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Mark A. Heyl

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GOLDEN PARACHUTES: DOES THE BUSINESS JUDGMENT RULE SIMPLY PERPETUATE THE PROBLEM?

I. INTRODUCTION

A corporate takeover is pending. Tensions run high for the employees of the target corporation who do not know if they will even be employed in the following months. The dynamic stock market thrives with investors trying to predict the effect of the merger on the corporation's stock and the industry at large. A loyal stockholder waits with anticipation, supportive yet ignorant of the complexities surrounding the pending change. When the dust settles, the stockholder discovers that his corporation's top executives have voluntarily terminated their employment for jobs elsewhere. As a result, these executives, who hold golden parachutes,¹ receive hundreds of thousands of dollars each in addition to their already substantial salaries, and the loyal stockholder feels "ripped-off." To his dismay, the stockholder discovers that he has no recourse. There are no statutes addressing this situation, and the courts, he finds, pursue a policy of deference to corporate directors through the business judgment rule.² The stockholder's personal loss is not significant, but seeing the substantial gain enjoyed by the executive, he knows it is wrong. Nonetheless, pursuit of an action against these people would be futile so nothing is done.

And so the controversy surrounding golden parachutes evolves. Some commentators argue that golden parachutes serve as security for desperate executives, while providing for continuity and objectivity in the management of a corporation.³ Others contend that these arrangements constitute cor-

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1. Golden parachutes are special termination agreements given to key corporate executives as compensation in the event that they are terminated following a change of control of the corporation. See *infra* notes 6-10 and accompanying text. This concept is discussed in more depth in the next section of this comment.

2. See *infra* text accompanying notes 57-64.

3. Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1266, 256 Cal. Rptr.

porate waste by dredging shareholders' pocketbooks in the midst of a hectic corporate reorganization.⁴ Over the last decade these debates have essentially remained unresolved.

Eventually, the issue is raised whether the business judgment rule is the proper standard of review for the conduct of "disinterested" corporate decision makers. This comment will begin by discussing the arguments surrounding golden parachutes and how these agreements have been handled by the legislature and judiciary thus far. It will then discuss the inside/outside director distinction⁵ and the adoption of golden parachutes in these corporate circles. Finally, this comment will ascertain whether the business judgment rule is the proper instrument by which to measure the propriety of a golden parachute agreement. Concluding that it is not the proper instrument in its present form, the comment will provide guidelines that are more appropriate for judging the propriety of adopted golden parachute agreements.

II. BACKGROUND

A. *Golden Parachutes Generally*

Golden parachutes are termination agreements that typically provide key corporate executives with lump-sum or installment payments in the event of a change of control⁶ of the corporation.⁷ These agreements are different than traditional employment agreements inasmuch as they "pay off" only in the event of a change of control.⁸ Although their terms vary

702, 712 (1989).

4. *International Ins. Co. v. Johns*, 874 F.2d 1447, 1459 (11th Cir. 1989).

5. An inside director is a director who has some interest in the corporation which is personal and/or financial, to the extent that he is an employee, officer or major stockholder of the corporation. An outside director is a non-employee director with little or no direct interest in the corporation he serves. BLACK'S LAW DICTIONARY 239 (5th ed. 1983).

6. It is important to distinguish between a "takeover" (which is the simple change of control in the interest of a corporation) and a "leveraged buy-out," which is another form of corporate change of control in which a company's management uses borrowed money to buy up the corporate stock from the shareholders. *Gaillard*, 208 Cal. App. 3d at 1266, 256 Cal. Rptr. at 712.

7. Note, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955 (1987) [hereinafter Note, *Golden Parachutes*].

8. Such changes of control are usually by way of mergers or acquisitions. When a change of control takes place, especially in the case of a hostile takeover, many of the target corporation's executives are treated like corporate refuse and

among corporations and depend substantially upon who will receive the compensation, golden parachutes typically include such benefits as guaranteed annual basic salary and bonuses for a specified number of years, easing or removal of stock option restrictions,⁹ accelerated or automatic vesting of pensions, and retirement and medical plans.¹⁰ Nonetheless, all golden parachutes can be broken down into three distinct general parts or provisions.

1. *General Provisions*

Golden parachute agreements contain three distinctive components: (1) a change of control clause, (2) a termination clause, and (3) a compensation clause.¹¹ The change of control clause makes the golden parachute operative in the event of shift in the ownership control of the corporation, such as by acquisition or merger.¹² The termination clause describes the circumstances under which the executive may terminate or be terminated from his employment following a change of control.¹³ While all termination clauses are triggered in the event of an involuntary termination, some agreements allow the

subsequently lose their jobs. Comment, *Golden Parachutes and Draconian Measures Aimed At Control: Is Internal Revenue Code Section 280G The Proper Regulatory Mode Of Shareholder Protection?*, 54 CIN. L. REV. 1293, 1294 (1986) [hereinafter Comment, *Draconian Measures*] (authored by Dana M. Leonard).

9. In the course of employment, a corporation may grant stock options to its employees as incentives for future performance. A "stock option" gives the possessor the right to purchase or sell the stock of a corporation at a specified price within a specified period of time. The option is an incentive for future performance in that if the company's value increases, which is reflected in the value of its stock, the value of the stock option will increase as well. As such, it is anticipated that the employee will work harder to increase the value of the company.

10. Hood & Bengé, *Golden Parachute Agreements: Reasonable Compensation or Disguised Bribery?*, 53 UMKC L. REV. 199, 202-03 (1985). Regarding the areas of the article by Hood & Bengé cited to in this comment, such article primarily uses Morrison, *Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982, at 82, and Comment, *Golden Parachutes - Executive Compensation or Executive Overreaching?*, 9 J. CORP. L. 346 (1984) as authority cited.

11. Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909, 910 (1985) [hereinafter Note, *Business Judgment*].

12. "Typically, a change of control is defined as an outside party's acquisition of a certain percentage of stock or as a change in the composition of the board of directors." *Id.* at 911.

13. See also Note, *Golden Parachutes*, *supra* note 7, at 957 n.11.

executive to leave either unconditionally or under certain specific circumstances.¹⁴ The compensation clause provides for the amount, method and duration of payment to the corporate executive, which can be distributed in either lump-sum or installment form.¹⁵

2. *Justifications for Golden Parachutes*

The most basic rationale for providing a golden parachute agreement is to compensate the executive for losses suffered from displacement of his job, which include its psychological benefits of power and prestige, and for costs incurred in the search for a new job.¹⁶ Yet while this rationale seems sound facially, some contend that it does not justify the enormous sums actually received by way of golden parachute agreements. Recent history, however, helps shed some light on the development of the golden parachute.

During the last decade, mergers and acquisitions have become increasingly common.¹⁷ In fact, the number of corporate takeovers in recent years is unprecedented.¹⁸ Generally, about half of a target corporation's top management leave the company within three years following a takeover. Termination may be voluntary or involuntary, but because of the high number of takeovers, today's corporate management has a strong incentive to protect itself in the event of a change of control.¹⁹ While goals such as self-protection would otherwise be attacked as illegitimate, advocates have proposed three legiti-

14. See Note, *Business Judgment*, *supra* note 11, at 911-12. See also Note, *Golden Parachutes*, *supra* note 7, at 957 n.12.

15. See Note, *Business Judgment*, *supra* note 11, at 912. See also Note, *Golden Parachutes*, *supra* note 7, at 957 n.13.

16. See Note, *Business Judgment*, *supra* note 11, at 912 n.16.

17. "Mergers between 1979 and 1985 grew at an annual rate of 19%, compared to a 6.9% growth rate between 1948 and 1979." McGee, *Mergers and Acquisitions: An Economic and Legal Analysis*, 22 CREIGHTON L. REV. 665, 665 (1989).

18. Generally, factors which have led to the increase in corporate takeovers include "the general deregulatory environment, fierce foreign competition and a change in viewpoint by the Federal Trade Commission. Much merger activity has occurred in the oil, banking, finance, insurance and transportation industries due to deregulation. Other mergers have been triggered by competitive pressures." See McGee, *supra* note 17, at 665. For a general discussion on the effect of golden parachute agreements in the context of the merger/acquisition environment, see McGee, *supra* note 17, at 676-78.

19. See McGee, *supra* note 17, at 676.

mate theories to provide justification for the adoption of golden parachute agreements.

a. *Compensation*

First, golden parachutes are said to foster an objective state of mind in the executive since he does not have to worry about his personal finances. As a result, he is in a better position to serve the best interests of the shareholders.²⁰ Essentially, proponents argue that the golden parachutes eliminate any conflict of interest that might otherwise arise during a takeover in the absence of such an agreement.²¹ Opponents contend that golden parachutes do more than ease executive tension. They say that the agreements go so far as to create a lackadaisical or apathetic attitude on the part of the executive, since he will be financially secure regardless of the outcome of the takeover.²² In fact, some executives may actually encourage a takeover that is not in the best interests of the shareholders if the executives stand to profit greatly from payments tendered under the provisions of their golden parachute agreements.²³

b. *Attract and Retain Key Executives*

Second, proponents argue that golden parachutes help companies attract key executives and retain them in the face of a takeover battle.²⁴ As such, the agreements benefit the corporation and the shareholders by assuring stability within the

20. See Hood & Bengé, *supra* note 10, at 205.

21. See Hood & Bengé, *supra* note 10, at 205-06.

22. See Hood & Bengé, *supra* note 10, at 206.

23. See McGee, *supra* note 17, at 678; Note, *Business Judgment*, *supra* note 11, at 918 n.45. A situation could easily arise in which an executive, by opposing a takeover, would simply continue to work for the corporation at a comfortable annual salary. However, with the presence of a golden parachute agreement, the executive may benefit from a takeover and the termination of his employment insofar as he would receive, by lump sum, the proceeds provided by the agreement which may exceed three or four times his former annual salary. As long as the executive is successful in obtaining employment with another company within a reasonable time period and for a comparable salary, then he will actually benefit to some extent by his change of employment. To this end, the executive may actually support a takeover that is not in the best interests of the corporation or its shareholders if he is confident that future employment can be found.

24. See Hood & Bengé, *supra* note 10, at 204.

leadership of the corporation.²⁵ Two reasons are presented to support this contention. First, since golden parachutes have become so popular among corporations, advocates believe that a corporation will fight to lure top executives away from their present companies unless the executives are given the security of such an agreement. Likewise, the possibility exists that companies will lose their own top executives unless they adopt golden parachute agreements as well.²⁶ Second, golden parachutes provide managerial stability in the face of a takeover since without such an agreement, a top executive may be inclined to discontinue his employment in the middle of the takeover battle, thereby leaving the corporation without leadership when it is most needed. The manager may leave in an effort to seek employment that is more secure in light of the likelihood of termination following a successful corporate takeover.²⁷

Opponents point out that top executives are well compensated for the risk of job loss and that such risks are an inherent part of every employment relationship, yet most employees are not provided the luxury of a golden parachute.²⁸ In addition, the risk of a top executive leaving his job during difficult times is unlikely, since company loyalty, personal pride, and the potential for an unfavorable reputation serve to keep top executives where they are.²⁹

c. *Defense Against Takeovers*

Third, proponents claim that golden parachutes serve as a deterrent to unwanted takeover attempts by increasing the cost

25. See Comment, *Draconian Measures*, *supra* note 8, at 1296.

26. See Hood & Bengé, *supra* note 10, at 204.

27. See Hood & Bengé, *supra* note 10, at 204. See also *supra* text accompanying note 19 (illustrating the extreme rate of executive employment termination following a corporate takeover).

28. See Hood & Bengé, *supra* note 10, at 204-05. A corresponding argument is that the danger of job loss is particularly prevalent for corporate management in the takeover situations. This type of job loss is not inherent in every job, and golden parachutes are adopted to provide additional compensation to this extent in the event of job loss.

29. See Hood & Bengé, *supra* note 10, at 205. It may also be the case that even the most selfish of corporate executives, who would not otherwise be affected by the consideration of loyalty or personal pride since they may be without either, may still consider the financial aspects of an unfavorable reputation incentive enough to remain loyal to their corporation during troubled times.

of the takeover. Costs increase insofar as the new owners would be obligated to honor the terms of the golden parachute entered into prior to the takeover.³⁰ Critics, however, point out that takeover costs are so high to begin with that the added cost of the agreements are inconsequential.³¹ The relative cost of a golden parachute agreement to the aggressor corporation is typically less than one percent of the total cost of the takeover, so that while the cost of compensating managers who possess golden parachute agreements may seem quite large, it is relatively small to the acquiring corporation.³² Accordingly, recent commentary suggests that golden parachutes do not serve as any significant deterrent at all.³³ Most of the commentary regarding golden parachute agreements has been highly critical of their use. But in order to fully appreciate the scope of golden parachute utility, the legislative and judicial treatment of these agreements must be considered.

B. *Tax Treatment of Golden Parachutes*

Before the courts had addressed the validity of golden parachutes, Congress enacted the Deficit Reduction Act of 1984³⁴ which provided for the adverse tax treatment of certain payments made under golden parachute agreements. Prior to this act, golden parachutes were considered a business expense and therefore fell within the provisions of section 162(a)(1) of the Internal Revenue Code.³⁵ This particular section provides that any reasonable payments made for purposes of compensation for services are tax deductible as a business

30. See Hood & Bengé, *supra* note 10, at 205.

31. See Hood & Bengé, *supra* note 10, at 205.

32. See generally Comment, *Golden Parachutes: Ripcords or Rip Offs?*, 20 J. MARSHALL L. REV. 237, 254-56 (1986).

33. See Note, *Golden Parachutes*, *supra* note 7, 958 n.15. But see Note, *Golden Parachutes*, *supra* note 7, 974 n.91. The court in *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989) did not choose to recognize this deterrence as a legitimate justification at all. *Id.* at 1266, 256 Cal. Rptr. at 712. Keep in mind that this point represents only one part of this controversy, and while it may reflect a small victory for opponents, much of the topic remains unsettled.

34. See Comment, *Draconian Measures*, *supra* note 8, at 1299; "Division A of the Deficit and Reduction Act, entitled the Tax Reform Act of 1984, added sections 280G and 4999 to the 1954 I.R.C." See Comment, *Draconian Measures*, *supra* note 8, at 1298 n.42 (citing The Deficit and Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 678 (1984)).

35. See Comment, *Draconian Measures*, *supra* note 8, at 1297-98.

expense if they are "ordinary and necessary."³⁶ Section 162 uses a subjective standard of review inasmuch as the courts address each situation on a case by case analysis.³⁷ Although this reasonable relationship standard of review for tax deductions is quite different from the strict, objective standard provided for by sections 280G³⁸ and 4999³⁹ of the Internal Revenue Code, section 162 is not superseded by these provisions.⁴⁰ In fact, sections 162(a)(1), 280G and 4999 apply to golden parachute agreements enacted or amended in any significant aspect after June 14, 1984 insofar as the agreement must meet the requirements of all three codes in order to receive any deductions. Those agreements adopted prior to June 15, 1984, are not subject to the provisions of sections 280G and 4999.⁴¹

While section 280G disallows corporations from taking golden parachute deductions allowed under section 162(a)(1), section 4999 provides for a twenty percent excise tax imposed on the recipient of a golden parachute payment paid by a corporation disqualified for deductions under section 280G.⁴² Section 280G essentially provides that a corporation is disqualified from taking a deduction under section 162(a)(1) of any "excess parachute payment," which is that amount in excess of the payee's "base amount" for such a payment.⁴³ The payee's

36. "A corporation may deduct all ordinary and necessary expenses incurred in operating the business, 'including a reasonable allowance for salaries or other compensation for personal services actually rendered.'" See Comment, *Draconian Measures*, *supra* note 8, at 1298 n.33 (quoting I.R.C. § 162(a)(1) (1982)). Reasonable compensation is that amount normally paid to similar employees in like situations. "Other factors courts consider relevant in determining reasonableness of compensation include: (1) comparison with other compensation; (2) the nature and extent of services rendered; (3) the net earnings of the corporation; (4) examination of the executive's previous compensation." See Comment, *Draconian Measures*, *supra* note 8, at 1298 n.38.

37. See Comment, *Draconian Measures*, *supra* note 8, at 1298.

38. I.R.C. § 280G (West Supp. 1984) (added by § 67(a) of the Tax Reform Act of 1984). For a detailed description of § 280G, see *infra* notes 43-47 and text accompanying notes 42-47.

39. I.R.C. § 4999 (West Supp. 1984) (added by § 67(b)(1) of the Tax Reform Act of 1984).

40. See Comment, *Draconian Measures*, *supra* note 8, at 1298.

41. See Comment, *Draconian Measures*, *supra* note 8, at 1298-99 & n.40.

42. See Comment, *Draconian Measures*, *supra* note 8, at 1298.

43. See I.R.C. § 280G(a)-(b)(1) which states: "(a) General rule.- No deduction shall be allowed under this chapter for any excess parachute payment. [¶] (b) Excess parachute payment defined.-[¶] (A) In general.- The term 'parachute payment'

"base amount" is his average annualized compensation over the preceding five years.⁴⁴

"Parachute payments" are classified into two categories: (1) any payment in the form of compensation which is *triggered by a change in control*, the aggregate present value of which equals or exceeds three times the payee's allocated base amount;⁴⁵ and (2) any payment in the form of compensation which violates any generally enforceable securities laws or regulations.⁴⁶ Therefore, if the payee receives a parachute payment that is either three times his average gross income or any amount in violation of a securities law or regulation,⁴⁷ the

means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment."

44. *Id.* at § 280G(b)(3)(A) which states: (3) Base amount.- [¶] (A) In general.- The term 'base amount' means the individual's annualized includible compensation for the base period."

§ 280G(d)(2) states:

The term "base period" means the period consisting of the most recent 5 years ending before the date on which the change in ownership or control described in paragraph (2)(A) of subsection (b) occurs (or such portion of such period during which the disqualified individual performed personal services for the corporation).

45. *Id.* at § 280G(b)(2)(A) which states:

(A) In general.- The term 'parachute payment' means any payment in the nature of compensation to (or for the benefit of) a disqualified individual if: [¶] (i) such payment is contingent on a change- [¶] (I) in the ownership or effective control of the corporation, or [¶] (II) in the ownership of a substantial portion of the assets of the corporation, and [¶] (ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to 3 times the base amount. [¶] For purposes of clause (ii), payments not treated as parachute payments under paragraph (4)(A), (5), or (6) shall not be taken into account.

46. *Id.* at § 280G(b)(2)(B) which states:

(B) Agreements.- The term 'parachute payment' shall also include any payment in the nature of compensation to (or for the benefit of) a disqualified individual if such payment is made pursuant to an agreement which violates any generally enforced securities laws or regulations. In any proceeding involving the issue of whether any payment made to a disqualified individual is a parachute payment on account of a violation of any generally enforced securities laws or regulations, the burden of proof with respect to establishing the occurrence of a violation of such a law or regulation shall be upon the Secretary.

47.

Under the Act, the term parachute payment also includes any payment under a contract that (1) provides for payments of a type which the Congress intended to discourage by enacting the new rules, and (2) that violates any applicable securities laws or regulations.

corporation will be excluded from any deduction for that part of the payment that exceeds the recipient's average annualized income. Likewise, under section 4999, the recipient will be taxed at a rate of twenty percent for this amount.⁴⁸

Congress intended to discourage the use of golden parachutes for several reasons. First, Congress felt that in "hostile" takeover situations,⁴⁹ golden parachutes are designed to dissuade an interested buyer from attempting a takeover by in-

However, the rules relating to reasonable compensation are not applicable in determining how much of any such parachute payment is excessive.

For this purpose, the Congress intended that applicable securities laws or regulations include State as well as Federal laws or regulations. However, the Congress intended this rule to apply only if the violation is a serious one. It was not intended to apply if the violation is merely technical in character or is not materially prejudicial to shareholders or potential shareholders.

JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, H.R. No. 4170, 98th Cong., 2d Sess. 199, 204-05 (1984).

48. I.R.C. § 4999(a), (b). This analysis of the tax code is very simplified and does not necessarily reflect the precise regulation. But for purposes of this comment, the general impact of the code sections on golden parachute agreements is reflected by the preceding prose. To illustrate, suppose Joe Executive makes a modest annual salary of \$100,000 as a vice president for XYZ Corp. Following a friendly takeover that qualifies as the statutory change of control, he is terminated from employment and receives a lump sum payment of \$500,000. In this example, \$100,000 is Joe's average annualized salary. (If he has been receiving raises over the last five years, we would take an average to determine this amount; also, if Joe is to receive many payments over a number of years, then the present value of those payments would be calculated.) Joe's "base amount" is \$100,000 and his allowable parachute payment is three times that amount, which is \$300,000. Therefore, Joe's "excess parachute payment" is anything over \$300,000, which is \$200,000. As such, XYZ Corp. will not be allowed under § 280C to take a deduction on the \$200,000 of excess parachute payment, and Joe will have a 20% excise tax of \$40,000 levied against him under § 4999 for the \$200,000 received.

49. "A hostile takeover (aiming to replace existing management) is usually attempted through a public tender offer. Other approaches might be unsolicited merger proposals to directors, accumulations of shares in the open market, or proxy fights that seek to install new directors." J. DOWNES & J.E. GOODMAN, *BARRON'S FINANCE AND INVESTMENT HANDBOOK* 410 (2d Ed. 1987). "A tender offer is an attempt by one company to purchase the shares of a corporation directly from the shareholder of that corporation. Such purchase offers are used in an effort to purchase the corporation out from underneath the management." *BLACK'S LAW DICTIONARY* 1316 (5th ed. 1979). If the tender offer is hostile, then it is an attempt to takeover the corporation without the consent of its management. A friendly takeover is one that is done with the blessings of the incumbent management.

creasing the cost of the purchase.⁵⁰ Congress stated that, as a matter contrary to public policy, golden parachute agreements that are intended to dissuade potential buyers should be strongly discouraged since they hinder acquisition activity.⁵¹

Congress was also concerned that the existence of these agreements may actually encourage key executives to support a takeover that is not in the best interest of the corporation and shareholders in order to take advantage of the parachute payments.⁵² Whether the agreement is made between the executive and the target corporation, the acquiring corporation, or some other interested party, Congress determined that such arrangements should be strongly discouraged.⁵³

Additionally, in theory, one presumes that a target corporation will be sold to the highest bidder, and that the target corporation will attempt to negotiate the highest price the purchaser can afford. To the extent that a portion of that amount must be paid to the officers of the target corporation, due to the existence of golden parachute agreements, there is less for the shareholders of that corporation who are its owners.⁵⁴ Congress determined that such arrangements should be discouraged.⁵⁵

While Congress has attempted to reduce the excessive use

50.

In many 'hostile' takeover situations, the Congress believed that such arrangements, commonly called 'golden parachute,' were designed in part to dissuade an interested buyer, by increasing the cost of the acquisition, from attempting to proceed with the acquisition. If the takeover did not occur, the target's executives and other key personnel would more likely retain their positions, so the golden parachute could have had an effect of helping to preserve the jobs of such personnel. Where no takeover bid yet commenced the Congress believed that golden parachutes were oftentimes entered into to discourage potential buyers from becoming interested. It was the view of Congress that to the extent golden parachutes had the desired effect in either such a case, they hindered acquisition activity in the marketplace and, as a matter of policy, should be strongly discouraged.

See JOINT COMMITTEE, *supra* note 47, at 199.

51. See *supra* note 7 & note 50 and accompanying text.

52. "In other situations, the Congress was concerned that the existence of such arrangements tended to encourage the executives and other key personnel involved to favor a proposed takeover that might not be in the best interests of the shareholders or others." See JOINT COMMITTEE, *supra* note 47, at 199.

53. See JOINT COMMITTEE, *supra* note 47, at 199-200.

54. See JOINT COMMITTEE, *supra* note 47, at 200.

55. See JOINT COMMITTEE, *supra* note 47, at 200.

of golden parachutes by corporations with the enactment of sections 280G and 4999, commentaries have suggested that the tax code is not the proper channel through which to regulate the use of golden parachutes.⁵⁶ Moreover, the courts have failed to discourage the use of golden parachute agreements through a deferential standard of review known as the business judgment rule.

C. *Business Judgment Rule*

The common law "business judgment rule" is a judicial policy of deference to the business judgment of corporate directors who are said to be in a better position to make business decisions than the courts.⁵⁷ It is a policy of restraint that gives corporate directors broad discretion in their decision making.⁵⁸ The rule is also premised on the notion that the management of the corporation has been entrusted to make such decisions, as opposed to the courts, and is better able to judge whether a particular act or transaction serves the needs and purposes of the corporation.⁵⁹ Managerial decisions are presumed to be founded on sound business judgment.⁶⁰ Under this rule, a director will not be held liable for mistakes in business judgment, if the mistakes are made in good faith and the director believes that the decisions were made in the best interest of the corporation.⁶¹

The business judgment rule, however, is not one of absolute immunity. The director cannot make unreasonable decisions and expect to escape liability through the business judgment rule.⁶² But while no court has, until recently, taken a

56. See Comment, *Draconian Measures*, *supra* note 8, at 1309.

57. *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 1263, 256 Cal. Rptr. 702, 710 (1989).

58. *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989).

59. *Gaillard*, 208 Cal. App. 3d at 1263, 256 Cal. Rptr. at 710.

60. *Id.* "Courts have formulated this rule to safeguard the corporate law policy that assures stockholders the right to vote directors out of office if they disagree with their decisions." *International Ins. Co.*, 874 F.2d at 1458 n.20 (citing *Entesra Corp. v. SGS Associates*, 600 F. Supp. 678, 685 (E.D. Pa. 1985)).

61. *Gaillard*, 208 Cal. App. 3d at 1263, 256 Cal. Rptr. at 710. *Cf. supra* note 79 for California's business judgment rule codified in § 309 of its Corporate Code.

62. *Gaillard*, 208 Cal. App. 3d at 1263-64, 256 Cal. Rptr. at 710. "Courts have properly decided to give directors a wide latitude in the management of the

definitive position on the rule's application to golden parachute agreements,⁶³ commentators have generally predicted that the rule will most likely govern their disposition.⁶⁴ In fact, following these predictions, two recent cases have applied the business judgment rule to the use of golden parachute agreements.⁶⁵

D. *Application of Business Judgment Rule to Golden Parachutes*

Because the issue of executive compensation is fundamentally a corporate business decision, and because golden parachutes often serve that valid corporate function, the court in *Gaillard v. Natomas Co.*⁶⁶ determined that such decisions are governed by the business judgment rule.⁶⁷ Likewise, the court in *International Ins. Co. v. Johns*⁶⁸ stated that in Florida the business judgment rule governs judicial review of a board of directors' decision to enact golden parachutes.⁶⁹

1. *Gaillard v. Natomas Co.*

Gaillard involved shareholder derivative actions in which four inside directors⁷⁰ entered into golden parachute

affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them . . ." *Id.* at 1264, 256 Cal. Rptr. at 710 (quoting *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 852-53, 47 Cal. Rptr. 392 (1965)).

63. *Id.* at 1265, 256 Cal. Rptr. at 711. See *Brown v. Ferro Corp.*, 763 F.2d 798 (6th Cir. 1985) (suit challenging corporation's enactment of golden parachutes dismissed as not ripe); *Schreiber v. Burlington Northern, Inc.*, 731 F.2d 163, 167 (3rd Cir. 1984) (question of management's breach of fiduciary duty in enacting golden parachutes not properly before the court), *aff'd*, 472 U.S. 1 (1985).

64. *Gaillard*, 208 Cal. App. 3d at 1265 n.8, 256 Cal. Rptr. at 711 n.8. See Note, *Golden Parachutes*, *supra* note 7, at 962, 956 n.6; Note, *Business Judgment*, *supra* note 11, at 912.

65. These two cases are *Gaillard*, 208 Cal. App. 3d at 1263, 256 Cal. Rptr. at 710 (1989) and *International Ins. Co.*, 874 F.2d at 1458 n.20 (11th Cir. 1989), decided March 23, 1989 and June 7, 1989, respectively.

66. 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989).

67. *Id.* at 1265, 256 Cal. Rptr. at 711.

68. 874 F.2d 1447 (11th Cir. 1989).

69. *Id.* at 1458.

70. These directors were also the corporation's five principal executive officers, which is why they are classified as "inside directors." *Gaillard*, 208 Cal. App. 3d at 1250, 256 Cal. Rptr. at 702. Outside directors are non-employee directors with little or no direct interest in the corporation they serve. BLACK'S LAW DICTIONARY 414 (5th ed. 1979). See *supra* note 5.

agreements and one was provided with a four-year consultation agreement in connection with a merger.⁷¹ Following a hostile tender offer⁷² by Diamond Shamrock Corporation, which eventually led to the friendly merger, Natomas' five inside directors prepared golden parachute agreements and presented them to the board of directors compensation committee.⁷³ The inside directors asserted that these agreements were conducive to the continuity of management.⁷⁴ On the committee's recommendation, the board of directors, of which only the twelve outside directors voted, approved the golden parachute agreements entitling the inside directors to eleven million dollars in cash payments in the event of a change of control and subsequent termination of employment.⁷⁵

Subsequently, Natomas' shareholders approved the merger, which included the golden parachutes and consultation agreement.⁷⁶ Shortly after the merger, the four key executives who received the golden parachute agreements terminated their employment, thus triggering lump sum payments totaling about ten million dollars.⁷⁷ In addition, the one inside director who contracted for the consultation agreement spent less than one day providing consultation services during the prescribed four-year period, but received one million dollars for his "services."⁷⁸

The court applied California's business judgment rule⁷⁹

71. *Gaillard*, 208 Cal. App. 3d at 1250, 256 Cal. Rptr. at 702.

72. *See supra* note 49 and accompanying text for a definition of "hostile tender offer."

73. *See supra* note 48.

74. *See supra* note 48. While the opinion does not go into any detail with respect to this argument, the text indicates that with the help of outside counsel, the inside directors convinced the committee that such arrangements were a common method used to insure that management would remain focused in its duties to the corporation despite the pending takeover and the possibility of job loss that accompanied it. *See infra* text accompanying note 85. This rationale corresponds to the justification of golden parachutes which indicates that golden parachutes serve to retain key management by stabilizing their financial anxiety during a takeover period.

75. *See infra* text accompanying note 85. The one director whose operation was being spun off received a consultation agreement entitling him to annual payments of \$250,000 for each of the four years following the merger. *See infra* text accompanying note 85.

76. *Gaillard*, 208 Cal. App. 3d at 1250, 256 Cal. Rptr. at 702.

77. *Id.*

78. *Id.*

79.

to golden parachute agreements in the context of an appeal to a motion for summary judgment which was granted against the shareholder plaintiffs.⁸⁰ As a result, the court's analytical depth is shallow since the court was required only to find a triable issue of fact by which the summary judgment could be reversed.⁸¹ With respect to the inside directors, the court found that since these directors were not performing as directors, but were admittedly acting in their own interest as individuals and employees, section 309, the business judgment rule, did not apply to them.⁸² As a consequence, the summary judgment in their favor was an error and therefore reversed.⁸³

Because the record did not show any evidence of conflict of interest or bad faith, the point of the inquiry regarding the outside directors was whether they acted in a manner which

7, pp. 1537-1538, eff. Jan. 1, 1977) codifies California's business judgment rule . . . and provides '(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the *best interests of the corporation* and with such care, including *reasonable inquiry*, as an *ordinarily prudent person in a like position* would use under similar circumstances. [¶] (b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by: [¶] (1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented, [¶] (2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or [¶] (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as in any such case, the director acts in good faith, after reasonable inquiry when the need therefore is indicated by the circumstances and without knowledge that would cause such a reliance to be unwarranted. [¶] (c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director.

Id. at 1264, 256 Cal. Rptr. at 710 (emphasis added).

80. *Id.* at 1250, 256 Cal. Rptr. at 702.

81. *Id.* at 1268, 256 Cal. Rptr. at 713.

82. *Id.* "The record discloses issues of fact on appellants' claims of, inter alia, breach of fiduciary duty and waste as to the five directors, which cannot be resolved as a matter of law on the basis of the record before us." *Id.*

83. *Id.*

they believed to be in the best interest of the corporation, and with such care as to include the reasonable inquiry of an ordinarily prudent person in a like position.⁸⁴

The court held that, as a matter of law, it could not find that the compensation committee was justified in relying solely on outside counsel's recommendation that the golden parachute agreements be adopted.⁸⁵ The golden parachute did not serve any of the functions, stated above,⁸⁶ by which such agreements are normally justified,⁸⁷ and, as a matter of law, the court found that the circumstances did not warrant further inquiry.⁸⁸ With respect to the consultation agreement adopted by the board, the court did not find it determinative that the particular director did not provide one million dollars' worth of consultation. California's business judgment rule requires that the court view the acts of the directors at the time such decisions were made.⁸⁹ The record indicates that the compensation committee considered the need for the consulting agreement, but decided that such agreement would serve a valid and necessary purpose for Natomas.⁹⁰ As a result, the court found that the outside directors were not liable, as a matter of law, for their approval of the consultation agree-

84. *Id.* at 1269, 256 Cal. Rptr. at 713.

85.

[The outside counsel] stated that continuity in management should be a concern of the Natomas board and that the golden parachutes would serve that purpose. [Counsel] did not explain, however, how the purported golden parachutes would serve such purpose, and the record does not indicate that any of the committee members requested further explanation of his conclusory opinion or analyzed among themselves how such purpose would be served by the amendments.

Gaillard, 208 Cal. App. 3d at 1269, 256 Cal. Rptr. at 714.

86. *See supra* text accompanying notes 16-33.

87. *Gaillard*, 208 Cal. App. 3d at 1270, 256 Cal. Rptr. at 714. *Gaillard* sets forth two of the three aforementioned justifications traditionally used to advocate golden parachute agreements: "(1) to foster executive objectivity toward merger and tender offers; and (2) to attract top executives to companies and industries where the odds of takeover are high." *Id.* at 1266, 256 Cal. Rptr. at 712. Apparently, this court did not consider the third justification, use as a defense to an unwanted takeover, adequate as such.

88. *Id.* at 1269, 256 Cal. Rptr. at 714. "The director who chaired the meeting indicated that the committee relied entirely upon [outside counsel] when agreeing to recommend the agreements." *Id.* *See supra* text accompanying note 84.

89. *See Gaillard*, 208 Cal. App. 3d at 1271, 256 Cal. Rptr. at 715.

90. *Id.*

ment.⁹¹

The court then turned to the conduct of the outside directors not on the compensation committee. The court stated that although a director is normally entitled to rely on the recommendations of a committee,⁹² the particular circumstances and timing of these golden parachute proposals create a triable issue of fact as to whether these directors exercised a level of inquiry that a reasonable person in a like position would exercise.⁹³ In this case, the court found a triable issue as to whether these directors had knowledge as to the questionable and controversial nature of golden parachutes such that it should cause them to make further inquiry.⁹⁴

While this case helps to illustrate the line of inquiry necessary to determine the validity of golden parachutes under the business judgment rule, it does not provide a structured analysis by which future cases can be modeled.⁹⁵ A more recent case, however, has provided such an analysis.

2. *International Ins. Co. v. Johns*

*International Ins. Co. v. Johns*⁹⁶ was a declaratory relief action brought by International Insurance Company following the settlement of a related shareholder's derivative suit.⁹⁷ The officers and directors involved in the prior action sought indemnification from International Insurance Company through an insurance policy that covered them for losses resulting from their wrongful acts committed within the scope of their em-

91. *Id.*

92. *See supra* note 76 & note 79 and accompanying text.

93.

Even as of the date of the merger, golden parachutes were highly controversial [cite omitted]. The board members, who presumably were appointed to the board because of their business and financial acumen, likely had, or should have had, some knowledge of this controversy. The proposal of the golden parachutes here under somewhat suspicious circumstances, i.e., *after* the tender offer and in the midst of merger discussions, raises the question of whether these directors should have examined the golden parachutes more attentively.

Gaillard, 208 Cal. App. 3d at 1272, 256 Cal. Rptr. at 715-16.

94. *Id.* at 1272, 256 Cal. Rptr. at 716.

95. The court's line of inquiry is limited because the court only needs to make a factual inquiry for purposes of a summary judgment appeal.

96. 874 F.2d 1447 (11th Cir. 1989).

97. *Id.* at 1447.

ployment.⁹⁸ The facts giving rise to these actions are as follows: As a result of substantial growth experienced by Southwest Florida Banks, Inc., Southwest's key officers expressed concern about the possibility of a merger.⁹⁹ Reacting to these concerns, Southwest's board of directors unanimously adopted a Performance Incentive Plan (PIP) in 1983.¹⁰⁰ This plan was designed to retain managerial talent by offering compensation, which was contingent and deferred, to key executives and full time employees after a period of five years of service or upon a change of control.¹⁰¹

Later that year, Southwest agreed to a merger which had not been contemplated when PIP was originally adopted.¹⁰² The merger agreement also included a five year consultation agreement offered to defendant Johns, Southwest's former chair to the board of directors.¹⁰³ As a result of the merger and change of control, certain directors and key employees received monetary awards under PIP.¹⁰⁴ These payments gave rise to a lawsuit by a disgruntled shareholder.¹⁰⁵

About one year after the payments were made, the parties to the derivative action settled the action with the court's approval.¹⁰⁶ The terms of the settlement agreement included the return of \$600,000 paid under PIP and a reduction in the term of Johns' consultation agreement from five years to two years.¹⁰⁷ Following this settlement, the officers and directors sought indemnification from International Insurance Company through an insurance policy that covered them for losses resulting from their wrongful acts committed within the scope of their employment.¹⁰⁸ But while International approved of and paid the pro rata share of the costs of defending the suit, it denied coverage of the actual settlement payments and then

98. *Id.* at 1452.

99. *Id.* at 1450.

100. *Id.* at 1451.

101. *Id.*

102. *Id.*

103. The consultation agreement provided for a five year term at an annual compensation rate of \$225,000. *Id.*

104. *Id.* at 1452 & n.8.

105. *Id.* at 1452.

106. *Id.*

107. *Id.*

108. *Id.*

brought this declaratory action to interpret the policy.¹⁰⁹

a. *Foundation Requirements - Initial Obstacles to the Application of the Business Judgment Rule*

To begin, the court discussed two obstacles to the application of the business judgment rule to golden parachute agreements: (1) golden parachutes are sometimes used as a defense tactic to corporate takeovers,¹¹⁰ and (2) when golden parachutes are awarded to members of the board who are inside directors, issues of self-dealing arise.¹¹¹ While a board's adoption of a golden parachute is given a stricter review than that ordinarily given under the business judgment rule, self-interested transactions are seldom given any protection.¹¹²

As a result of their strong desire to protect themselves from termination following a merger, top executives may face a conflict of interest with the corporation's shareholders.¹¹³ The conflict of interest results from their anxiety regarding potential termination, their desire to "remain entrenched" and their fiduciary duty of loyalty to act in the best interest of the corporation and its shareholders.¹¹⁴ In fact, the directors are

109. 874 F.2d 1447 at 1452.

110. See *supra* text accompanying notes 29 & 30.

111. *International Ins. Co.*, 874 F.2d at 1458. Self-dealing is no more than a self-serving act in the context of business dealings. This is to be distinguished from those decisions that are made with the best interest of the corporation in mind. Self-dealings are those business decisions which are made for the best interest of the decision maker and not the corporation.

112. *Id.* at 1258-59. As is discussed in the following text of this comment, the adoption of a golden parachute agreement necessitates the inquiry as to whether the adoption was self-serving or in the best interest of the corporation and its shareholders. While the business judgment rule provides for judicial deference of corporate directors' business decisions, such decisions are presumed to be founded on sound business judgment. Under this rule, a director will not be held liable for mistakes in business judgment, if the mistakes are made in good faith and the director believes that the decisions were made in the best interest of the corporation.

It follows that those decisions that are self-serving do not serve the best interest of the corporation, and therefore, the director should not be given the protection of the business judgment rule. As such, golden parachute agreements are subjected to a stricter scrutiny in order to determine whether issues of self-dealing arise.

113. See McGee, *supra* note 17 at 676.

114. See McGee, *supra* note 17 at 676. An executive has two separate roles within the corporation, and as such must wear two hats. He wears the hat of the

faced with this desire for entrenchment regardless of whether or not the corporation is faced with a buyout.¹¹⁵ In light of this conflict of interest, the directors will find it very difficult to remain purely objective in their decision-making.¹¹⁶ The court declared that because of the board's desire to remain entrenched, the directors' actions must withstand the scrutiny of a threshold test before applying the business judgment rule.¹¹⁷

In the case that directors have adopted defense tactics against buyouts, the threshold test (otherwise referred to as the *Unocal* standard) is two-fold: The directors must show that "(1) they had reasonable grounds to believe that a danger to corporate policy existed, which can be satisfied by a showing of good faith and reasonable investigation, and (2) that the defensive measure adopted is reasonable in relation to the threat posed."¹¹⁸ Accordingly, if these two requirements are met, then the business judgment rule can be applied to the directors approving the golden parachute agreements.¹¹⁹ Thus the court stated that the initial issue to consider is whether the board intended to enact the golden parachutes as a defense tactic.¹²⁰ If their intent is defensive, then the *Unocal* standard would apply; otherwise not.¹²¹ With respect to International Ins. Co., the court concluded that defense was not the intent of PIP and as a result, it would not scrutinize the board's ac-

corporate executive who owes a duty of loyalty to the corporation and its shareholders, and he wears the hat of an employee of the corporation. As an employee, he seeks to satisfy his personal wants and needs, such as obtaining a high salary and a comfortable work atmosphere. But situations arise in which the executive has conflicting interests and must choose one hat or the other. In these situations, the executive's duty of loyalty dictates that he act in good faith and refrain from using his position to further his personal interests. In addition, if he seeks to further his personal interests he must make a full disclosure to the corporation which reveals his position and the conflict of interest that accompanies it.

115. *International Ins. Co.*, 874 F.2d at 1459.

116. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (quoting *Bennett v. Propp*, 187 A.2d 405, 409 (1962)).

117. *Id.* at 954.

118. *International Ins. Co.*, 874 F.2d at 1459 (quoting *Unocal Corp.*, 493 A.2d 946, 955 as cited in *Tate & Lyle PLC v. Staley Continental Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 93,764 at 98,585, 1988 WL 46064 (Del. Ch. May 9, 1988)).

119. *Id.*

120. *Id.*

121. *Id.* at 1459-60.

tion under the *Unocal* two-part test.¹²²

The second obstacle to the application of the business judgment rule concerns self-interested transactions. If the compensation plan is such that it only serves the personal interest of the directors that approve it, the plan shall be voidable.¹²³ In this situation, the court said that the board must show good faith and adequate consideration to the corporation so as to avoid the action's classification as corporate waste.¹²⁴ However, the court described two situations in which self-dealings do not foreclose the court from review under the business judgment rule.¹²⁵ These situations are (1) a disinterested board or a majority of the shareholders approve the director's self-interested plan,¹²⁶ and (2) when a board passes or adopts a plan upon the recommendation of a committee of disinterested directors.¹²⁷ Recommendation by a disinterested committee is prima facie evidence that the adoption was disinterested and subject to the business judgment rule.¹²⁸ Regarding the adoption of PIP, the court found that both of these conditions were met and that the business judgment rule should apply as a result.¹²⁹

b. *Application Under Corporate Waste Framework*

Once the initial obstacles have been satisfied, the court will scrutinize the golden parachute within the corporate waste framework. Because of the deference typically given corporate directors under the business judgment rule courts are not willing to call upon a director to explain his actions in the absence of corporate waste.¹³⁰ Corporate waste is found when there is a showing of an abuse of discretion, fraud, bad faith, or ille-

122. *Id.* at 1460.

123. *Id.* (citing *Kerbs v. California E. Airways*, 33 Del. Ch. 69, 909 A.2d 652, 655 (1952)).

124. *Id.*

125. *Id.*

126. *Id.* "If this ratification occurs, the court will review the implementation of the action under the business judgment rule." *Id.*

127. *Id.* "When golden parachutes are adopted by subcommittees composed of 'disinterested' outside directors, courts will generally not make a self-dealing inquiry." See Note, *Golden Parachutes*, *supra* note 7, at 965 & n.48.

128. *International Ins. Co.*, 874 F.2d at 1460.

129. *Id.* at 1461.

130. *Id.* at 1459 (citing *Rogers v. Hill*, 289 U.S. 582, 591-92 (1933)). See *supra* text accompanying notes 57-64.

gality, and unless one of these four factors can be found, the court will apply the business judgment rule.¹³¹ The second obstacle to the application of the business judgment rule is illustrative of the bad faith factor, but it can be rebutted by a showing that disinterested directors recommended the golden parachute agreement.¹³² In fact, the *International Ins. Co.* court stated that a compensation plan is not considered corporate waste if the plan bears a reasonable relationship to the consideration received by the corporation.¹³³

The court determined that this "reasonable relationship" test is comprised of three inquiries. First, the court must determine whether the corporation received the benefit of its bargain. If the corporation received nothing in exchange for the benefit conferred, then the plan constitutes corporate waste. Second, the court should then determine that if the corporation did receive some benefit, whether the compensation was so disproportionate that a reasonable person would not think that the corporation had received any benefit, or quid pro quo.¹³⁴ If no quid pro quo resulted from the exchange, then the compensation payments would constitute no more than a corporate gift, and may be classified as corporate waste if unreasonable. Third, the court must decide whether the services performed by the employee triggered the payments. In other words, the court must find that the motive for adopting the plan was compensation for services rendered or because of some other purpose.¹³⁵

Finally, the *International Ins. Co.* court concluded that PIP bore a reasonable relationship to the benefits received by the corporation.¹³⁶ Southwest intended first, to retain its key employees during the five years of uncertainty to follow the adoption due to the excessive number of bank mergers taking place, and second, to insure that the corporation's key executives would continue to act in the best interest of the corpora-

131. *International Ins. Co.*, 874 F.2d at 1461.

132. See *supra* notes 123-29 and accompanying text.

133. *International Ins. Co.*, 874 F.2d at 1461.

134. "[Quid pro quo] is nothing more than the mutual consideration which passes between the parties to a contract, and which renders it valid and binding." BLACK'S LAW DICTIONARY 1123 (5th ed. 1979).

135. *International Ins. Co.*, 874 F.2d at 1461.

136. *Id.* at 1469.

tion if faced with a buyout.¹³⁷ Southwest's needs were substantial, and PIP was designed to address them.¹³⁸ Relying on the same analysis, the court determined that the consultation agreement adopted for Johns did not constitute corporate waste.¹³⁹

III. ANALYSIS

A. *Analysis of Obstacles to the Application of the Business Judgment Rule*

As discussed above, *International Ins. Co.* set forth two obstacles to the application of the business judgment rule to golden parachute agreements.¹⁴⁰ These obstacles reflect, to some extent, the attitude of Congress regarding golden parachutes. Not only did Congress intend to discourage the use of golden parachute agreements because they hinder acquisition activity, but Congress was also concerned that the presence of a golden parachute may encourage key executives to support a takeover that is not in the best interest of the corporation in order to take advantage of the parachute payments.¹⁴¹

1. *Use of Golden Parachutes as a Defense Tactic*

The first obstacle entails the use of golden parachutes as a defense tactic to corporate takeover.¹⁴² It is encouraging that this particular use of golden parachutes is withheld from the protection of the business judgment rule. Not only has Congress indicated its strong disapproval of golden parachute agreements, but commentary suggests that such agreements do little more than provide key executives with large sums of money at the shareholders' expense without actually discouraging prospective buyers to any significant degree.¹⁴³ Since these agreements represent but a small fraction of the total purchase price of the corporation, no investor will likely be dis-

137. *Id.* at 1462.

138. *See id.* at 1463-69.

139. *Id.* at 1470.

140. *See supra* text accompanying notes 110-11.

141. *See supra* note 7 & notes 50-53 and accompanying text.

142. *International Ins. Co.*, 874 F.2d at 1458.

143. *See supra* text accompanying notes 31-33.

couraged and subsequently, the shareholder will inevitably shoulder the burden of the compensation agreement.¹⁴⁴

In *International Ins. Co. v. Johns*, the court used the *Unocal* standard, but it is unclear from the opinion whether the court in *Unocal Corp. v. Mesa Petroleum Co.*¹⁴⁵ was meant to reflect Congress' view¹⁴⁶ of golden parachutes. Nonetheless, the *Unocal* standard¹⁴⁷ and the Joint Committee's General Explanation coincide and are subsequently adopted by the court in *International Ins. Co.* Even though the court in *International Ins. Co.* states that Florida law dictates that the business judgment rule be used to determine the propriety of the golden parachute agreements, such application is tempered by the *Unocal* standard. Interestingly, *Unocal* was decided in the Delaware courts, which apply the business judgment rule liberally. The subsequent adoption of this standard in a federal court may perpetuate the liberal application of the business judgment rule as it was interpreted by the Delaware court in *Unocal*.¹⁴⁸

As discussed above, if the court determines that the golden parachute was adopted as a defense tactic, then the directors must show that they had reasonable grounds to believe that a danger to corporate policy existed, and that a golden parachute agreement is reasonable in light of the threat posed.¹⁴⁹ This test uses a very subjective standard, requiring a case by case analysis. In *International Ins. Co.*, the court brushed this question aside in a preliminary determination that the golden parachute agreements were not adopted for purposes of takeover defense. The court stated that, to the

144. See *supra* text accompanying notes 31-33.

145. 493 A.2d 946, 955 (Del. 1985).

146. Congress' view on the use of golden parachutes for purposes of a takeover defense is reflected in the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984. See JOINT COMMITTEE, *supra* note 47.

147. See *supra* text accompanying note 118.

148. Even though the court uses Delaware's approach, it cannot be interpreted as a federal approach since the court is relying on Florida state law in this action. The court's justification for using Delaware's approach is as a matter of Florida precedent. It states, "[w]e rely with confidence upon Delaware law to construe Florida corporate law. The Florida courts have relied upon Delaware corporate law to establish their own corporate doctrines." *International Ins. Co.*, 874 F.2d at 1459 n.22.

149. *Id.* at 1449 (quoting *Unocal Corp.*, 493 A.2d at 955 as cited in *Tate & Lyle PLC v. Staley Continental Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep (CCH) § 93,764 at 98,585, 1988 WL 46064 (Del. Ch. May 9, 1988)).

contrary, PIP was adopted as an incentive to management in order to encourage higher performance, and when adopted, no takeover was even contemplated.¹⁵⁰

In *Gaillard v. Natomas Co.*,¹⁵¹ the golden parachute agreements were undoubtedly adopted in anticipation of a takeover, since they were proposed following a hostile tender offer¹⁵² and were subsequently presented to the shareholders as part of the merger proposal.¹⁵³ However, the facts do not indicate that the agreements were proposed for purposes of a takeover defense. On the contrary, the agreements were proposed for the purpose of providing for a smoother takeover transition which actually supports such a takeover.

But how strictly will the *Unocal* standard be applied? The directors must show that they had reasonable grounds to believe that a danger to corporate policy existed, which can be satisfied by a showing of good faith and reasonable investigation, and that the defensive measure adopted is reasonable in relation to the threat posed,¹⁵⁴ but they need only address these issues when the golden parachute has been adopted as a defense tactic. If the board of directors is aware of the *Unocal* standard, the golden parachute will not be introduced in the board meeting minutes as the defense to a pending merger. Instead, the board can carefully avoid the standard by stating within the minutes that the golden parachutes are adopted in an effort to insure a smooth merger in case one comes to pass. This was the rationale used by the Natomas Corporation's board in *Gaillard v. Natomas Co.*, and nothing in the court's opinion indicates that the truth of this rationale was scrutinized. Unless other relevant factors, such as the timing of its adoption and the amount of the golden parachute payments, are used to determine the purpose of the golden parachute agreement's adoption, then the *Unocal* standard is useless.

In addition, the courts are in a position to avoid the application of the *Unocal* standard if they so choose. Facially, the *Unocal* standard has some bite, but the courts can simply address the issue and move on to the an application of the busi-

150. *Id.* at 1451.

151. 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989).

152. *See supra* note 49 and accompanying text.

153. *Gaillard*, 208 Cal. App. 3d at 1250, 256 Cal. Rptr. at 702.

154. *See supra* text accompanying notes 118-19.

ness judgment rule. With the gaps in its application, the *Unocal* standard is impressive only upon first glance.

2. *When Issues of Self-Dealing Arise*

The second obstacle is encountered when golden parachutes are awarded to members of the board who are inside directors.¹⁵⁵ In this situation, the court must determine whether the directors are acting on their own behalf or on behalf of the corporation and its shareholders.¹⁵⁶ If an adopted compensation plan serves the personal interest of the directors that approve it, it shall be voidable.¹⁵⁷ However, if a plan is approved by a disinterested board or a majority of the shareholders, then the golden parachute is not voidable. In this latter situation, the actions of the directors are protected by the business judgment rule. In *International Ins. Co.*, the court determined that these conditions were met and that the actions of the directors were thereby subject to the protection of the business judgment rule.¹⁵⁸

Congress seems to support this obstacle as well. The Joint Committee's General Explanation of the Deficit Reduction Act of 1984 states that the committee was concerned that the existence of these golden parachute agreements may actually encourage top management to support a takeover that is not in the best interest of the corporation in order to take advantage of its parachute payments.¹⁵⁹ Congress suggests that such arrangements should be strongly discouraged,¹⁶⁰ and to some extent, this second obstacle helps to prevent such a situation.

However, on second review, differences between the second obstacle and Congress' view become apparent. While Congress appears to be concerned with the effect of golden parachutes on the mind of the recipient executive, the *International Ins. Co.* court was concerned with the actual adoption of the golden parachute agreement and the state of mind of those who adopt it. Advocates of this second approach might argue

155. See *supra* note 5 and accompanying text.

156. *International Ins. Co.*, 874 F.2d at 1458.

157. *Id.* at 1460 (citing *Keber v. California E. Airways*, 33 Del. Ch. 69, 90 A.2d 652, 655 (1952)).

158. *Id.* at 1461.

159. See JOINT COMMITTEE, *supra* note 47, at 199.

160. See JOINT COMMITTEE, *supra* note 47, at 199-200.

that if the adoption of the golden parachute is not self-serving, then the agreement will provide only reasonable compensation for the executive who will then presumably act in the best interest of the corporation. This argument suggests that an agreement that provides only reasonable compensation would not tempt an executive to support an unfavorable takeover, and as such, no conflict of interest would arise.

Realistically though, an interested executive is likely to lobby for the most beneficial compensation plan he can get. In addition, it is unlikely that disinterested directors will know when such a plan will provide enough compensation to the executive to encourage him to remain with the company, but not so much that he will support the takeover in order to realize the benefits of the agreement. In this situation, the business judgment rule provides the protection necessary for disinterested directors to make competent decisions without fear of judicial reprisal should their decision turn out to be inappropriate in hindsight.

Perhaps the presence of this uncertainty is the reason why Congress strongly discourages the use of golden parachutes through the tax law. Determining whether an executive will act in the best interest of the corporation and its shareholders or whether he will act only for his own interest is difficult, if not impossible. An executive who is party to a golden parachute agreement may be more inclined to act in a self-serving manner, and since his support is theoretically based on his own personal assessment of the benefits of the takeover, no one can legitimately substantiate an accusation of bad faith. Congress' solution to this dilemma is to strongly discourage the use of golden parachutes by imposing adverse tax consequences on the parties to golden parachute agreements with very large payments.¹⁶¹ Apparently, Congress feels that the best solution is to remove the temptation and what it perceives as the source of the conflict. Hence, without the presence of the golden parachute agreement, an executive will not have the incentive to support an unfavorable takeover and therefore no conflict of interest will arise.

Within the confines of its power to tax,¹⁶² Congress had

161. See *supra* text accompanying notes 142-48.

162. U.S. CONST. art. I, § 8, cl. 1 states: "[t]he Congress shall have Power to

made the first step toward discouraging the use of golden parachutes. If a board of directors adopts a golden parachute that is too large or in violation of the securities laws, the corporation and the beneficiary will suffer adverse tax consequences. The tax laws adopted by Congress do not discourage the use of *all* golden parachutes, but only those so large that they are more likely to create a conflict of interest. Congress' solution, however, is not the solution chosen by the court in *International Ins. Co.*

The *International Ins. Co.* court used an approach which seeks to determine the subjective state of mind of those who have adopted the compensation agreement. An analysis of "self-dealing" is subjective insofar as it involves the director's state of mind and who he seeks to benefit by his actions. But since determining the director's subjective state of mind is nearly impossible, the court used objective standards to measure the board's actions in order to determine whether self-dealing has taken place. The court determined that approval of the compensation plan by a disinterested board or majority of shareholders was admitted as prima facie evidence that the adoption was not for the purpose of self-dealing. In this case, the business judgment rule would be used.

In *Gaillard*, while the five interested directors prepared and presented the golden parachute and consultation agreements to a disinterested compensation committee, the plans were approved by twelve disinterested directors sitting on the board following a recommendation by such committee.¹⁶³ As a result, the court determined that the business judgment rule should apply. Under *International Ins. Co.* analysis, because the plans were approved by a disinterested board and the interested directors did not vote, the court determined this was prima facie evidence that no self-dealing took place. Thus, the actions of the directors were subject to the protection of the business judgment rule and the analysis that accompanies it.

The *International Ins. Co.* decision draws a sharp line between interested directors and disinterested directors, which is founded on direct benefit, that should disturb the reader. The

lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the Common Defence and general Welfare of the United States."

163. *Gaillard*, 208 Cal. App. 3d at 1250, 256 Cal. Rptr. at 702.

assumption is that if the director stands to benefit *financially*, he is an interested director, while the director who will *not* benefit financially is disinterested. This is a black and white determination by the court; there is no grey. This assumption is ridiculous insofar as benefits do not have to be financial or immediate. One would hope that the distinction could be drawn so easily, but that is not a realistic approach. The courts have admitted that a golden parachute should be voidable when it is adopted by a self-dealing director, but otherwise not. The grey area is being ignored here, and in order to address the true nature of the problems surrounding golden parachute agreements, the courts must realize that the problems arise from the size and nature of the golden parachutes themselves. Congress has addressed the problem from this angle, as should the courts. Of course, the question of self-dealing is only a preliminary question, but this discussion illustrates the scope of the problem and how the courts have chosen to ignore it.

B. *Corporate Waste and Protection under the Business Judgment Rule*

Once the court determines that the golden parachute was not adopted for an improper purpose, the court will analyze the directors' decision within the context of the business judgment rule. The court in *International Ins. Co.*, in other words, determined that absent a showing of corporate waste,¹⁶⁴ it will not question the director's decision or require that the director explain his action in any way.¹⁶⁵ To that end, a compensation plan is not considered corporate waste if it bears a reasonable relationship to the consideration received by the corporation.¹⁶⁶

As discussed in the preceding text,¹⁶⁷ the "reasonable relationship" test seeks to determine whether the corporation has received the benefit of its bargain. Therefore, the compensation agreement is considered reasonable if it conferred a benefit to the executive that is not disproportionate to that

164. See *supra* text accompanying note 131.

165. *International Ins. Co. v. Johns*, 874 F.2d 1447, 1459 (citing *Rogers v. Hill*, 289 U.S. 582, 591-92 (1933)).

166. *Id.* at 1461.

167. See *supra* text accompanying notes 133-35.

received by the corporation. When the benefits conferred are obviously disproportionate, such that the agreement in no way benefits the corporation and its shareholders, the director's decision is considered a blatant error in judgment and he will not be protected under the business judgment rule. In this case, the director would be liable to the corporation for the loss incurred by it as a consequence of the director's mistake.

As discussed in preceding text, advocates of golden parachutes maintain that golden parachutes serve to eliminate any conflict of interest that might otherwise arise in the absence of such an agreement¹⁶⁸ and that they help to attract key executives and retain them in the face of a takeover battle,¹⁶⁹ thereby helping to maintain managerial stability in the face of such a takeover.¹⁷⁰

These types of goals, however, are easy to defend beneath the deferential scrutiny of the business judgment rule. In fact, the burden of proof required of someone claiming corporate waste is very high in light of the reasonable relationship test. The corporate directors claim that they are seeking to provide managerial stability and that golden parachutes are a reasonable means to that end. Directors may even claim that the agreements are necessary to maintain stability. Yet the reasonable relationship test looks only to the goals and benefit at the time of adoption, and ignores the actual affect of the golden parachute. As mentioned above, the business judgment rule provides that if a corporate director's decision can be supported by any reasonable goal, however lofty, such a decision will be set aside without scrutiny. Unfortunately, the reasonable relationship test fails to take into account that the executive who is party to a golden parachute agreement may not be as concerned with the stability of the management as he is with the benefits he may receive. In fact, this is one of the primary concerns addressed by Congress.¹⁷¹

Opponents argue that the risk of top executives leaving their jobs is unlikely since company loyalty, personal pride, and the potential for an unfavorable reputation serve to keep top

168. See Hood & Bengel, *supra* note 10, at 205-06.

169. See Hood & Bengel, *supra* note 10, at 204.

170. See Comment, *Draconian Measures*, *supra* note 8, at 1296.

171. See *supra* text accompanying notes 52-53.

executives where they are.¹⁷² Others contend that golden parachutes will do more than ease executive tension but go so far as to create a lackadaisical or apathetic attitude on the part of the executive, who is assured of financial gain regardless of the outcome of the takeover.¹⁷³ Ironically, the business judgment rule is designed to protect an innocent director from liability in situations such as this. An innocent director will not know when an executive is properly motivated by a golden parachute or when the executive will take advantage of a situation because the payments are too much. As a result, the business judgment rule is an attempt to protect an innocent director from liability for what may be deemed a bad decision with the aid of hindsight. Directors cannot ascertain the intentions of the executive who is a party to the golden parachute, but have only an expectation that the executive will act in the best interest of the corporation. The problem with using the business judgment rule in the context of golden parachutes lies within this difficult situation. In an effort to protect the innocent director, the less than innocent directors slip through as well and avoid liability. These directors, though they receive no immediate financial reward, may receive some future benefit from the inside directors for whom the golden parachutes were approved. As such, the outside director benefits politically. Once again, the simple black and white classification of directors fails to resolve the true problems at hand.

In *Gaillard*, golden parachute agreements were provided for four inside directors as part of a friendly merger agreement following a hostile tender offer.¹⁷⁴ Even though the disinterested members of the board of directors approved the compensation agreements upon the recommendation of the compensation committee, the court determined that the golden parachutes did not serve any of the traditional functions by which such agreements are normally justified.¹⁷⁵ The compensation committee relied upon the advice of their outside counsel,¹⁷⁶ who stated that it was common practice, in mergers, to

172. See Hood & Bengé, *supra* note 10, at 205.

173. See Hood & Bengé, *supra* note 10, at 206.

174. See *supra* text accompanying notes 72-73.

175. *Gaillard v. Natomas Co.* 208 Cal. App. 3d 1250, 1270, 256 Cal. Rptr. 702, 714 (1989). See *supra* notes 8, 10 & 11, and notes 85-87 and accompanying text.

176. The outside counsel in this case, Joseph H. Flom, is the senior partner of

adopt arrangements in order to ensure continuity of management and provide economic protection for those key employees who might be affected.¹⁷⁷ The opinion does not indicate that Natomas' outside counsel suggested the golden parachutes were necessary in this case, and apparently the compensation committee did not bother to inquire into this matter further.¹⁷⁸

Even within the extremely deferential scrutiny of the business judgment rule, a corporate director is subject to a duty of reasonable inquiry.¹⁷⁹ It is also true that a director may rely on the advice of counsel when the subject area is within such counsel's expertise.¹⁸⁰ But because the golden parachutes were prepared by the outside counsel who recommended that they be adopted,¹⁸¹ and because the same outside counsel drafted the golden parachute agreements at the request of Natomas' chief executive officer who was party to his own golden parachute agreement,¹⁸² the outside directors must have realized that outside counsel was at least somewhat biased. Upon reasonable inquiry, outside directors may have discovered that the benefits of golden parachute agreements to the corporation are in controversy and that just because their outside counsel says that golden parachutes are commonly used in mergers does not mean that they *should* be used. Instead, the outside directors accepted their outside counsel's recommendation without reasonable inquiry, and the golden parachutes were adopted.

Skadden, Arps, Slate, Meagher & Flom. He is an attorney of high repute who specializes in corporate takeovers and mergers. His support of a particular course of action in the context of a corporate merger is undoubtedly valuable, but it cannot relieve a corporate director of liability or his duty of inquiry.

177. *Gaillard*, 208 Cal. App. 3d at 1261, 256 Cal. Rptr. at 708; *see supra* note 85 and accompanying text.

178. *See supra* note 85 and accompanying text.

179. Section 309 of California's Corporate Code provides in part that:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the *best interests of the corporation* and with such care, including *reasonable inquiry*, as an *ordinarily prudent person in a like position* would under similar circumstances.

See supra note 79 for this code section reproduced in whole (emphasis added).

180. *See supra* note 79 and accompanying text.

181. *Gaillard*, 208 Cal. App. 3d at 1259-61, 256 Cal. Rptr. at 707-08.

182. *Id.*

Shortly after the merger, the four key executives who received the golden parachute agreements terminated their employment, thus triggering the lump sum payments which totalled about ten million dollars.¹⁸³ In addition, the one inside director who received the consultation agreement spent less than a day providing consultation services during the prescribed four year period.¹⁸⁴ Despite the questionable circumstances under which the recipients obtained their benefits, the executives/inside directors who received payments did not violate the agreement by voluntarily terminating their employment. The golden parachutes provided that they could terminate their employment for good reason within six months following the merger.¹⁸⁵ Following the six-month period, the recipients could terminate their employment for any reason and still receive payments under the plan. In fact, the payment would actually be reduced according to the length of time they remained employees of Natomas following the six-month period.¹⁸⁶ Such a reduction in payments may have even encouraged these executives to terminate their employment as quickly as possible. With this kind of incentive to leave, it is doubtful that the golden parachutes would have helped to facilitate a smoother transition beyond the six-month period.

Not only did the committee fail to define the purpose for which the golden parachutes were being provided and the benefit received by the corporation, but the agreements were actually designed to encourage the executives to terminate their employment. This situation raises a fundamental problem that has been overlooked by commentators in the past, but which becomes apparent by this case in point.

C. *Subjective Problems of Analysis Overlooked*

The fundamental problem with the court's analysis is that it applies objective standards of review to the subjective intent of the parties involved. This practice, however, is common, since subjective intent is all but impossible to actually determine. The difference in this case is that the objective analysis is

183. *Id.* at 1250, 256 Cal. Rptr. at 702.

184. *Id.*

185. *Id.* at 1259-60, 256 Cal. Rptr. at 707.

186. *Id.* at 1260, 256 Cal. Rptr. at 707.

too far removed from the true nature of the problem. The court uses an objective analysis to determine the subjective intent of those directors who adopted the golden parachutes, while the amount of the golden parachutes was subjectively chosen by the directors for the purpose of affecting the executive to the extent that it eliminates his conflict of interest. This situation becomes more clear by the following illustration.

When outside directors are approached by inside directors with a proposal for a compensation agreement such as a golden parachute, the outside directors should theoretically assume an objective stance whereby they evaluate the propriety of the proposed agreement and the benefit which the agreement will confer upon the corporation and its shareholders. In reality, this objectivity may not occur for two reasons.

For one, outside directors, in many cases, are not only dependent upon the inside directors for providing essential information regarding the operations and needs of the corporation, but they may also be indebted to the inside directors insofar as the inside directors may have helped them secure a position on the board in the first place.¹⁸⁷ This type of subjectivity may not be present in all situations, but in those cases in which it is present, an outside director may find it very difficult to remain purely objective with respect to the compensation to be given an inside director who is a close colleague and perhaps a good friend.

This situation is precisely that which the present line of inquiry fails to anticipate. As long as the golden parachute agreements are approved by the "disinterested" directors of the board, and the compensation is not so disproportionate as to constitute corporate waste through the reasonable relationship test, then the deferential business judgment rule is applied. The business judgment rule, however, requires little justification to pass beneath the scrutiny of the court.

Essentially, the court has assumed that the categorization of a director as "disinterested" insures that he will make his decisions in an objective manner. Yet such a categorization may be unwarranted. To assume that a disinterested director

187. Interview with Gary S. Vandeweghe, Esq. Gary S. Vandeweghe is a senior partner of Rankin, Oneal, Center, Luckhardt & Lund, a law office based in San Jose, California (Dec. 18, 1989).

will act objectively because he has no direct personal or financial interest is tantamount to assuming that an executive, who has secured the benefits of a golden parachute agreement, will undoubtedly act in the best interest of the corporation, since his loyalty is untainted by any measurable conflict of interest.

Congress may have anticipated this lack of objectivity surrounding golden parachutes when enacting the relevant section of the Deficit Reduction Act of 1984. Congress was concerned that the existence of golden parachute agreements may actually encourage key executives to support takeovers not in the best interest of the corporation and shareholders in order to take advantage of the parachute payments.¹⁸⁸ Congress consequently determined that some of these arrangements should be strongly discouraged.¹⁸⁹ Specifically, very large golden parachutes should be discouraged since that are more likely to encourage illegitimate behavior.

When disinterested corporate directors adopt golden parachute agreements, they usually justify them with the traditional yet unverified arguments of those who favor their use. However, by applying the business judgment rule in this situation the decisions of these corporate directors are sheltered from any substantial scrutiny by the courts. In fact, the burden of proof is so great as to make a suit against these directors nearly impossible. In essence, courts have given corporate directors the red carpet treatment regarding most of their decisions. One must go as far as to show bad faith or fraud in order to overturn a board's decision. Congress' solution is to impose adverse tax consequences to discourage the use of certain golden parachute agreements. The courts, on the other hand, have done nothing to discourage their use.

The business judgment rule was developed with a legitimate concern in mind. Directors *should* be protected from liability when their good faith decisions turn out to be wrong. This comment is not meant to dispute that proposition. But golden parachute agreements present a new realm of controversial issues, which the business judgment rule is unequipped to handle. The adoption of golden parachutes by corporate directors presents conflicts of interest and self-dealing issues

188. See JOINT COMMITTEE, *supra* note 47, at 199.

189. See JOINT COMMITTEE, *supra* note 47, at 199-200.

that are complex and subjective. Generally, the business judgment rule is appropriate since the board's decisions do not necessarily have an impact on the individual directors. As such, we assume the decisions are made in good faith. But in the case of golden parachute agreements, the individual directors may be impacted personally and politically. As a result, courts should not defer to a board's decisions so quickly. Rules must be developed in order to provide both corporate directors and the courts with clear guidelines for the adoption of golden parachutes.

IV. PROPOSAL.

The first obstacle to the application of the business judgment rule, presented by the *International Ins. Co.* court,¹⁹⁰ is practical, effective and does not need to be changed. The second obstacle, however, is flawed and must be modified.¹⁹¹ The second obstacle provides that the compensation plan shall be voidable if it only serves the personal interest of the directors that approve it.¹⁹² In order to avoid being classified as corporate waste, the board must show good faith and adequate consideration to the corporation.¹⁹³ The obstacle is flawed only with respect to the two exceptions to this rule. These exceptions are when a disinterested board or a majority of the shareholders approve the plan,¹⁹⁴ and when a board passes or adopts a plan upon the recommendation of a committee of disinterested directors.¹⁹⁵ These exceptions provide evidence that the adoption was disinterested and therefore subject to the business judgment rule.¹⁹⁶ These exceptions should be dismissed. As previously discussed, it is not clear when a director is "interested" or "disinterested" since immediate financial gain is only one of many ways in which a director may have a

190. The first obstacle concerns the use of golden parachutes as a defense tactic to an unwanted takeover. See *supra* notes 7, 29 & 30, and notes 110 & 113-22 and accompanying text.

191. The second obstacle concerns self dealings by corporate director with respect to golden parachutes. See *supra* notes 111-12 & 123-29 and accompanying text.

192. See *supra* note 123 and accompanying text.

193. See *supra* note 124 and accompanying text.

194. See *supra* note 126 and accompanying text.

195. See *supra* note 127 and accompanying text.

196. See *supra* note 128 and accompanying text.

personal stake in the decision. The two exceptions ignore the reality of the situation and assume objectivity where there may be none.

The second obstacle, as modified, should state, "If the compensation plan is such that, *at the time it is adopted*, it only serves the personal interest of the directors that approve it, the plan shall be voidable." It is enough that if a plaintiff can show that, at the time of its adoption, a golden parachute serves only the personal interests of the directors that approved it, then such golden parachute agreements should be voidable. The burden of proof, in this case, is quite enough since any benefit conferred upon the corporation would be enough to overcome the obstacle and move on to the general rule.

Generally though, the business judgment rule is not the proper instrument by which to measure the propriety of golden parachute agreements, since the rule provides insufficient protection against conflicts of interest and self-dealing by directors and officers. In fact, the benefits conferred upon corporations by golden parachutes scarcely justify their use to any extent. The strongest argument supporting these compensation agreements, which is that they help to attract executives from other companies and retain key corporate executives that are already employed, is tantamount to supporting bribery. Loyal and reliable executives should be sufficiently compensated in the first place. Thus far, the courts have refused to face the real issues behind the use of golden parachutes, and consequently have adopted an ineffective approach which perpetuates the problem of unjustified benefits to corporate executives at the expense of the shareholder.

In order to solve the problems resulting from the adoption of golden parachute agreements, the judiciary or state legislatures should develop clear guidelines regarding their disposition. The following is an example of such guidelines through legislation:

- (a) As used in this section, "golden parachute" shall mean any agreement which provides a corporate employee with compensation, whether monetary or otherwise, by lump-sum or installment, upon termination of employment following a change of control.¹⁹⁷

197. The rule would have to contain additional definitions regarding the mea-

(b) Subject to provisions of subsection (c), corporate directors shall not be held liable for the adoption of a golden parachute when such director believes the golden parachute to be in the best interest of the corporation and has exercised such care, including reasonable inquiry, as an ordinary prudent person in a like position would under similar circumstances.¹⁹⁸

(c) The following *rebuttable* presumptions, affecting the burden of proof, shall be used to determine whether a golden parachute was adopted by a director in the best interest of the corporation:

(1) The decision to make payments pursuant to a golden parachute which amount to less than or equal to double the recipient's annualized salary, are presumed to be made in the best interest of the corporation.

(2) The decision to make payments pursuant to a golden parachute which amount to more than double the recipient's annualized salary, are presumed *not* to be made in the best interest of the corporation.

(d) Golden parachutes are voidable when a court of law of this jurisdiction holds that such golden parachute was not adopted in the best interest of the corporation for which the board sits.

(e) Directors, who vote to adopt a golden parachute subsequently held, by a court of law of this jurisdiction, not to have been adopted in the best interest of the corporation for which the board sits, are liable to the corporation for the losses resulting from such adoption.

V. CONCLUSION

Congress has suggested that the use of golden parachutes should be "strongly discouraged" in order to prevent the abuses which can develop as a result of their use. In an effort to remain entrenched, management may seek to discourage a takeover by bidding up the cost of such a takeover by way of a golden parachute agreement. In addition, some fear that exec-

sure of compensation with respect to time (present value), termination of employment, and change of control. Some of these provisions are described in the preceding text of this comment. See *supra* notes 7-15 and accompanying text.

198. This section should be expanded as necessary to include any additional parts of the business judgment rule that are relevant to corporate decision making (e.g., reliance on certain unbiased individuals for information necessary for an educated decision).

utives may take advantage of a golden parachute agreement by favoring takeovers that do not serve the best interest of the corporation and its shareholders.

The court's solution is the application of the business judgment rule following a preliminary inquiry into the purpose for adoption of the golden parachute. But as this comment has pointed out, the court's solution is flawed. Not only has the court given outside directors the red carpet treatment through a meager line of scrutiny, but it has failed to consider the human element, that is, the fact that there is no guarantee that inside directors will act as is anticipated following the adoption of the golden parachute.

The fact that these golden parachutes remain a common practice does not justify their use to any degree. Apparently the courts have disregarded a perpetual wrong, despite Congress' strong discouragement of the use of these golden parachutes. Congress graciously paved the road that the court chose not to follow. Not only did a federal court fail to follow such a path, but essentially the court condoned the use of golden parachutes for the future.

Golden parachute agreements are, in most cases, no more than an unjustified financial drain on the shareholders' equity, and they have no place in corporations. They reflect an abuse of power by those who are supposed to represent the best interests of the corporate shareholders, and only with clearly established guidelines can this abuse of power be controlled. The proposed legislation, set forth above, is a viable solution to the problems inherent in golden parachute agreements. By shifting the burden of proof and challenging the judgment of corporate directors with respect to golden parachutes, the abuse will subside. The present method of deference given corporate directors in this area is offensive and this scrutiny must be modified.

Mark A. Heyl

