

Golden Parachutes: Contents, Issues and Trends

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ABSTRACT

This paper explores a relatively new executive perquisite, golden parachutes (GP's). The number of firms that have or are planning to adopt GP's is discussed. Features of GP's are outlined. Reasons that firms have adopted GP's are explored. Finally, a series of arguments against this practice are laid out.

INTRODUCTION

If a top executive of a major corporation simply stuffed a suitcase with company money and stuck it under his bed as an insurance policy against losing his job in an unfriendly takeover of his company, his action would be seen as outright theft.... [Though] there are clearly legal differences between cash-filled suitcases and the so-called golden parachute contracts the ethical differences are hard to discern--Business Week editorial (October 4, 1982).

"Golden parachutes" (GP's) were "the hottest new executive suite perk [of 1982]" (Klein, 1982, p. 56). A typical GP guarantees a specified number of senior executives several years salary, fringe benefits and bonuses if they are forced to leave or if they choose to leave when a change of control takes place.

GP's are a relatively new phenomenon. One of the first GP's was reputedly written for Reliance Electric executives during the takeover battle with Exxon in 1979 (Kleinfield, p. D1). By 1982, estimates of the number of major American firms with or considering GP's ranged from one third (McLaughlin, p. 47) to one half (Forbes, May 24, 1982). There probably are, however, many less GP's actually enacted than actively considered since management does not appear to be interested in making public the existence of potential parachutes.

The intense, indeed often virulent, criticism of this perk in the business press, as seen in the Business Week editorial above, makes such contracts worthy of close scrutiny. Business has come to expect criticisms of its practices in the popular press but when Business Week, Dun's Review (May, 1981) Forbes (May 24, 1982), Fortune (December 13, 1982) and The Wall Street Journal (December 8, 1982) all publish articles and/or editorials critical of this practice, business would be well advised to take note. The perception of unethical behavior is clearly widespread.

The most likely reason behind the popularity of GP's is the recent increase in merger activity. In 1981 alone there were over 2300 reported mergers (McLaughlin, p. 47). Mergers create substantial uncertainty for managers and may be the single largest source of involuntary executive turnover. According to Business Week:

...a new survey by "outplacement" consultants Drake Beam Morin, Inc. shows that of 1300 executives--with incomes of between \$30,000 and \$125,000--who were "severed" in the 18 months ended August 31 [1982], a disquieting 32% were let go during mergers, takeovers, and the like (September 27, 1982, p. 118).

Several recent studies seem to support this conclusion. For example, one study indicates that within three years of a merger 52% of the executives of the acquired firm leave (Wall Street Journal, August 18, 1981). Additionally, over 1500 Pullman employees (not all executives) have been dismissed since late 1980 when Pullman was acquired by Wheelabrator-Frye (Wall Street Journal, July 7, 1982). Since Allegheny acquired Sunbeam, about half of Sunbeam's corporate staff of 160 employees has departed (Wall Street Journal, July 7, 1982). Immediately after RCA sold Picker Corporation to General Electric of Great Britain the top eight executives of Picker were fired (New York Times, April 6, 1982).

Within this environment of high levels of merger activity and the resulting executive turnover which merger activity implies, the popularity of GP's has grown explosively. Since all that is needed to implement a GP is board approval, not shareholder approval, GP's can be (and have been) added to executive compensation programs. With the 1980 amendments of Section 4021 of regulation SK, the SEC does require "after the fact" disclosure of special executive compensation programs in proxy statements or 10-K reports. It is, however, still possible for firms to draft GP's but to withhold implementation until a hostile takeover looms.

METHODOLOGY

In this study the executive compensation sections of the proxy statements for twenty one firms known to have GP's were examined. This sample of GP's was assembled using a two-stage process. First, the proxy statements of a random sample of fifty of the Fortune 500 firms were reviewed for any evidence of GP's.

Subsequent examination revealed that seven (14 percent of the sample) of these firms had GP's in place. This is consistent with a study by Ward Howell which found 15 percent of the 1000 largest U.S. firms with GP's (Morrison, 1982, p. 82). Second, a review of the business press revealed fourteen additional firms with GP's. These fourteen were added to the seven from the random sample to constitute a study sample of twenty one. Table 1 provides a list of firms comprising the overall sample. In parentheses behind each firm's name is its ranking in the 1982 Fortune 500 list. Five of the firms were in the top 100, four in the second 100, seven in the third 100, one each in the fourth and fifth 100 and one not listed.

TABLE 1
FIRMS IN SAMPLE

American Bakeries* (451)
AMF (245)
Bendix Corp. (86)
Brunswick (260)
Cleveland Cliffs (NA)
Con Agra* (255)
Conoco (14) [1981 ranking]
Control Data (144)
Diamond Shamrock (112)
Emhart* (215)
Ferro Corp. (392)
Gulf Resources
and Chemical Group (459)
Kimberly-Clark (147)
National Steel* (94)
Phelps Dodge (246)
Phillips Petroleum (15)
Superior Oil* (187)
Sun Co.* (17)
Sunbeam (237)
U.S. Industries (285)
Warnaco* (481)

* = Comes from random sample

Content analysis was conducted on each of the 21 proxy statements. The analysis focused on the following six questions:

- (1) How many executives are covered?
- (2) How is "change of control" defined?
- (3) Does the GP apply to voluntary as well as involuntary termination of employment?
- (4) Are there "giveback" provisions if the executive obtains other employment?
- (5) What compensation is provided?
- (6) What other benefits are provided?

RESULTS

Number of Executives Covered

All but three of the proxies examined stated the number of classes of executives covered by their GP agreements. Coverage ranged from one executive (Warnaco) to 80 at Kimberly-Clark. One firm (Superior Oil) approved GP's for all

present and future officers. The average number of executives covered by GP's in companies reporting a specific number is nearly sixteen. The overall average is undoubtedly higher since the number of executives covered at Superior Oil was excluded from this average.

Change of Control

In seven of the proxy statements "change of control" was specifically defined as any party acquiring a certain percentage of the voting shares. Those percentages ranged from 20 to 35 percent. In four of the seven cases and one in which a percentage of the voting stock was not specified, "change of control" could also occur if the majority of the board changed. No definition was provided in seven statements and the definition was "provided elsewhere" in six others. In one statement "change of control" was simply defined as a purchase of a substantial number of shares.

"Walkaway" Clauses

In twelve of the twenty one GP's examined, the proxy statements explicitly state that the GP applied to voluntary as well as involuntary termination. In only two cases (Con Agra and Warnaco) were the benefits in any way reduced if the termination was voluntary. Thus, an executive who feels that his/her responsibility, authority or status within the corporation has been diminished after a takeover may "pull his/her own ripcord." Kimberly-Clark, for example, permits its officers to collect 3 years full pay and benefits if for any reason within 2 years after a merger he or she chooses to resign (except the drastic circumstances of death, disability, or normal retirement) (Kimberly-Clark Proxy Statement 3/15/82).

None of the remaining nine proxies explicitly prohibit payment of salary and benefits if the termination is voluntary. It is thus reasonable to assume that "walkaway" clauses are an all but universal feature of GP agreements.

"Giveback" Provisions

"Giveback" provisions are aspects of GP agreements that require executives who have left the acquired company to return some or all of their salary and benefits if and when they begin other employment. One GP (Gulf Resources and Chemical) explicitly stated that the terminated executives would under no circumstances forfeit any compensation acquired under the GP. In fact, in the proxies of only five of the firms in the sample were there any discussions of "givebacks." And, in only two cases were the "give-backs" total, i.e. as soon as the executive began to receive a salary elsewhere all GP compensation would cease.

Compensation Provisions

The central provision in each of the GP's examined was compensation. In a few cases compen-

sation was provided through a guarantee of employment, but in most cases compensation came as a lump sum payment. The amount of compensation ranged from one year to seven years of salary. Two to three years was most common. In only seven of the proxies examined was the compensation other than two or three years.

In addition to a salary settlement, nine of the GP's provided bonus compensation as well. In most cases the bonus related to the same years as the salary settlement, but in one case (Conoco) the bonus was based on the highest bonus ever attained.

Other Benefits

Besides salary and bonuses, all but six of the examined GP's contained other benefits for the departing executive. Three of the GP's explicitly continued the general benefits package of the corporation for the departed executives. In six GP's stock options were specifically guaranteed, in seven a retirement adjustment plan was included, in five insurance benefits continued and in one case moving expenses were included.

In only three GP's were there estimates of the total cost of the GP provisions. For Con Agra the cost was estimated at \$2,500,225 for 10 executives. For Gulf Resources and Chemical Group the cost was estimated to be \$9,400,000 for 13 employees. For Bendix the estimated cost of the GP's was estimated to be \$4,706,000 for 16 covered employees.

ARGUMENTS FOR

Though most of the commentary about GP's has been negative, there are several arguments raised by their proponents that must be considered. Perhaps the most common defense of GP's is that they encourage executives to stay with their firms in the event of a hostile takeover attempt. This argument supposes that without GP's the uncertainty surrounding a takeover attempt might be sufficient to cause a number of executives to "jump ship" at a time of severe organizational trial. GP's thus "buy" the loyalty of senior management.

However, one must ask whether there is any justification for a policy which ostensibly tries to encourage management to perform as it should. Further, most takeover specialists scoff at the notion that management is likely to depart during a takeover attempt. They note that there is virtually no evidence of managers bailing out in a time of crisis. In fact, the group dynamics of senior management are such that to do so would be seen as "disloyal" and the person bailing out would "lose face" (McLaughlin, p. 48).

Sometimes one comes across the argument that GP's are simply another form of executive compensation similar to bonuses, stock options,

etc. They might then be viewed as just another facet of a total executive compensation package, eliminating yet another unnecessary distraction of executive life.

There is generally little argument about compensation levels that are determined in a free market. However, executive compensation at senior levels may not be determined strictly in such a market. There is substantial evidence that management effectively controls the boards of many major firms. High levels of executive compensation might thus be more a function of political control of the firm than it is of supply and demand.

Some companies (particularly those that have GP's covering broad classes of managers) justify GP's on the basis of rewarding employee loyalty. Many companies feel that they have a responsibility to their employees which is nearly as important as their responsibility to their stockholders and customers (Brenner and Molander, 1977). GP's are one way of assuring that new, uncaring senior management doesn't run roughshod over the firm's old, loyal employees.

Firms may well have some responsibilities to groups other than shareholders. However, it is not obvious that new management will simply sweep away the target's previous employees. Presumably the majority of the target's employees are one of the valuable assets that the raider would want to retain. It seems that only senior management is in obvious jeopardy. Hostile takeovers succeed only when existing management has seriously neglected its duties to its shareholders. All too often it seems that this argument is simply a smokescreen that senior management tries to hide behind.

Another argument sometimes seen is that GP's can add to the acquisition cost of a takeover and are thus a legitimate way of forcing the raider to either think twice or raise the ante. In a similar vein, it is argued that since GP's generally go into effect only in the event of a successful hostile takeover, they are a device for raising the price to the raider but not to a compatible "white knight."

This argument assumes that shareholders really care whether their stock is purchased by a raider or by a white knight. It is quite likely that most don't. However, current management probably does. In fact, if the white knight agrees to keep existing management on (as part of a "deal" to easily acquire the target) they may in fact be doing current shareholders a disservice by, possibly, accepting this merger simply because it is better for management.

Finally, proponents of GP's contend that the cost of the GP is borne by the stockholders of the raiding firm and not by the stockholders of their own firm. Thus, issues of fiduciary responsibility to one's own stockholders doesn't enter into this particular situation.

This argument is fatally flawed. A "raiding" firm is willing to pay only so much to acquire a target firm. If the target successfully pumps up costs that the raider must pay, the target is worth correspondingly less. In fact, every additional million dollars that a raider must pay the target's management is a million less that it will pay the target's shareholders. GP's thus are a direct assessment on the shareholders of the target firm, not those of the raider.

ARGUMENTS AGAINST

On the other hand, there is growing criticism of GP's. This section will analyze some of that criticism from several different perspectives. Most of this criticism stems from the suspicion that GP's are implemented in order to benefit existing management and not necessarily shareholders. In fact, many feel that though management will often try to cloak these actions as increasing shareholder welfare, such arguments are often very tortured.

Golden parachutes might thus be seen as yet another manifestation of the effects on firm actions when control shifts from stockholders to manager. This phenomenon, first noted by Berle and Means (1929), has been extensively documented in the last two decades (Monsen and Downs, 1963). Basically, these studies found systematically inferior financial performance for firms which were controlled by their managers versus those controlled by their stockholders.

Management

As noted earlier there are conflicting theories on whether or not GP's increase management's will to resist a hostile takeover attempt or not. Most proponents of GP's claim that management has an obligation to resist at least some takeovers (in order to ultimately increase shareholder welfare such as by finding a better offer.) This theory suggests that GP's help preserve the management team when cohesiveness is required.

As argued in the previous section, there seems to be little support for this notion. In fact, logically it would seem that GP's would actually decrease managerial resistance to a hostile takeover attempt. Picture the beleaguered executives of the target company who do not have GP's. Their firm is a takeover target (generally at a considerable premium over recent market price) because some other company believes that it can manage the target's resources considerably more efficiently than can the existing management. In other words the market has given the management of the target a failing grade. Job prospects, etc. don't look good. Without a GP the target firm's management has a very real incentive to do whatever is necessary to preserve their jobs. Note that this incentive may, in their

minds (after all managers are profit maximizers as well), supercede the goal of maximizing shareholder profits.

On the other hand, if the target's management can get GP's the cost (to them) of losing the takeover battle decreases dramatically. In fact, it is hard to imagine how a GP would on the whole weight an individual manager's decision more toward fighting than toward "throwing the game." Now this may in fact be desirable. Easterbrook and Fischel in a recent issue of the Harvard Law Review presented a very powerful case for total managerial passivity in the face of a takeover attempt (Easterbrook and Fischel, 1981). They contended that any managerial resistance ultimately decreases shareholder welfare. GP's may be one way of moving toward such passivity. However, it is ironic that management justified GP's for precisely the opposite reason. Of course it would be embarrassing and possibly legally dangerous for management to acknowledge that it must be bribed in order to act in the shareholders' best interest.

Board of Directors

Another perspective to examine this issue from is that of the board of directors. Only the board can give top managers GP's. Why might they do so if doing so is not clearly for the shareholder's benefit? Unfortunately, there is considerable evidence that the boards of many major firms have, in effect, been captured by senior management. Often board members serve only at the discretion of the firm's president and have been reputedly forced off boards by unhappy presidents for exhibiting some independence.

In fact, the Brunswick Corporation enacted GP's not only for its managers but also for certain members of its board. Any outside director over 55 years of age and with more than five year's service could at his/her discretion quit after a hostile takeover and continue receiving his/her annual retainer of \$22,000 for life (Klein, p. 56). The justification for this GP is difficult to ascertain.

Stockholder

In a market economy firms are, in theory, formed by investors who put their own capital at risk and hire managers in order to realize certain goals, generally financial. The principal duty of management is thus to meet the goals set by the stockholders. Management's compensation is justified by the return that stockholders receive from management's decisions. It is assumed that higher pay, bonuses and other compensation give management additional incentive to manage the stockholders' assets wisely and efficiently.

In fact, any managerial decisions that appear primarily self-serving and that cannot be justified on the basis of increasing shareholder wealth are not protected by the business

judgement rule and expose managers to legal risks. Thus if the thesis that GP's represent wealth transfers from stockholders to managers (propounded in the previous section) is correct then there is no justification from the stockholder's perspective for GP's.

Legal Issues

Business Week suggests that GP's are functionally equivalent of theft. Are they legal? Can shareholders successfully sue and claim damages? At this time no decisions involving GP's has been rendered. However, at least two shareholder suits involving GP's (Brunswick and Gulf Chemicals and Resources Group) have been filed.

On the surface, however, it seems unlikely that the courts will find against management in these cases. The business judgement rule has, to date, proven to be an effective shield against virtually all suits filed that question management decisions. In fact, the courts have consistently ruled that "management has the right, and even the duty, to oppose a tender offer it determines contrary to the firm's best interests" (Easterbrook and Fischel, p. 1163). To the extent that management can successfully claim that GP's aid such opposition the courts are likely to uphold them. Yet, such practices do appear to be a serious violation of the fiduciary responsibility of the members of the board. As such there is a finite possibility that the courts may actually set a new precedent in this area.

Ethical Issues

Even if GP's were to prove to be legal, they still wouldn't, necessarily, be ethical. In fact, it's difficult to find any possible ethical justification for GP's. This isn't to suggest that high compensation in itself is unethical. If a manager is hired for \$1,000,000 or more per year in an arm's length transaction, then there is no ethical problem whatsoever. Income differentials are a necessary element of a market economy and one that helps drive it toward efficiency.

However, as noted above there is reason to believe that GP's are not granted "at arm's length." Multimillion dollar salaries can be justified since the fortunes of a major company can turn on the judgement of senior management. However, a multimillion dollar reward for so mismanaging a company as to depress its stock price to the point that an outside group is willing to pay a considerable sum in order to gain control of its assets is unconscionable. Recent evidence indicates that takeovers result in gains to the stockholders ranging from 14% to 50% (Easterbrook and Fischel, p. 1187). One way of viewing this premium may be as the extent to which the target firm was mismanaged by its previous management.

In fact, the existence of GP's today is very similar to the existence of insider trading

prior to 1933. Insider trading has always amounted to theft, even before it was made illegal. Likewise, GP's are a direct and unjustified transfer of funds from shareholders to managers.

Public Relations

GP's are a public disaster. Even the business press attacks them. In a time of economic hardship and union givebacks news of GP's can prove, at best, to be a serious embarrassment as International Harvester discovered in late 1982. Even if GP's could be justified economically, ethically, or however, one must ask whether or not the existence of GP's compensates for the various costs associated with the negative publicity.

Public Policy

This may, in fact, be the key perspective. As argued earlier a hostile takeover occurs only when a group external to the target firm perceives that they could do a considerably better job of managing the target firm's assets than current management is. GP's might then be seen as a reward for poor management. This certainly turns any incentive system on its head.

Though the authors are not suggesting that any managers have consciously driven a firm into the ground in order to collect their GP's, this frightening possibility does exist. As a matter of public policy it would be wise to encourage effective, efficient management and discourage the opposite. Regulations prohibiting GP's would be one step in that direction. However, to be truly effective, they would need to be coupled to rules such as those proposed by Easterbrook and Fischel which would reduce or eliminate management's right to oppose a takeover.

CONCLUSIONS

Golden parachutes are both morally indefensible and hurt the public image of American business. Though the particular managers involved are probably better off because of such contracts, the American business system is undoubtedly wounded by it. Not only is it in the public interest and the stockholder interest to eliminate GP's, but it is also in the interest of the American business community.

If such abuses continue, public outcry and media attention will certainly provoke new laws and regulations that will inhibit or even eliminate the issuance of GP's. Sethi has argued that "...the corporate interest must emanate from the public interest and cannot be inconsistent with it" (Sethi, 1982, p. 34). If American business is perceived by the public as attempting to line their own pockets new laws and regulations will soon follow.

(References will be provided upon request.)