

Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review

“Golden parachutes” are special termination agreements that shelter executives from the effects of a corporate takeover.¹ Typically, golden parachutes are “triggered” by a change in control of the corporation.² Once operative, they provide executives who are dismissed or who, under certain circumstances, resign as a result of a takeover with either continued compensation for a specified period following the executives’ departure or with a lump-sum payment.³

Although relatively new,⁴ golden parachutes are rapidly becoming commonplace.⁵ Notwithstanding the recent popularity of golden parachutes, however, their legality and desirability as a form of executive compensation have been challenged by many who believe that golden parachutes are nothing more than corporate looting. Stockholders have mounted court challenges but have not yet obtained any definitive decision on the merits;⁶

1. For a more detailed description of golden parachutes, see R. WINTER, M. STUMPF & G. HAWKINS, *SHARK REPELLENTS AND GOLDEN PARACHUTES* 425-28 (1983) [hereinafter cited as R. WINTER]; see also *infra* pp. 910-12.

2. Definitions of the “change of control” that triggers a golden parachute or makes operative the change-of-control provisions of a regular employment contract fall into two basic categories: those defining a change in the company’s status (often called change-of-control clauses), and those defining a change in the protected executive’s status (often called termination clauses). These two types of triggering mechanisms often are used in combination. Ward Howell International, Inc., *Survey of Employment Contracts and “Golden Parachutes” Among the Fortune 1,000*, at 2, 3 (Dec. 29, 1983) (on file with the *Yale Law Journal*) [hereinafter cited as Ward Howell Survey].

3. According to Ward Howell’s survey of Fortune 1,000 companies using golden parachutes, 44.8% offered golden parachutes consisting of lump-sum payments. There were no lump-sum payments at 46.2% of the companies, and at 9.1% payment form was not specified. Of the contracts providing lump-sum payments, 39% did so only if the company terminated the executive, while 21.8% did so simply if the executive left because of the change, including resignation as well as termination. Ward Howell Survey, *supra* note 2, at 4.

Compensation components of the golden parachutes surveyed typically included base salary (76.9% of contracts), bonus (53.8% of contracts), and stock option acceleration (39.2% of contracts). Lump-sum payments were usually some multiple of a year’s compensation. At 11.9% of the companies, compensation was not measured in years of pay because it consisted only of bonuses or of stock options. *Id.*

4. Until recently, only a few management compensation contracts contained the takeover clauses characteristic of golden parachutes. McLaughlin, *The Myth of the Golden Parachute*, *MERGERS & ACQUISITIONS*, Summer 1982, at 47.

5. At the beginning of 1984, 48% of the American corporations in the Fortune 1,000 protected their top officers with employment contracts, an increase of 20% over 1982. Of those employment contracts, 49% contained some change-of-control clause. At that time, 29% of all employment contracts contained specific change-of-control triggers and thus could be considered golden parachutes. Ward Howell Survey, *supra* note 2, at 1.

6. No case involving golden parachutes has dealt directly with their legality. See, e.g., *Schreiber v. Burlington Northern, Inc.*, 731 F.2d 163, 167 (3d Cir. 1984) (issue of whether management breached

Congress has attempted to tax golden parachutes out of existence;⁷ and the Securities and Exchange Commission has proposed legislation to limit the use of golden parachutes.⁸ In addition, a growing number of commentators question the legitimacy of compensating executives through golden parachutes.⁹

This Note proposes a standard of review for courts to apply in assessing the legality of specific golden parachutes. After briefly describing golden parachutes and their current legal status, the Note demonstrates that properly crafted golden parachutes can serve a legitimate economic function. Having defined that function, the Note discusses the controversy surrounding golden parachutes and argues that the evidence against golden parachutes is not sufficient to warrant a blanket prohibition of all such agreements. The Note then sets forth a standard which will allow courts to distinguish those golden parachutes that serve a legitimate economic function from those that are improperly drafted or wasteful.

I. BACKGROUND OF GOLDEN PARACHUTES

A. Description

Most golden parachutes currently in effect have three key components: (1) a change-of-control clause, (2) a termination clause, and (3) a compensation clause.¹⁰ The change-of-control clause defines when the golden

fiduciary duty through use of golden parachutes found not properly before court); *Wolgin v. Simon*, 722 F.2d 389, 393 (8th Cir. 1983) (golden parachute issue avoided on procedural grounds); *Lewis v. Anderson*, 453 A.2d 474, 480 (Del. Ch. 1982) (case dismissed because plaintiff lacked standing).

7. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 67, 98 Stat. 494 (to be codified at I.R.C. §§ 280G, 4999), places strict limitations on the deductibility to corporations of golden parachute benefits and, under certain circumstances, imposes a 20% excise tax on the benefits received by the executive. The legislation clearly reflects Congress' belief that golden parachutes are not desirable. See H.R. REP. NO. 861, 98th Cong., 2d Sess. 849-54, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 751, 843-47. For a more detailed description of the provisions of the Act dealing with golden parachutes, see *infra* note 84.

8. If enacted, the SEC's proposed legislation would bar the implementation of golden parachutes during a tender offer. See H.R. 5698, 98th Cong., 2d Sess., 130 CONG. REC. 4,359 (1984).

9. See, e.g., Riger, *On Golden Parachutes—Ripcords or Ripoffs? Some Comments on Special Termination Agreements*, 3 PACE L. REV. 15 (1982); Note, *Golden Parachutes—Executive Compensation or Executive Overreaching*, 9 J. CORP. L. 346 (1984) [hereinafter cited as Note, *Executive Overreaching*]; Comment, *Golden Parachutes: A Perk That Boards Should Scrutinize Carefully*, 67 MARQ. L. REV. 293 (1984); Note, *Golden Parachute Agreements: Cushioning Executive Bailouts in the Wake of a Tender Offer*, 57 ST. JOHN'S L. REV. 516 (1983) [hereinafter cited as Note, *Cushioning Executives*]; Note, *Future Executive Bail Outs: Will Golden Parachutes Fill The American Business Skies?*, 14 TEX. TECH. L. REV. 615 (1983) [hereinafter cited as Note, *Bail Outs*]; Note, *Golden Parachutes: Executive Employment Contracts*, 40 WASH. & LEE L. REV. 1117 (1983) [hereinafter cited as Note, *Employment Contracts*].

10. For a summary of the common provisions contained in each of the three components of golden parachutes, see Profusek, *Executive Employment Contracts in the Takeover Context*, 6 CORP. L. REV. 99, 112-15 (1983); see also Ward Howell Survey, *supra* note 2, at 1-10 (describing common provisions).

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parachute becomes operative.¹¹ 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.¹² The termination clause defines when executives may terminate their employment contracts and receive their golden parachute payments once a change in control has occurred.¹³ The terms of such clauses vary widely;¹⁴ some require that the

11. Profusek, *supra* note 10, at 105-07.

12. The following is an example of a change-of-control clause that triggers a golden parachute if a specified amount of the corporation's outstanding securities is acquired by a single purchaser:

Provided that, without limitation, such a change in control shall be deemed to have occurred if and when any "person" (as that term is used in Sections 13(d) and 14(d)(2) of the Securities Exchange Act of 1934) becomes a beneficial owner directly or indirectly of securities of the Company representing 20% or more of the combined voting power of the Company's then outstanding securities.

R. WINTER, *supra* note 1, at 439 (quoting from Champion Int'l Corp., Form 10-K Report for year ended Dec. 31, 1980).

The provision below is an example of a change-of-control clause that triggers a golden parachute if there is a change in the composition of the corporation's board of directors:

The term control shall mean . . . any change in the composition of the Board of Directors of the Company resulting in a majority of the present directors of the Company not constituting a majority two years hence, *provided*, that in making such determination directors who were elected by, or on the recommendation of, such present majority, shall be excluded.

Id. at 440 (quoting from Mohasco Corp., Form 10-K Report for year ended Dec. 31, 1980).

Some change-of-control provisions combine the two approaches described above:

A Change in Control shall mean . . . the acquisition by any corporation or group of associated persons acting in concert, excluding affiliates, if any, of the Company as of the date hereof, of an aggregate of more than 25% of the outstanding shares of voting stock of the Company coupled with or followed by the election as directors of the Company of persons who were not directors at the time of such acquisition if such persons shall become a majority of the Board of Directors of the Company.

Id. at 441 (quoting from Kennametal Inc., Form 10-K Report for year ended June 30, 1981).

13. Profusek, *supra* note 10, at 107.

14. Below are three examples of termination clauses, each affording a different degree of protection to the executive:

Executive may, at his election and upon 90 days' prior written notice to the Company, terminate his employment in the event that (a) Executive shall in his absolute judgment determine that due to changed circumstances occurring on or after the Effective Date he is unable effectively to carry out his duties and responsibilities as contemplated hereby

R. WINTER, *supra* note 1, at 461 (quoting from Cleveland-Cliffs Iron Co., Form 10-K Report for year ended Dec. 31, 1981).

In the event that Employee should determine in good faith that his status or responsibilities with the Company has or have diminished subsequent to a Change in Control, and shall for that reason resign from his employment with the Company within two years after such Change in Control, Employee shall be entitled to receive all of the payments and enjoy all of the benefits specified in Section 2 hereof.

Id. (quoting from Union Commerce Corp., Form 10-K Report for year ended Dec. 31, 1981).

Without your express written consent, a change in your reporting responsibilities, titles or offices as in effect immediately prior to a Change in Control, or any removal of you from or any failure to re-elect you to any of such positions, except in connection with the termination of your employment for Cause, Disability or Retirement or as a result of your death or by you other than for Good Reason.

Id. at 462 (quoting from Martin Marietta Corp., Schedule 14D-9, filed Aug. 1982). Other clauses contain provisions allowing executives to terminate their employment if they are required to move from their current employment location or if their salary or benefits are substantially reduced. *See id.* at 462-63.

executive actually be dismissed, while others give the executive an unconditional right to terminate employment after a takeover has occurred. The compensation clause provides executives with a lump-sum payment or a continuation of base salary and benefits for a specified period.¹⁵ These payments are intended to compensate executives for displacement losses.¹⁶

B. *Current Legal Status*

Most commentators agree that the "business judgment rule" of current corporation law applies to golden parachutes.¹⁷ In general, the business judgment rule requires that courts defer to the good faith business judgment of the board of directors.¹⁸ The rule is based on a belief that judicial deference to board decisions is necessary to encourage boards to take risks and exercise their best judgment; risk-taking and sound judgment may be impaired, it is felt, if boards fear their decisions might be second-guessed

15. Profusek, *supra* note 10, at 108.

16. The displacement losses suffered by executives include the loss of the power and prestige that are incidental to running a company, as well as the loss of salary executives incur while searching for new jobs. Since it is impossible to replace directly the power and prestige displaced executives lose, golden parachutes typically provide pecuniary payments in excess of the loss in salary an executive is likely to experience. The following is a typical golden parachute compensation clause:

The Corporation will promptly pay you upon your request as termination compensation in a lump sum amount . . . equal to two times the highest annual base salary (not including bonuses under the Corporation's Incentive Compensation Plan) paid or payable by the Corporation to you for the three calendar years ending with the year of such termination, except that in the event there are fewer than 24 months remaining from the date of such termination to your normal retirement date, the lump sum compensation shall equal such highest annual base salary times the fraction the numerator of which is the number of months so remaining to your normal retirement date and the denominator of which is 12.

R. WINTER, *supra* note 1, at 468 (quoting from Phelps Dodge Corporation, Form 10-Q Report for quarter ended June 30, 1981).

17. One commentator has noted that "it appears likely the courts will (and should) follow the usual business judgment rule with regard to golden parachute contracts." Herzel, *Golden Parachute Contracts: Analysis*, NAT'L L.J., Feb. 15, 1982, at 20, 23. See also Profusek, *supra* note 10, at 103 (suggesting that business judgment rule applies); Note, *Executive Overreaching*, *supra* note 9, at 348 (same); Comment, *supra* note 9, at 311 (same); Note, *Cushioning Executives*, *supra* note 9, at 530 (same); Note, *Bail Outs*, *supra* note 9, at 624 (same). But see Riger, *supra* note 9, at 35-39 (arguing that a fairness standard should apply).

18. In *Panther v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981), the court described the business judgment rule as follows:

[d]irectors of corporations discharge their fiduciary duties when in good faith they exercise business judgment in making decisions regarding the corporation. When they act in good faith, they enjoy a presumption of sound business judgment, reposed in them as directors, which courts will not disturb if any rational business purpose can be attributed to their decisions. In the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors.

Id. at 293 (quoting lower court opinion at 486 F. Supp. 1168, 1194 (N.D. Ill. 1980) (citations omitted)). See also 3A W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1039 (M. Wolf rev. ed. 1975) (discussing business judgment rule); H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* 661 (3d ed. 1983) (same).

by the courts, which normally have the benefit of hindsight but only limited business experience.¹⁹ This policy of judicial deference gives boards of directors broad discretion in making corporate decisions.²⁰ Consequently, the majority of existing golden parachutes will probably pass judicial scrutiny if challenged,²¹ although insufficient case law currently exists to corroborate this assertion.²²

Commentators who dispute the legality of golden parachutes argue that these agreements are not supported by adequate consideration.²³ They assert that the ostensible benefits of golden parachutes, such as management objectivity toward takeover attempts and the attraction and retention of quality executives, do not provide adequate consideration for the large payments that golden parachutes typically award displaced executives.²⁴ The assertion, however, stems from a lack of understanding of the economic function golden parachutes serve.²⁵ As discussed below, golden

19. See, e.g., *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 183, 237 N.E.2d 776, 781 (1968). Judicial deference under the business judgment rule to board decisions concerning executive compensation and, in particular, the implementation of golden parachutes has been criticized by many who believe that boards are incapable of making objective decisions concerning executive compensation. See, e.g., M. MACE, *DIRECTORS: MYTH AND REALITY* 108 (1971) (directors not likely to "rock the boat"); Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 610–22 (1982); Moscow, *The Independent Director*, 28 BUS. LAW. 9, 11 (1972); Loomis, *The Madness of Executive Compensation*, FORTUNE, July 12, 1982, at 42:

It is widely believed that many compensation committees are rubber stamps, unwilling to be hard-nosed about the pay of top executives, particularly those chaps who are fellow members of the board. Any reader of this article can imagine what his own attitude would be if he were required to sit in semi-public judgment on the salaries of his peers, some of whom were good friends. He would likely avoid harsh judgments and, in the end, be generous to a fault, particularly if he had the privilege of using money not his own.

Id. at 45.

Many commentators believe that boards are not impartial because they are dominated by officers of the corporation. See, e.g., Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 376–84 (1975) (because of time constraints, information constraints, composition, selection, and tenure, boards of directors seldom exercise much control over or have significant influence on officers of corporation); W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 173 (5th ed. 1980); J. JURAN & J. LOUDEN, *THE CORPORATE DIRECTOR* 287–89 (1966). This lack of board independence, it is argued, leads to a situation different from that contemplated by the business judgment rule, which assumes that directors are making impartial, good faith business decisions free from the influence of parties with vested interests. These criticisms have led to proposals ranging from the adoption of a stricter judicial standard of review, see, e.g., Note, *Cushioning Executives*, *supra* note 9, at 535–41 (suggesting use of fairness standard), to discussions over the possible need for federal legislation, see Moore, *Congress Takes Dim View of Golden Parachutes*, Legal Times of Wash., Oct. 25, 1982, at 5, col. 2.

20. See, e.g., *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 183, 237 N.E.2d 776, 781 (1968).

21. "[S]ince there are proper motives for these contracts [golden parachutes], courts are unlikely to substitute their own judgments for those of directors except in situations involving particularly inept or outrageous conduct." Herzog, *supra* note 17, at 23.

22. See *supra* note 6.

23. See, e.g., Riger, *supra* note 9, at 25–35.

24. *Id.*

25. Some commentators believe that golden parachutes serve no valid economic purpose. One critic of golden parachutes has stated that a golden parachute, "seen clearly, is no more than the self-serving effort by executives, with de facto control over position and pay, to preserve these in the face

parachutes are intended to compensate executives for their efforts by shifting to the corporation a risk that the executives would otherwise bear. The benefits that accrue to the corporation are incidental to this form of compensation, not the consideration given for it.²⁶

II. ECONOMIC FUNCTION OF GOLDEN PARACHUTES

The primary economic function of golden parachutes is to compensate executives through risk shifting. Because there are many other forms of compensation,²⁷ the mere fact that golden parachutes can be utilized to compensate executives does not in itself make them particularly useful. Compensating executives through the risk shifting facilitated by golden parachutes, however, serves additional economic functions that other forms of compensation cannot. The two most important functions are the reduction of agency costs and the attraction of executives to industries with high displacement risks. An understanding of the economic functions of golden parachutes will help courts assess the legality of specific golden parachute provisions.

A. Reducing Agency Costs

The importance of risk shifting, and thus of compensating executives through golden parachutes, stems from the concept of agency costs.²⁸ Since executives normally do not own the corporations they manage,²⁹ their interests may diverge from those of stockholders.³⁰ While investors can protect themselves from firm-specific risk through diversification,³¹ executives

of a takeover, with special benefits for themselves at corporate expense if the effort fails." *Id.* at 33.

26. Consider the following analogy: A corporation could compensate its executives by providing them with new clothing. One incidental benefit of such a form of compensation might be the enhanced appearance of the corporation's executives. This benefit would not, however, be the consideration given by the executives in return for the clothing. The consideration would be the effort exerted on behalf of the corporation by the executives. Similarly, the consideration given for golden parachutes is the effort of executives on behalf of the corporation. The incentives that golden parachutes arguably create are incidental benefits of using this form of executive compensation.

27. Forms of executive compensation include salary, insurance, stock options, percentage bonuses, and pensions. For a discussion of the compensation practices of corporations, see Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 247-51 (1983) (discussing studies of executive compensation).

28. The term "agency costs" was introduced in Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

29. The usual separation of ownership from control in modern corporations has long been a recognized fact. See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4-5, 66, 68 (1932).

30. Jensen & Meckling, *supra* note 28, at 308.

31. Investment returns are normally evaluated on the basis of risk and return. J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 15 (4th ed. 1977). Return is defined in terms of the cash returns expected during a given period. *Id.* at 20. Risk is a measure of the possibility that the actual returns over the period will differ from those which are expected. *Id.* at 15. Risk consists of two components: market risk (or changes in returns due to general market conditions) and firm-specific

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usually cannot.³² Executives may thus oppose a transaction that benefits the stockholders if the transaction is not personally beneficial.³³ For example, executives who believe that a successful takeover will lead to their replacement may engage in defensive tactics designed to thwart the takeover. Moreover, they may do so even if the takeover would be beneficial to the stockholders.³⁴ Defensive tactics range from relatively innocuous changes in the articles of incorporation to costly measures that can devastate the firm, such as selling off valuable assets or entering into undesirable contracts that are contingent on a change of control.³⁵ As a consequence of this possible divergence of interests, corporations incur agency costs, which include the costs of monitoring and restricting management behavior as well as the lost profits that result when executives fail to maximize profits.³⁶ According to neoclassical economic theory, corporations desire to minimize agency costs;³⁷ golden parachutes provide one means of achieving this corporate goal.

risks (changes in returns due to factors that are unique to the individual company). *Id.* at 61.

Since companies face different kinds of firm-specific risk, investors can eliminate these risks by diversifying, *i.e.*, holding the securities of many different companies. During a given period, some companies will do better than expected while others will do worse. By holding stock in many companies, investors will be less likely to experience substantial fluctuations in their expected returns as a consequence of the actual performance of any given firm, because the lower-than-expected returns of some firms will be offset by the higher-than-expected returns of others. R. BREALY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 119-21 (1981).

32. To diversify away the firm-specific risk associated with their investments of human capital in their employer, executives would have to spread their human capital around by working part-time for a number of different firms. Since this is practically impossible, executives are forced to bear the firm-specific risks associated with their investments.

33. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175 (1981).

34. *Id.* at 1174-75.

35. For a list and description of the more common defensive tactics, see 1 M. LIPTON & E. STEINBERGER, *TAKEOVERS AND FREEZEOUTS* 263-325 (1978). See also E. ARANOW, H. EINHORN, & G. BERLSTEIN, *DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL* 193-206 (1977) (describing various tactics used to thwart tender offers). A great deal has been written concerning the propriety of defensive tactics. See, e.g., Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Easterbrook & Fischel, *supra* note 33; Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lipton, *Takeover Bids in the Target's Boardroom: An Update after One Year*, 36 BUS. LAW. 1017 (1981); Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901 (1979); Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978); Wachtell, *Special Tender Offer Litigation Tactics*, 32 BUS. LAW. 1433 (1977); Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068 (1983).

36. See Jensen & Meckling, *supra* note 28, at 308; Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55, 66 (1979).

37. See Jensen & Meckling, *supra* note 28, at 308.

The emergence of golden parachutes is attributable to the increased incidence of corporate takeovers.³⁸ When a takeover occurs, it is commonplace for the senior executives of the firm to be replaced.³⁹ Consequently, the recent increase in the number and size of takeovers⁴⁰ has exposed executives to greater risk of displacement or frustration of career expectations.⁴¹ As a result, executive job security has declined, reducing the expected value of existing executive compensation packages.⁴² The reduction in the expected value of executive compensation creates disequilibrium: The value of executives' compensation packages falls while the value of executives' services remains constant.⁴³ Executives thus have an incentive to increase the expected value of their compensation by seeking employment elsewhere. Corporations can respond in one of three ways: (1) increase executives' immediate benefits or pecuniary compensation, (2) do nothing, or (3) shift the increased risk from the executives to the corporation by providing golden parachutes.

The risk-shifting nature of golden parachutes makes them the most reasonable of the above alternatives for dealing with the disequilibrium caused by increased takeover activity. Although increasing immediate benefits and pecuniary income compensates executives for diminished job security, this solution provides no incentive for managers to refrain from further reducing their risk of displacement by engaging in costly defensive

38. McLaughlin, *supra* note 4, at 47 (increased use of golden parachutes understandable in light of increase in merger activity); Morrison, *Compensation: Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982, at 82 (increased merger activity has resulted in more and more golden parachute clauses appearing in executive employment contracts); Moore, *Golden Parachute Agreements Shelter Displaced Executives*, Legal Times of Wash., Oct. 25, 1982, at 1, col. 1 (golden parachutes have prospered in era of hostile takeovers); Klein, *Controversial Perk: A Golden Parachute Protects Executives, But Does It Hinder or Foster Takeover?*, Wall St. J., Dec. 8, 1982, at 56, col. 1 (increased merger activity explains prevalence of golden parachutes).

39. Perham, *Surge in Executive Job Contracts*, DUN'S BUS. MONTHLY, Oct. 1981, at 87 (study showed 52% of target company executives either leave or are fired within three years after takeover). See also HAYES, HAYES/HILL INCORPORATED: STUDY OF EXECUTIVE EMPLOYMENT (1981) (42% of target management is all that remains five years after successful takeover); *Holding On in a Takeover*, BUS. WK., Sept. 27, 1982, at 118 (of 1300 executives who lost jobs during 18 month period ending August 31, 1982, 32% were displaced during or after change in control of their respective corporations).

40. In 1981, for example, there were 2,313 merger transactions with a total value of \$73 billion. *Merger Review*, MERGERS & ACQUISITIONS, Spring 1982, at 6. This was a record-breaking dollar amount. *Id.* Although the total number of takeovers per year is still below the numbers reached during the 1960's, the volume of hostile takeovers and the size of takeovers have increased. Note, *Employment Contracts*, *supra* note 9, at 1117 n.1.

41. See *supra* note 39.

42. The expected value of an executive compensation package is a function of the amount provided under the package and the certainty that the amount will be paid. If the certainty of payment is decreased while the amount to be paid remains constant, the overall value of the package will decline.

43. Equilibrium describes a situation in which opposing forces are balanced. In the case of executive employment, equilibrium exists when both the corporation and its executives give up something equal in worth to that which they receive in return. When the value of the compensation given executives decreases while the value of the executives' services remains constant, disequilibrium occurs. The self-interest of executives will create pressures for re-establishing equilibrium.

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tactics designed to thwart a takeover attempt. The second possibility, doing nothing, creates an incentive for executives either to seek other employment or to reduce displacement risk through defensive tactics. Providing golden parachutes, in contrast, shifts most of the displacement risk from the executives to the corporation, reducing executives' incentives to oppose takeovers that are beneficial to the corporation. Golden parachutes are therefore a useful means of reducing agency costs.

B. *Attracting Executives to Industries with High Displacement Risks*

Golden parachutes are also useful in providing long-term incentives for executives to enter industries in which the potential displacement losses from takeovers are above average,⁴⁴ although this is not their primary function. Absent golden parachutes or other protections, executives may hesitate to invest their human capital in corporations that require the acquisition of a great deal of firm-specific knowledge and experience, because such knowledge and experience cannot be transferred if the executives are displaced by a takeover. By shifting takeover risk to the corporation, golden parachutes enable firms that require their managers to become very specialized to attract talented executives.

The increased displacement risks that highly specialized executives bear obviously can be offset in a number of ways, including increases in immediate cash compensation. Golden parachutes, however, enable corporations to hold all other forms of compensation equal among executives while still compensating particular executives for increased displacement risk. This avoids the problems of devising a compensation system that all of the firm's executives will perceive as fair even though executives whose responsibilities and seniority are similar may be paid different amounts because some are more specialized than others. Moreover, using golden parachutes to shift the risks of specialization from executives to the corporation avoids a potential moral hazard: An executive who receives immediate compensation for bearing greater specialization risks may still try to avoid such risks by failing to become as specialized as would be optimal for the firm, even though the executive has already been compensated for so doing.

44. "Executives in specialized firms (monopolies or firms that are serving very special niches) are more apt to qualify for golden parachutes than those in competitively organized industries where experience in one firm easily transfers to another." Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1218 n.63 (1984).

In summary, the economic function of golden parachutes is to compensate executives through risk shifting and thereby to achieve other corporate goals, such as minimizing agency costs and attracting talented executives.⁴⁵ In some respects, golden parachutes are analogous to other forms of compensation which provide remuneration through risk shifting. For example, a company's accident insurance plan compensates employees by shifting the risk of loss that would otherwise be borne by the employees. The value of the compensation provided by the insurance is equal to the premium that employees would otherwise have to pay to receive similar protection from a third party. Similarly, an executive who is covered by a golden parachute receives compensation, whether or not her company is actually taken over, when each year the corporation in effect pays her annual takeover insurance premium. The value of this compensation is the amount the executive theoretically would have to pay in order to receive such insurance from another source.⁴⁶

III. THE CONTROVERSY SURROUNDING GOLDEN PARACHUTES

Despite the unique ability of golden parachutes to reduce agency costs through risk shifting, many commentators support legislative intervention or strict judicial review to limit severely the use of golden parachutes.⁴⁷ These commentators variously assert that golden parachutes (1) are ineffective in creating the executive objectivity⁴⁸ necessary to reduce agency

45. Some commentators have argued that an additional purpose of golden parachutes is to ward off undesirable takeover attempts. See Cooper, *The Spread of Golden Parachutes*, INSTITUTIONAL INVESTOR, Aug. 1982, at 65, 68; Klein, *supra* note 38, at 56, col. 1. They argue that golden parachutes reduce the likelihood that a corporation will be taken over by increasing the cost of such a takeover.

By requiring the corporation to compensate displaced or demoted executives for their losses, golden parachutes may in fact increase the cost of a takeover. With few exceptions, however, the cost of golden parachutes relative to the total cost of a takeover is very small—below one percent. Morrison, *Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982, at 86. It is, therefore, unlikely that golden parachutes are generally an efficacious means of avoiding a takeover. See *id.* Martin Lipton of Wachtell, Lipton, Rosen & Katz has opined that a corporation's implementation of a reasonable number of golden parachutes has "no deterrent effect whatsoever on takeover attempts." *Id.* Indeed, golden parachutes may actually encourage takeovers by reducing senior executives' opposition to them.

46. At least two companies now offer "tender offer defense expense insurance" to defray the costs target companies incur in resisting a takeover attempt. See Business Management Liability Insurance Committee, *Tender Offer Defense Insurance Policy*, 37 BUS. LAW. 243 (1981); Aronson, *Tender Offer Defense Expense Insurance*, BEST'S REV., June 1981, at 38; *Lloyd's Offers U.S. Concerns Insurance for Costs of Fighting Hostile Takeovers*, WALL ST. J., May 12, 1980, at 14, col. 2. Given the willingness of insurers to make the difficult actuarial determinations necessary to offer such insurance, it is possible that similar policies could be offered to protect executives from displacement losses. The primary obstacle would be writing the policy so as to avoid the moral hazards involved. Insurers would have to protect themselves from the possibility of an executive's taking out a policy after receiving inside information regarding a probable takeover.

47. See Riger, *supra* note 9, at 25-39; Note, *Executive Overreaching*, *supra* note 9, at 351-57; Comment, *supra* note 9, at 299-310; Note, *Employment Contracts*, *supra* note 9, at 1117-37; Note, *Bail Outs*, *supra* note 9, at 619-23.

48. "Executive objectivity" refers to a situation in which managers are able to evaluate the merits

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costs,⁴⁹ (2) may create perverse incentives and thereby actually increase agency costs,⁵⁰ (3) reduce the discipline over executives which the market for corporate control provides⁵¹ and (4) are not necessary to attract executives to firms.⁵² The opponents of golden parachutes have not, however, provided sufficient support for their assertions to warrant greatly restricting the use of golden parachutes. Indeed, a number of plausible arguments support the use of golden parachutes.

A. Effectiveness of Golden Parachutes

The most common criticism of golden parachutes is that golden parachutes are unlikely to compensate executives fully for displacement losses and, thus, will not reduce agency costs by removing the incentives for executives to engage in defensive tactics.⁵³ It is, however, highly probable that golden parachutes will compensate reasonably competent managers sufficiently to create executive objectivity. Because of the close relationship between executives and directors, executives often influence decisions concerning their own compensation. It is therefore unlikely that

of a takeover offer independent of its possible effect on themselves.

49. See, e.g., McLaughlin, *supra* note 4, at 48.

50. See, e.g., Note, *Bail Outs*, *supra* note 9, at 619-23.

51. See, e.g., Note, *Cushioning Executives*, *supra* note 9, at 541.

52. See, e.g., Riger, *supra* note 9, at 28-29.

53. See Morrison, *supra* note 38, at 86; Cooper, *supra* note 45, at 68. It is argued that the loss of prestige and power resulting from a takeover cannot be compensated adequately through pecuniary payments and, therefore, that golden parachutes will not compensate displacement losses sufficiently to create executive objectivity.

Possibly the most infamous takeover struggle in which executive objectivity was perhaps lacking despite the existence of golden parachutes is a 1982 takeover attempt involving Bendix, Martin Marietta, Allied Corporation, and United Technologies. When Bendix attempted to buy a control block of Martin Marietta's stock, Martin Marietta teamed up with United Technologies and attempted a "Pac-Man" defense by making a tender offer to acquire Bendix. Allied then came to Bendix's rescue by acquiring Bendix. Despite the fact that Martin Marietta's executives were given golden parachutes, the executives vigorously fought off Bendix's takeover attempt. As a result of borrowing to finance purchases of Bendix's stock, Martin Marietta's debt was increased, thereby lowering its book value, increasing its debt leverage and reducing its bond rating. In response to Martin Marietta's Pac-Man defense, Bendix adopted golden parachutes covering 16 officers, including one golden parachute which guaranteed Bendix's Chief Executive Officer, William Agee, \$805,000 per year for five years to be paid regardless of whether Agee was terminated after a takeover. Bendix justified these golden parachutes as being necessary to ensure unbiased decisionmaking. William Agee has reportedly since stated, however, that he would not have done anything differently had he not had a golden parachute. Morrison, *supra* note 38, at 84; see also Tuab, *Haste Maketh Waste*, FINANCIAL WORLD, Dec. 1-15, 1982, at 17; Holusha, *Bendix Chief Playing for High Stakes*, N.Y. Times, Sept. 10, 1982, at 1, col. 3; *Bendix Provides Salary Guarantees for 16 Officers*, Wall St. J., Sept. 10, 1982, at 2, col. 2.

Commentators point to takeover attempts such as the Bendix example to support the argument that golden parachutes do not create executive objectivity. See, e.g., Morrison, *supra* note 38, at 84. As in the Bendix case, however, most of the examples used involve takeovers in which the golden parachutes given the executives were not implemented until the executives had already begun to oppose the takeover. Rather than serving as risk-shifting devices to create objectivity, these golden parachutes most likely were intended to serve as safety precautions against the possibility that the recalcitrant executives' takeover defenses would fail. Thus, these examples are not persuasive in predicting how executives who are given golden parachutes prior to a takeover attempt will respond to the attempt. For an

corporations will adopt golden parachutes that the executives view as inadequate and that are, consequently, ineffective.

Moreover, even if some golden parachutes do not fully compensate executives, they probably provide sufficient compensation to prevent executives from engaging in the more damaging defensive tactics, such as selling major assets and entering into undesirable contracts.⁵⁴ Executives who are compensated for most of their displacement losses probably will not be willing to risk their reputations by taking such drastic actions.⁵⁵ By contrast, executives who have no golden parachutes will be more likely to risk their reputations by opposing a desirable takeover, because the executives stand to lose more if the takeover attempt is successful.

B. Possible Adverse Effects of Golden Parachutes

Other critics of golden parachutes have argued that the problem with golden parachutes is not that they provide insufficient compensation to create executive objectivity, but that they provide excessive compensation and thereby increase agency costs by creating perverse incentives.⁵⁶ These critics apparently believe that the close relationship between directors and executives gives executives an opportunity to engage in self-dealing by demanding excessive golden parachutes.⁵⁷ The close relationship between executives and directors, however, taints all board decisions concerning executive compensation and has no special significance in the golden parachute context. Golden parachutes are merely one form of compensation for which executives bargain. There is no reason to believe that, under normal circumstances, an executive will bargain for an excessive golden parachute, choosing to forego more immediate forms of income.

argument that the implementation of golden parachutes once a takeover has begun should be forbidden, see *infra* note 58.

54. The defensive tactics used by Brunswick Corporation to oppose a takeover attempt by Whittaker Corporation illustrate the high costs of the more abusive types of defensive tactics. In early January 1982, Whittaker tried to acquire Brunswick by making a hostile tender offer for Brunswick's stock. The motive for the takeover attempt was to gain control of a medical unit owned by Brunswick. In response to the tender offer, Brunswick's management rejected Whittaker's \$26.50-per-share offer and sold the medical unit to a third party, making Brunswick less attractive to Whittaker. The sale of one of Brunswick's valuable assets to avoid a takeover, however, was not without its costs. When the dust settled, Brunswick's stock was selling for half the price of the original tender offer. Morrison, *supra* note 38, at 84.

55. An executive's reputation, like any other asset which increases his marketability, has economic value. An executive will choose not to engage in self-dealing if doing so will decrease the value of his reputation by more than the return he expects the self-dealing to yield. Consequently, when an executive has little to gain from engaging in undesirable defensive tactics and a great deal to lose if the tactics affect his reputation, the executive can be expected not to engage in defensive tactics. The opposite is also true. For a persuasive analysis in another context of the economic value of a reputation for honesty, see Nelson, *The Economics of Honest Trade Practices*, 24 J. INDUS. ECON. 281 (1976).

56. See, e.g., Note, *Bail Outs*, *supra* note 9, at 621.

57. See *id.*

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There is, however, one special circumstance in which managers may desire to bargain for an excessive golden parachute: When a takeover is imminent, executives may try to receive all their compensation in the form of a golden parachute. Fortunately, this possibility may soon be eliminated. Congress currently is considering an SEC proposal to bar the implementation of golden parachutes during a tender offer.⁵⁸ Moreover, by adopting the standard of review proposed later in this Note, courts can easily prevent this kind of behavior.

C. *Effect of Golden Parachutes on Market Discipline of Executives*

Many commentators believe that the threat of a takeover gives executives an incentive to maximize stock prices and, consequently, shareholder wealth.⁵⁹ Opponents of golden parachutes argue that golden parachutes reduce this incentive by making takeovers more expensive—and therefore less likely—and by sheltering executives from their consequences.⁶⁰ If this argument were correct, golden parachutes could actually increase agency costs by eliminating a form of market discipline that tends to reduce agency costs. In fact, however, the relative cost of golden parachutes compared to the total cost of a takeover is low (below one percent) in most cases and is unlikely to thwart an otherwise desirable takeover.⁶¹ Indeed, since golden parachutes reduce executives' incentives to engage in costly defensive tactics,⁶² golden parachutes actually may reduce takeover costs.

Moreover, as long as golden parachutes provide compensation only for the losses that conscientious executives are likely to incur as a result of displacement, they will not undermine the market's tendency to discipline slothful or dishonest executives. The market for corporate control is a

58. See *supra* note 8. Prohibiting the implementation of golden parachutes during a takeover is probably desirable. During a takeover, executives will have significant bargaining power to demand excessive golden parachutes in return for not opposing the transaction. Moreover, since both the executives and the directors probably will soon be replaced, they will have little concern over how the stockholders may react to the golden parachutes. Finally, the golden parachutes will probably be of diminished value in creating executive objectivity, since the executives already will have taken an initial position on the takeover when the golden parachutes are adopted and may not be able to modify their position easily. Prohibiting the implementation of golden parachutes during takeovers creates an incentive for corporations to adopt golden parachutes prior to a takeover, thereby avoiding the above-mentioned problems.

59. See, e.g., Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965). Manne argues that the market for corporate control provides incentives for executives to maximize profits and asserts that executive inefficiency is reflected in stock prices. Thus, if an executive does not act in the best interest of the stockholders, the stock price will fall, making the firm a more attractive takeover prospect. Since executives are often displaced by a takeover, they will have an incentive to maximize stock price to avoid such an event. *Id.* See also Easterbrook & Fischel, *supra* note 33, at 1168-74; Fischel, *supra* note 35, at 5-7; Gilson, *supra* note 35, at 841-45; Note, *Cushioning Executives*, *supra* note 9, at 541-42.

60. See, e.g., Note, *Cushioning Executives*, *supra* note 9, at 541-42.

61. See *supra* note 45.

62. See *supra* pp. 914-17.

crude means of disciplining managers. In large firms, where golden parachutes are most prevalent, only the most outrageous self-dealing or inefficiency will have an impact on share price.⁶³ Executives who engage in such activity will undoubtedly experience displacement losses exceeding the compensation provided by golden parachutes: The effects of such behavior on the executives' reputations will make finding similar employment more difficult.⁶⁴

D. *Need for Golden Parachutes*

Opponents of golden parachutes also argue that such agreements are unnecessary to attract and retain quality executives.⁶⁵ Golden parachutes are certainly unnecessary in the sense that other forms of compensation could be substituted to attract and retain executives. This does not prove, however, that golden parachutes are without merit. As discussed above, golden parachutes may be superior to other forms of compensation if they simultaneously reduce agency costs and increase executive job security. Unless opponents of golden parachutes can show that elimination of these agreements would not be offset by increased compensation in other forms, they cannot argue persuasively that golden parachutes are not useful in attracting and retaining executives.⁶⁶

IV. A SUGGESTED APPROACH TO REVIEWING GOLDEN PARACHUTES

The controversy concerning the desirability and effectiveness of golden parachutes is by no means settled. The most common attacks on golden parachutes are not entirely convincing, and reasonable arguments support

63. In a multi-million dollar corporation, an executive can engage in self-dealing that costs the company tens of thousands of dollars without noticeably affecting share price. Moreover, in many cases, the transaction costs of taking over a company will exceed the costs of executive self-dealing, making a takeover attempt unprofitable and therefore unlikely. See Vagts, *supra* note 27, at 239.

64. Since golden parachutes compensate only the displacement losses of competent executives, the increased losses suffered by incompetent or dishonest executives will not be compensated by golden parachutes. Therefore, incompetent or dishonest executives will not be able to escape market discipline through golden parachutes.

65. See Cooper, *supra* note 45, at 68; Morrison, *supra* note 38, at 86; Riger, *supra* note 9, at 28-30.

66. It is reasonable to believe that the added compensation provided by golden parachutes is necessary to retain executives. The ease of entry and the substantial pool of talent should make the market for corporate executives a competitive one. Assuming that it is competitive, one would expect salaries not to exceed the amount required to attract executives. See Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Shavell, *supra* note 36.

The question concerning golden parachutes should not be "do they make executives act differently?" but rather "would executives demand other compensation to act the same if their golden parachutes were taken from them?" Joseph Flom, a merger and acquisition specialist with Skadden, Arps, Slate, Meagher & Flom, claims that golden parachutes "are so common that a management that refuses them might very well risk losing the services of a number of key employees." Morrison, *supra* note 38, at 83.

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the view that golden parachutes can be useful in reducing agency costs and attracting executives. It thus would be premature for courts to adopt a draconian standard of review that would severely limit the use of golden parachutes. Admittedly, golden parachutes are sometimes abused. The business judgment rule, however, provides a doctrinal basis for a two-tiered standard of review that could eliminate current abuses without unduly restricting corporations' ability to use golden parachutes.

A. *The Proper Standard of Review*

The business judgment rule requires that courts defer to boards' good faith decisions concerning management compensation packages.⁶⁷ When deciding whether a board has acted in good faith in determining executive compensation, courts typically require that the compensation bear a reasonable relationship to the services performed by the executive.⁶⁸ If the services provided by the executive are wholly unrelated to the compensation given, the board's decision will be invalidated as corporate waste.⁶⁹

Courts seldom invalidate compensation packages as being so excessive that they are not reasonably related to executives' efforts.⁷⁰ Rather, courts generally defer to board decisions concerning the overall level of executive compensation.⁷¹ Consequently, courts probably will not invalidate most compensation packages containing golden parachutes on the grounds that the compensation provided is excessive. Courts are, however, more critical of compensation plans that are *structured* so as not to be reasonably related to the executives' efforts. For example, courts have invalidated pension plans implemented when executives covered by the plans were near retirement.⁷²

By requiring courts to defer to board decisions involving executive compensation only when that compensation is reasonably related to executive efforts, the business judgment rule provides a doctrinal basis for invalidating wasteful golden parachutes. Desirable golden parachutes that serve as

67. See *supra* notes 18–19.

68. See, e.g., *Kerbs v. California Eastern Airways*, 33 Del. Ch. 69, 90 A.2d 652, 656–58 (1952); see also N. LATTIN, *LATTIN ON CORPORATIONS* 266 (2d ed. 1971) (discussing business judgment rule).

69. *Kerbs*, 90 A.2d at 652–58.

70. *But see* *Rogers v. Hill*, 289 U.S. 582, 591 (1933) (executive bonuses invalidated as excessive).

71. See, e.g., *McQuillen v. National Cash Register Co.*, 112 F.2d 877, 883–85 (4th Cir.), *cert. denied*, 311 U.S. 695 (1940); *Shlensky v. Wrigely*, 95 Ill. App. 2d 173, 183, 237 N.E.2d 776, 781 (1968); *Heller v. Boylan*, 29 N.Y.S.2d 653 (Sup. Ct.), *aff'd on rehearing*, 29 N.Y.S.2d 702, *aff'd*, 263 A.D. 815, 32 N.Y.S.2d 131 (N.Y. App. Div. 1941).

72. See *Fogelson v. American Woolen Co.*, 170 F.2d 660, 663 (2d Cir. 1948).

risk-shifting devices provide compensation that is reasonably related to executives' efforts. Such golden parachutes give executives continued protection from displacement losses as long as the executives perform their duties.⁷³ Correspondingly, abusive golden parachutes that go beyond risk shifting and give executives payments in excess of their displacement losses are not reasonably related to executives' efforts. Such payments are unearned bonuses that are contingent upon the occurrence of a takeover, an event which bears no logical relationship to the executives' efforts.⁷⁴ In short, risk-shifting golden parachutes satisfy the business judgment rule's "reasonable relationship" requirement while wasteful golden parachutes that go beyond risk shifting do not.

The above discussion suggests that courts should apply a two-tiered approach to determining the legality of compensation packages containing golden parachutes. Courts should first address the more traditional question associated with the business judgment rule: whether the entire compensation provided by the package is so excessive that it could not be reasonably related to the executives' efforts. Although courts will seldom invalidate golden parachutes on this basis,⁷⁵ the question must be addressed to ensure that what appear to be legally permissible golden parachutes are not being added to compensation plans that are already at the limit of reasonableness. If the total compensation is reasonable, courts must then determine whether the golden parachutes involved serve as risk-shifting devices and are, therefore, *structured* so as to relate reasonably to the efforts they are intended to compensate. This second level of inquiry provides the stronger weapon against abusive golden parachutes and is well within the bounds of permissible review under the business judgment rule.

73. As mentioned earlier, a golden parachute that shifts risk is similar to an employee accident insurance program. The value of the golden parachute is equal to the premium one would have to pay to purchase similar insurance. The compensation provided is related to the employee's efforts because the employee knows that if she fulfills her obligations she will then receive the insurance.

74. Golden parachutes that go beyond risk shifting are similar to an annual employee lottery through which a lucky employee receives additional "compensation" from the company. The additional compensation is not related to the employee's efforts. An employee can work diligently and receive all or nothing. *See generally* *Rogers v. Hill*, 289 U.S. 582, 591 (1933) (bonus payments that bear no relationship to value of services for which they are given constitute gift of corporate funds); 1 G. WASHINGTON & V. ROTHSCHILD, *COMPENSATING THE CORPORATE EXECUTIVE* 244 n.186 (3d ed. 1962) ("As to bonuses and similar retroactive increases of salary except where there has been an expressed or implied understanding that they may be granted if conditions warrant, there is no consideration for them.").

75. *See supra* notes 18-20.

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B. *Identifying Risk-Shifting Golden Parachutes*

In evaluating whether a golden parachute facilitates risk shifting, a court should examine both the components of the golden parachute and the extent of its coverage.

1. *Components*

As noted earlier, golden parachutes contain three key components: a change-of-control clause, a termination clause, and a compensation clause. Courts should scrutinize carefully each of these components to ensure that they facilitate risk shifting. The purpose of the change-of-control clause, which describes the circumstances under which a golden parachute becomes operative,⁷⁶ is to identify changes in the corporation that are likely to threaten an executive's career status.⁷⁷ The clause should thus identify as trigger events only those changes that could have such an effect. The difficulty in defining a change of control makes any guideline somewhat arbitrary,⁷⁸ but most golden parachutes require at least a twenty-percent stock acquisition or a change in a majority of the directors in order for them to become operative.⁷⁹ Courts should carefully scrutinize golden parachutes with change-of-control clauses that deviate significantly from these norms. If it appears that the golden parachutes can become operative in situations that obviously do not threaten the executives, the golden parachutes should be invalidated.

The termination clause specifies when an executive has suffered sufficient losses from a takeover to warrant allowing the executive to receive his or her golden parachute benefits and terminate employment with the corporation.⁸⁰ Because the purpose of golden parachutes is to protect executives from the adverse consequences of takeovers, golden parachutes that give managers an unconditional right of termination should be invalidated. The mere fact that the corporation has been taken over should not be a sufficient basis for an executive's terminating his or her employment and receiving golden parachute payments.⁸¹ On the other hand, because an

76. Profusek, *supra* note 10, at 105-07.

77. *Id.*

78. The actual percentage of stock one must hold in order effectively to control a corporation varies according to the circumstances. For example, in a firm with only a few shareholders, all of which are actively interested in how the firm is managed, one may need 51% of the firm's stock in order to control the corporation. W. CARY & M. EISENBERG, *supra* note 19, at 208-12. In contrast, in a large corporation with thousands of stockholders which are, for the most part, not interested in the general management of the firm, a person holding 10% of the corporation's stock may be able to exert considerable influence over the corporation. *Id.*

79. Ward Howell Survey, *supra* note 2, at 3.

80. Profusek, *supra* note 10, at 107.

81. Allowing executives the right to receive their golden parachute benefits and terminate their employment following a takeover which has not adversely affected the executives is inconsistent with

acquiring company can make life miserable for incumbent executives without actually dismissing them, golden parachutes that require executives only to make a good faith showing of a material, adverse change in their duties or conditions of employment should not be invalidated.

Since golden parachutes are intended to compensate executives for displacement losses,⁸² the compensation clause should reflect the expected magnitude of those losses. Boards should consider factors relevant to an executive's ability to gain new employment, such as age, transferability of skills, and labor-market conditions, when setting the level of compensation to be provided. If it is clear that no such evaluation was made, a court should consider invalidating the golden parachute. For example, a court should invalidate a golden parachute which provides an executive with continued compensation beyond the time the executive normally would have retired.

Because many displacement losses are subjective, it often will be difficult for courts to determine whether golden parachute payments are excessive. The only clear cases will be those involving golden parachutes that obviously reflect an attempt to provide compensation in excess of displacement losses. A number of recent developments will, however, help eliminate golden parachutes with excessive compensation clauses. Under the recently enacted Deficit Reduction Act,⁸³ golden parachutes that give executives payments greater than or equal to three times their total annual compensation are presumed excessive for tax purposes, resulting in the corporation's losing its deduction for the golden parachute payments as well as in the imposition of a twenty-percent excise tax on the beneficiaries of the payments.⁸⁴ The Act will not directly eliminate excessive golden parachute payments because it does not forbid payments of any

the view that golden parachutes compensate executives by shifting a risk of loss, because no loss need occur in order for the payments to be made.

When Morton-Norwich acquired Thiokol Corporation, a number of Thiokol executives terminated their employment and received golden parachute payments, although they apparently had not suffered significant displacement losses. Thiokol's President, Robert Davis, reportedly took his four-million dollar golden parachute because "it stuck in his craw not to be CEO." Other executives took their golden parachutes because they were nearing retirement or just did not want to work for Morton. Dorfman, *The Thiokol Defections*, *FORBES*, Mar. 28, 1983, at 110. Arguably, these golden parachutes went beyond risk shifting by having termination clauses that allowed the golden parachutes to become operative before their recipients suffered significant losses.

82. Profusek, *supra* note 10, at 108.

83. Pub. L. No. 98-369, § 67, 98 Stat. 494 (1984).

84. Under the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 67, 98 Stat. 494 (to be codified at I.R.C. §§ 280G, 4999), "excess parachute payments" paid or accrued are not deductible to the corporation. Furthermore, a non-deductible 20% excise tax is imposed on the beneficiary of the "excess parachute payments." The provision only applies to golden parachutes that provide payments equal to or in excess of three times the employee's base amount. The "base amount" is the employee's average annualized gross income from the corporation over the five-taxable-year period preceding the taxable year in which the change of ownership or control occurs. Special provisions apply if the

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magnitude.⁸⁵ Nevertheless, it is still likely to deter corporations from implementing golden parachutes that give benefits equal to or in excess of three years' compensation, particularly when courts are likely to scrutinize closely golden parachute payments which are deemed excessive under the tax laws. Because most golden parachutes give executives benefits equal to or less than their compensation for three years,⁸⁶ the new legislation will help eliminate the more serious abuses without severely restricting the use of golden parachutes. The increased disclosure of golden parachutes now required under the federal securities laws⁸⁷ will probably also serve as a significant check on the implementation of golden parachutes that provide unreasonably large benefits.⁸⁸ This is particularly likely given the hostile reaction that excessive golden parachutes have received in the press after their disclosure.⁸⁹

employee has worked less than five years. "Excess parachute payments" are those parachute payments that exceed the "base amount" and are not reasonable compensation for personal services actually rendered by the employee. It is presumed that no golden parachute payment is reasonable compensation for personal services actually rendered. The presumption may be rebutted only by clear and convincing evidence. See generally H.R. REP. NO. 861, 98th Cong., 2d Sess., 849-54, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 751, 843-47 (describing the new tax law pertaining to golden parachutes).

85. See *id.* While the prospect of losing substantially all of the corporation's tax deduction and causing a 20% excise tax to be imposed on a large portion of the golden parachute payments will deter some corporations from adopting excessive golden parachutes, it will not directly eliminate all such abuses. Because the legislation applies only to golden parachutes that provide benefits equal to or in excess of an amount equal to three times the executive's salary, many golden parachutes will not be affected. (In its survey of golden parachutes among executives of Fortune 1000 companies, Ward Howell found that 51.1% of golden parachutes provide payments equal to or less than three times the executives' annual salary. See Ward Howell Survey, *supra* note 2, at 4. Moreover, 25.9% of the golden parachutes reviewed had compensation provisions not expressed as a multiple of the executive's annual income and could therefore involve payments of less than three times the executive's annual income. *Id.*) More importantly, the provision makes no attempt to distinguish between golden parachutes that compensate through risk shifting and those that simply provide displaced executives with unearned bonuses. Finally, the legislation ignores the "final period problems" surrounding a takeover: If directors are willing to adopt golden parachutes that are harmful to the corporation, it is unclear that denying the corporation a deduction for these golden parachutes after a change of control occurs—and the directors are probably replaced—will discourage the directors from implementing the golden parachutes. Similarly, the 20% excise tax can be shifted from the executives to the acquiring corporation merely by increasing the golden parachute payments by the amount of the tax.

86. See Ward Howell Survey, *supra* note 2, at 4.

87. "Responding in part to the increasing use of 'golden parachute' arrangements and to the recommendation of its advisory committee on tender offers, the SEC, in new paragraph (e) of Item 402 of Regulation S-K, has expanded the language of old paragraph (i) of Item 402 specifically to require disclosure of plans or arrangements for additional compensation that will be triggered by a change of control of the issuer or a change in the executive's responsibilities as well as those triggered by termination of employment." Spencer & Olson, *Dissonant Chorus Greets SEC Proxy, Perk Rule Changes*, Legal Times of Wash., Nov. 7, 1983, at 13, col. 1.

88. As Justice Brandeis once wrote, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." L. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT* 92 (1914); see generally Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983) (discussing rationale for disclosure requirements).

89. See, e.g., "Golden Parachutes" for Ousted, New York Times, April 6, 1982, at L1, col. 2.

2. Coverage

In addition to reviewing the three common components of golden parachutes, a court should also review the list of employees in a corporation which are covered by golden parachutes. Golden parachutes are intended to compensate employees by shifting takeover risks from the employees to the corporation. Golden parachutes given to employees who are not subject to such risks are not compensatory and are therefore wasteful. Moreover, such golden parachutes do not fulfill the other economic functions—reduction of agency costs and encouragement of firm-specific specialization—that risk-shifting golden parachutes serve. Instead, they give employees an unexpected bonus in the event of a takeover.⁹⁰ Since lower-level executives and non-management employees are unlikely to suffer displacement losses as a result of a takeover, courts must carefully scrutinize golden parachutes that purport to compensate such employees through risk shifting.

CONCLUSION

The more notorious golden parachutes contain unconditional rights of termination or other clearly abusive terms. The approach proposed above, which is grounded in the business judgment rule, can eliminate such abuses. In addition, this two-tiered standard of review will not unduly impede the ability of corporations to reduce agency costs and attract executives through the use of reasonable golden parachutes.

—*Kenneth C. Johnsen*

90. In 1982, Beneficial Corporation provided 234 employees with golden parachutes. Morrison, *supra* note 38, at 86. It is doubtful that all of these employees would have suffered significant losses in the event of a takeover. It is even more questionable that providing these employees with golden parachutes reduced agency costs.