

Two strikes rule — playing by the rules

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- Full effects of two strikes rule for shareholder approval of companies' remuneration reports are still playing out
- Experience of one company brings to light questions about process of calling meetings and validity of notice
- A contemporaneous notice of spill meeting is unlikely to be valid as it does not comply with or play by the rules

The 2012 reporting season saw the consequences of the so-called 'two strikes rule' play out for the first time since the legislation was introduced to the *Corporations Act 2001* in 2011. More than 100 listed companies were facing their second strike in 2012 and, importantly, these companies were potentially facing a total board spill for the first time since the new legislation was introduced.

Listed companies are now operating in an era of greater shareholder activism and board accountability and the two strikes rule, in the words of the chair of one affected company, is 'a lightning rod for disaffected shareholders', with direct and potentially serious consequences.

Still in its infancy, the new legislation is yet to be fully applied or tested by the courts and — as with all new areas of the law — many company secretaries and boards are working out how to manage the reality and the practicality of the two strikes rule. Our review and analysis of companies facing, and ultimately receiving, a second strike in 2012 has identified a potential

loophole in the legislation of which company secretaries, boards and the government should be mindful.

To understand this potential loophole, it is important to understand the two strikes rule.

What is the two strikes rule?

In summary, the two strikes rule is a staged process that works like this.

1. At its annual general meeting (AGM), the company must put a resolution to approve the remuneration report to shareholders. If more than 25 per cent of eligible shareholders vote against the resolution, the company receives a 'first strike'.
2. At the following year's AGM, the company must again put a resolution to approve the remuneration report to shareholders. If, in that year, more than 25 per cent of the eligible shareholders again vote against the resolution, the company receives a 'second strike'.
3. If the company receives two consecutive 'no' votes on the remuneration report resolutions, then the company must immediately put to the AGM at which the second 'no' vote was cast a resolution to hold a spill meeting.
4. If the majority of those at the AGM eligible to vote on the spill resolution vote to support the spill resolution, then all board positions (except for the managing director) are declared vacant and become open for election, and a special meeting must then be held within 90 days of the spill resolution — the extraordinary general meeting (EGM).
5. The EGM will then consider whether to spill some or all of the board.

Each step has specific rules in relation to shareholder voting eligibility.

Who has received a first strike?

In 2011, 108 companies received a first strike (which equates to around five per cent of listed companies). Of those, four were ASX 100 companies. Some of the companies which received a first strike included Crown Ltd, Pacific Brands Ltd and Linc Energy Ltd (Linc).

News and Views

Who has received a second strike?

Last year, approximately ten of the 108 companies received a second strike, including Penrice Limited, Globe International Limited, Linc Energy Ltd, Rey Resources Limited, Emerald Oil and Gas NL, Celamin Holdings NL, Cabcharge Australia Limited and Ask Funding Limited. Significantly, no ASX 100 company received a second strike.

Of those who received the second strike, three then received a vote to move to a spill meeting (Penrice Limited, Globe International Limited and Rey Resources Limited). However, as the entire board of Rey Resources resigned after the meeting there was no need for a spill meeting to be held.

Penrice Limited is due to hold its meeting on 25 January 2013 and Globe International Limited is scheduled to meet on 6 February 2013. By the time you read this, the results of those meetings will be known.

Where's the loophole?

At the same AGM at which the 'second strike' occurs, the company needs to put the resolution known as a 'spill resolution' to shareholders.

The spill resolution must outline that another meeting (the spill meeting) will be held. This meeting must take place within 90 days from the date of the AGM at which the company receives the second strike.

This means that companies which have received a first strike need to plan for a second strike and a spill resolution, when setting the agenda for the AGM. The agenda must include the usual resolution to approve the remuneration report and a spill resolution.

The spill resolution will be conditional upon receipt of the second strike and only needs to be put to the shareholders if a company receives the second strike. Unlike the resolutions in relation to the first and second strikes, the spill resolution requires a simple majority (that is more than 50 per cent) of those eligible to vote to succeed.

Of course, even if a second strike is received, it does not always follow that shareholders will vote to spill the board.

The potential 'loophole' in the legislation flows from the requirement to hold the spill meeting. This is illustrated in the case of Linc.

Linc had received a first strike. On 26 October 2012, it issued its notice of meeting for the AGM to be held on 29 November 2012 at which it could receive a second strike. On the same day, it issued a separate notice of meeting for a spill meeting that would occur if the second strike was received. The notice of meeting for the spill meeting stated that the spill meeting would be held immediately following the company's AGM and included a

resolution for the re-election of all current directors other than the Managing Director.

On the face it, Linc had followed the process required by the Act but it poses an interesting question: was Linc's contemporaneous notice of spill meeting valid when shareholders have not yet passed the resolution to hold the spill meeting, and did its notice of spill meeting really meet the required notice period under the Act?

In Linc's case, the point was moot, as the spill motion was not passed so the spill meeting was never held. But the question bears further examination.

What does the Act say?

Section 250V of the Act states:

At the later AGM there must be put to the vote a resolution (the spill resolution) that:

- (a) another meeting (the spill meeting) of the company's members be held within 90 days; and
- (b) all the company's directors cease to hold office immediately before the end of the spill meeting;
- (c) and resolutions to appoint persons to offices that will be vacated immediately before the end of the spill meeting be put to the vote at the spill meeting.

Section 250W then discusses the process if the spill resolution is passed, namely, the following conditions must be complied with.

Section 250W(2) The company must hold the spill meeting within 90 days after the spill resolution was passed.

Section 250W(3) Nothing in subsection (2) authorises any person to disregard:

- (a) section 249HA (Amount of notice of meetings of listed company); or
- (b) if a person intends to move a resolution relating to the appointment of a director of the company – any provision of the company's constitution that requires a minimum period of notice for such a resolution.

Does a contemporaneous notice of spill meeting fit within the legislative requirements?

Compliance with s 250V

In the Linc example, the proposed spill meeting was to be held on the same day as the AGM. Section 250V outlines the requirements for the spill meeting resolution. The resolution contained within the notice of meeting complies with these requirements.

Compliance with s 250W

Section 250W(2) states that the spill meeting must be held within 90 days *after* the spill resolution is passed (our emphasis). The question therefore is whether the proposed meeting date (being the same day as the AGM) is 90 days 'after' the spill resolution.

Section 250W(3) states that the company cannot disregard the minimum notice periods contained in the Act or the company's constitution.

Under s 249HA of the Act, a listed company must provide at least 28 days' notice of a general meeting. These must be 'clear days' and as such do not include the date of the notice or the date which the notice is posted. It also generally does not include the date of the actual meeting. In practice, we suggest that companies generally allow at least 31 days from the notice date to the AGM date to ensure compliance with the Act. Failure to provide a clear 28 days notice can render the meeting invalid.

In addition, Linc's constitution requires that nominations for directors must be given in accordance with the requirements of the ASX Listing Rules. Listing Rule 14.3 states that an entity must give shareholders up to 35 business days before the meeting to lodge nominations for the election of directors. This notice period of up to seven weeks before a general meeting acts to ensure that the company is given adequate notice from an eligible nominee setting out their nomination as a director candidate for election at that meeting. In practice, this means that a notice of meeting cannot be produced or issued until that notice period has passed.

Furthermore, for a spill meeting to be called, the shareholders must have passed the resolution to hold the spill meeting in accordance with s 250V of the Act. A spill meeting cannot be called until the resolution is passed.

In our view, the notice period requirements would therefore be triggered by the passing of that resolution by the shareholders and be counted after the date of the notice of spill meeting. This means that, again in our view, the spill meeting cannot be held before the appropriate notice of meeting is given, which in the case of directors nominations are least 30 business days (or six weeks) before the meeting.

Does a contemporaneous notice of spill meeting fit the 'vibe'?

While it is strongly arguable that the legislation has unintended consequences in that unhappy shareholders are given the means to vent their displeasure about matters which may have nothing to do with remuneration, we are reminded that the purpose of the two strikes reforms were to provide an additional level of accountability for directors and increased transparency for shareholders.

The Explanatory Memorandum, which accompanied the reform legislation, states that a company will need to comply with any minimum notice period so as to ensure that shareholder nominated candidates can seek endorsement at the spill meeting.

A contemporaneous notice of spill meeting provides no opportunity for members to nominate new directors.

Closing the loophole?

If indeed there is the potential for confusion or a loophole in the legislation, a simple solution could be to clarify s 250W(2) with minor amendments to the Act.

Such amendments would provide clarity in relation to time frames of providing the notice of meeting for the spill meeting as well as ensuring the appropriate level of shareholder participation and corporate transparency is ensured.

Conclusion

While there may be some ground for confusion as to the actual timing of the spill meeting, we consider that a contemporaneous notice of spill meeting is not appropriate for the following reasons.

1. **No meeting has been called** — The shareholders have not yet passed the resolution to hold the spill meeting and a notice of meeting cannot be issued until and unless a meeting is called.
2. **Failure to comply with notice periods** — Despite a spill meeting technically being held 'within' 90 days of the AGM, the required notice periods pursuant to s 250W(3) have not been met.
3. **Failure to comply with ASX Listing Rules and company constitution** — The notice period is not compliant with either Listing Rule 14.3 or the company's constitution.
4. **Contrary to good policy** — A contemporaneous notice prevents shareholders nominating for the board and does not adequately provide for the opportunity for shareholders to raise concerns or for companies to address those concerns, all of which is contrary to good corporate governance and to the intent of the legislative reforms.

While 2012 saw the playing out of further stages of the two strikes rule, it is still a very new and unsettled area of the law. As we know, when the reforms were first introduced, they contained other anomalies and loopholes which the government acted swiftly to close (in relation to proxy voting by the chair, in particular).

With the benefit of a further year and the practical exercise of the new laws, it may be time for the government to consider this issue in more detail.

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