

**Speaker:** Prof. Geof Stapledon

Invitations will be distributed at the end of March.

**NEWS CORPORATION TRIAL DATE SET!**

A group of local and international superannuation funds will have their case heard in court on 26 April 2006, in relation to the events surrounding News Corporation's decision to extend a shareholder rights plan ("Poison Pill") beyond one year without any further reference to shareholders.

ACSI asserts that News Corporation's decision represents a serious breach of its word as conveyed to shareholders at a time when the News Corporation Board was seeking shareholder support in October 2004, to endorse News Corporation's proposed move to the Delaware jurisdiction from Australia.

The Court explained:

*"... In effect, defendants' argument is that the board impermissibly ceded power to the shareholders. Defendants' argument is that the contract impermissibly restricted the board's power by granting shareholders an irrevocable veto right over a question of corporate control."*

The Court similarly rejected the defendants' argument that their agreement was unenforceable because it restricted their ability to fulfil their fiduciary duties.

**The Court's decision in News Corp. is a significant step forward for shareholders rights and empowerment under Delaware law. To the extent that shareholders are pursuing corporate governance reforms through negotiations with boards of directors, they can take comfort that, if those efforts result in the adoption of irrevocable (or specific duration) corporate governance policies upon which the shareholders rely (e.g., by refraining from running a proxy contest to oust the current board), the board cannot simply rescind those policies with impunity.**

Additionally, the Court has recognised that shareholders are the **"ultimate holders of power under Delaware law,"** and that corporate directors cannot hide behind their fiduciary duties as an excuse to squelch shareholder power.

News Corp. had sought to delay the final resolution of the case. Specifically, they had filed an application asking the Court of Chancery to certify this case for an immediate appeal to the Delaware Supreme Court, and to stay all proceedings until the appeal was resolved.

The Supreme Court of the State of Delaware refused to hear News Corp's application to appeal the Court of Chancery decision.

This means that the "stay" on proceedings towards a full trial is dissolved and we are free to move to trial in the Chancery Court.

We are now in the process of collecting evidence for the trial, which will be held on 26 April 2006.

**AWB INQUIRY CLAIMS ITS FIRST SCALP**

On 9 February 2006 the Directors of AWB issued a statement advising that Andrew Lindberg, Managing Director of AWB had tendered his resignation at which point the Board appointed the Chairman of AWB Limited, Mr Brendan Stewart, as the Executive Chairman of the Company.

Further developments that are unfolding in terms of the Inquiry in certain Australian Companies in relation to UN Oil-For-Food Programme as it relates to AWB include that on 3 March 2006 The Australian along with many other newspapers reported that John Howard's department had been sent a diplomatic cable warning of the alleged kickbacks.

In addition Commissioner Cole has asked the federal Government to extend the commission's terms of reference to give him more time to hear evidence and prepare his report. The inquiry was due to be wrapped up and report prepared to the Government by March 31.

"We are predisposed to recommend to the Governor-General that an extension of time be granted beyond the current deadline of March 31." Mr Ruddock said.<sup>1</sup>

ACSI is closely monitoring the developments in the Inquiry as it relates to AWB and how its corporate structure and its governance may have played some part in what is and will be conveyed as part of the Inquiry. It is however, premature to form a final opinion until the findings of the Inquiry are handed down at which time we will liaise with the office of Commissioner Cole to ensure that we, and our members are fully apprised about the relevant governance issues.

<sup>1</sup> 'Cole wants more time for inquiry', The Australian, 4 March 2006 by Samantha Maiden, Sid Marris

**EXECUTIVES HEDGING THEIR BETS**

The weekend Australian on March 4-5 2006 included an interesting article ‘Execs hedge incentives to protect pay’, written by Michael West. Through our review of remuneration reports and at recent corporate governance forums ACSI Officers have frequently seen and heard the following statements justifying executive remuneration.

“This might look like a lot, but it aligns the chief executive’s interests with your own,”

However, as “the Australian” article points out this is not always going to be the case particularly where executives use synthetic schemes to hedge the downside risk associated with their variable remuneration i.e. at risk component of their pay.

The Australian first broke this story in 2002 following a survey it conducted. However, it’s an issue that appears to have more or less slipped under the radar.

“It goes against the grain of why we, as shareholders, approve these (executive remuneration) schemes,” says ACSI executive officer Phil Spathis.

“Why should anyone get something for nothing?” says Spathis. “We regard remuneration as one of the key motivators. If you are insulated for the vagaries of the business cycle then the only ones who will suffer are the shareholders.”

As correctly pointed out in the article by ISS Australia managing director Professor Geof Stapledon, synthetic products are just another form of trading. If they have the effect of protecting from a fall in the stock price they are equivalent to selling.

While it may be argued that the ASX should do more, we as representatives of the underlying beneficiaries of these companies must send a clear message that this is unacceptable. ACSI will in due course write to Boards that allow such practices to seek

their rationale for such a policies. Put quite simply, we think the practice is a disgrace.

**HELP WANTED – MISSING VOTES!**

On 9 February 2006 AMP Capital Investors released its bi-annual Corporate Governance Report that has highlighted potential problems with shareholder voting systems following the first audit of its votes.

Chief Investment Officer, Mark O’Brien, noted that, “There are a variety of potential reasons for missing votes, given that counting involves a number of stages and is quite a complex manual process with many organisations involved.

“Simple data entry errors, out-of-date registry records, share registry errors, unusual voting deadlines and the frantic pace of the proxy season may all contribute to lost, or inaccurately recorded, votes,” he said.<sup>2</sup>

The question that this raises is how often this happens and how can shareholders be sure their votes are being counted?

ACSI is liaising with both AMP Capital Investors and IFSA to see what can be done to improve proxy-voting mechanisms. We’ll keep you informed of any developments.

**INTERNATIONAL NEWS**

**US**

**US director election rules still being debated**

In the US currently, directors can be elected on a minority of votes cast at annual meetings. In 2005 the American Bar Association (ABA) Committee on Corporate Laws, released a discussion paper ‘Voting by shareholders for the election of directors’.

<sup>2</sup>

<http://www.amp.com.au/display/file/0.2461.FI125765%255FSI3.00.pdf?filename=Feb+1+%2D+AMP+Capital+Investors+gives+remuneration+reports+the+thumbs+up+but+flags+voting+system+glitches%2Epdf>

On 17 January 2006 following the receipt of responses to the discussion paper the ABA Committee on Corporate Laws issued a press release and Preliminary Report detailing possible amendments to the Model Business Corporation Act (the "Model Act") relating to voting by shareholders for the election of directors. This a statutory blueprint followed by a majority of states.

The following is a brief explanation of the proposals the Committee is considering in terms of amending the Model Act:

- (a) The Committee proposes an amendment that would permit articles-of-incorporation provisions to specify that incumbent directors remain in office until their successors are elected and qualify. This amendment would permit corporations to fashion majority voting systems in which an incumbent director could not be seated on the board or could be seated only for a limited period of time if that director fails to receive a required vote.
- (b) To enable either the shareholders or the board of directors of public corporations (other than those that provide shareholders with cumulative voting rights) unilaterally to adopt a majority voting standard that will not pose a risk of harm to the corporation, the Committee proposes adoption of a new section that would permit such corporations to replace plurality voting with a modified plurality voting rule under which a director would be elected by a plurality vote but would serve only for a period of time not exceeding 90 days following the election if the director receives more votes against than for his or her election. The directors would be empowered to fill the vacancy created by that early termination with any qualified individual.
- (c) To facilitate adoption of majority voting policies in which directors agree to submit their resignation to the board upon failing to receive the required vote, the

Committee proposes the adoption of amendments that would clarify and expressly recognise that a director's resignation can be effective upon the happening of specific events (such as the failure to achieve a majority shareholder vote coupled with board acceptance of the resignation) and that a director may submit a binding irrevocable resignation.

The Preliminary Report also explains the Committee's preference for facilitating alternative director election systems, which can be adopted through private ordering, rather than changing the current statutory plurality default rule that continues to govern in the absence of a joint decision by directors and shareholders to adopt an alternative voting system for director elections in the articles of incorporation.

Justifying its decision to default to plurality voting, the panel cited the potential negative consequences of failed elections, "combined with the uncertainty of applying an untested voting standard as the default rule for public corporations."<sup>3</sup>

The Committee sought further comment on the proposed amendments by 20 February 2006. Some ACSI members with a group other global funds have been critical of the proposed amendments and have called on the ABA panel to explain why it did not recommend majority voting as the default practice for US companies. For a copy of the Preliminary Report and the submission visit –

<http://www.abanet.org/dch/more.cfm?com=CL270000&mod=10>

The committee will meet this week to evaluate the comments and decide on and approve proposals. Those proposals will be released by mid-March and published in *Business Lawyer*, an ABA publication. The committee will take final action after the

<sup>3</sup> *DJ Investors Press ABA To Back Majority Vote For Directors*, by Phyllis Plitch Of DOW JONES NEWSWIRES, 1 March 2006

official comment period, which is expected to end in early June.<sup>4</sup>

**UK**

**Executive Compensation in the UK**

At a recent conference ‘Corporate Governance – Managing Risk and Driving Value’ held on 24 February 2006 Kevin Keasey, Halifax Bank Professor of Financial Services, Leeds University Business School provided an interesting perspective on executive remuneration in the UK.

From his paper of particular interest were his views in relation to the importance of context and how it is informing the current debate in the UK; recent trends in UK executive compensation and the challenges he posed.

Importance of Context

Kevin explained why in his view the analysis of executive compensation needs to be from a variety of perspectives and with a full understanding of the context. In particular he explained that the debate has quietened over the past year and the following UK factors can explain this.

1. The Economy – the UK economy has had a long positive period. People have felt better off, salaries have been rising, consumption has been increasing (on the back of equity release and debt) and people feel wealthier through increasing house prices.
2. The Public Sector – the UK economy has been kept afloat (to a degree) through the expansion of the public sector and this has led to substantial pay rises (£150k for the management of a health trust) in addition to the normal perks of job security and final salary pensions.
3. Pensions – a lot of private companies have closed their final salary pension schemes and the government has

brought in caps to the values which have tax benefits. This has negatively affected directors and compare this to what has been happening in the public sector.

4. The Housing Market – a lot of people have ‘got wealthy’ through their houses and these gains often put in the shade gains made from company activities.
5. The City is doing well – the bonuses this year have been large with the Aston Martins, Ferraris being ordered, country houses being bought, etc.

Kevin then argued that as a consequence of all the above, company directors (executives) are feeling aggrieved – they are no longer on the defensive. ‘The base of their argument is they run businesses which are at the core of the real wealth generation of the economy; off the back of their efforts a lot of people are doing very well...’

Recent Trends

Kevin highlighted the following major trends in UK executive compensation:

1. Base salary growth remains robust (10%) and above national averages for all employees. CEO pay (FTSE 100) about 30 times national average. Tends to be greatest at most senior levels. CEO pay about 4 times that of senior executives. For FTSE 100 averages at £600k
2. Annual bonus levels increasing at the most senior of levels – one reflection of the difficulty of trying to find good Long Term Incentive Plans (LTIPs). Between 70 and 100% of salary. Takes the figure to almost £1 million.
3. LTIPs showing a 10% increase in value but changing structure. Options becoming less popular due to FRS 20 - options now hit the P&L. Being replaced with Performance Share Plans and Deferred Annual Bonus Plans. Do not convey same tax advantages but can be used to

<sup>4</sup> Refer Footnote 3.

lock individuals into the company. Also easier to tie bonus to actual actions of individuals and remove short-term transitory market effects. Takes the figure to just sub £2m.

4. EPS growth and Relative Shareholder Returns growth remain the most popular of performance measures, commonly accepted by investor communities. We know they both have problems (companies may be short termist, earnings may grow on back of economic cycles – not always tied to competitive value creation) but what are the simple alternatives? The problem is we wish executives to focus on both short and long term. Some evidence that executives value longer term plans (options, etc.) at a discount (up to 40%) to what it costs the company. Such plans are often complex and not easy to discuss or communicate. There is a small move to tie rewards to individual value drivers and business plans. Given the vagaries of business life, compensation committee needs some discretion in making awards. Need to be able link rewards to achievements in easily communicable way. A lot of companies have a jumble of performance systems which need simplifying and re-aligning. This confusion will increase under FRS 20 which expenses the fair value of option awards.
5. Pension changes mean there is now limit on tax free pot of £1.8m. Will affect most senior of executives. Move to look at most tax efficient way forward. Companies offering salary supplements of between 15 and 30% to individuals who take care of own pensions. Takes the figure for CEO's to just over £2m about 100 times national pay average.<sup>5</sup>

<sup>5</sup> 'Executive Compensation in the UK' by Kevin Keasey, presented at the ISS, University of Melbourne, Centre for Corporate Law and Securities Regulation, Corporate Governance Conference on 24 February 2006.

### Challenges

Kevin concluded by highlighting the following challenges.

"It needs to be recognised that executive compensation is only one tool to achieve long term value maximisation – it is but one aspect of corporate governance and perhaps too much faith has been placed in it. In fact, we should ask why the tool has gained so much traction."

To move to a more balanced approach to executive compensation, Kevin argued that there needs to be consideration of the following:

1. 'A clear emphasis on the creation of sustainable value
2. Compensation committees need to align compensation packages with the strategies of the company
3. Directors should not benefit from short term windfalls which arise through stock volatility
4. There should be frequent communication with shareholders
5. Costs of options and share grants to the company should be explicitly recognised
6. There should be full transparency of compensation packages and the processes which were involved with their determination.<sup>6</sup>

### **ABI issue revised Guidelines**

In December 2005 the Association of British Insurers (ABI) published updated guidelines on executive remuneration which has focused on the role of Remuneration Committees in ensuring that the premium commanded by executives is consistent with the principles of pay for performance and

<sup>6</sup> Refer Footnote 5.



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that they are not paid more than is necessary.

Peter Montagnon, ABI Director of Investment Affairs, commented:

*"While a shift towards more variable pay is healthy, shareholders are concerned that this masks a ratchet upwards in reward. This could have detrimental consequences if the premium commanded by executives rises too far above general levels of pay in the economy or if the market and business performance turned down".*

The revised guidelines have emphasised the following:

1. The need for remuneration packages to be aligned with business strategy and the particulars of the company. These need to be communicated to shareholders.
2. All new share based incentive schemes to be subject to shareholder approval.
3. Compensation committees must guard against windfall gains
4. Performance conditions should be measured over a three-year (or more) period. Strong encouragement is given to longer-term performance measurement and deferred vesting.
5. Scheme rules should state that there will be no automatic waiving of performance conditions either in the event of a change of control or a capital reconstruction. Where share incentive awards vest early as a consequence of a change of control, awards should vest on a time pro-rata basis.
6. Costs of share incentive schemes should be disclosed at the time shareholder approval is sought. Value of awards to participants and likely dilution to shareholders should be disclosed.

7. The regular, annual phasing of awards is to be encouraged because it reduces 'windfall' gains.

8. Dilution should not exceed 10%.<sup>7</sup>

For a complete copy of the ABI paper visit <http://www.abi.org.uk/Members/circulars/viewAttachment.asp?EID=12773&DID=12437>

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This newsletter is correct to the best of our knowledge and belief at the time of going to press. It is, however, written as a general guide so it is recommended that specific professional advice is sought before any action is taken

<sup>7</sup> Extract from paper 'Executive Compensation in the UK', refer Footnote 5.