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# Golden Parachutes: Ripcords or Rip Offs, 20 J. Marshall L. Rev. 237 (1986)

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# COMMENTS

## GOLDEN PARACHUTES: RIPCORDS OR RIP OFFS?

Corporate executives haphazardly plummeting to unemployment lines, with compensation decreasing, and personal esteem diminishing, pull the ripcords of their "golden parachutes" and float to secure ground.[1] Golden parachutes[2]—those multi-million dollar bailouts that make corporate America's richest executives even richer when their companies are taken over—are under attack these days. A golden parachute is a special employment agreement between a corporation and its key executives.[3] Golden parachutes differ from traditional employment agreements because they become operative only when the control of a company changes hands.[4] If the

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1. The term "golden parachute" is intended to create an image of a corporate executive bailing out of a crashing airplane, pulling the ripcord of his parachute and landing safely in a pile of the corporation's money.

2. For a more in-depth description of golden parachutes, see R. WINTER, M. STUMPF AND G. HAWKINS, SHARK REPELLENTS AND GOLDEN PARACHUTES, 425-28, 910-12 (1983) [hereinafter cited as SHARK REPELLANTS].

3. *See* McLaughlin, *The Myth of the Golden Parachute: What Every Dealmaker Should Know*, 17 MERGERS & ACQUISITIONS 47 (1982) (corporations only offer golden parachutes to limited number of senior executives); Morrison, *Compensating: Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982, at 82, 86 (key executives are sole receivers of golden parachute employment agreements); Klein, *Controversial Perk: A Golden Parachute Protects Executives, But Does It Hinder or Foster Takeovers?*, Wall St. J., Dec. 8, 1982, at 56, col. 2 (typical golden parachute agreement covers one to six corporate executives); Ward Howell International, Inc., Survey of Employment Contracts and "Golden Parachutes" Among the Fortune 1,000 (Dec. 29, 1983) (on file with author) [hereinafter cited as Survey of Employment Contracts] (two to five executives in typical corporation protected by golden parachutes); *see also* Lewis v. Anderson, 453 A.2d 474, 480 (Del. Ch. 1982) (nine senior executives covered by Conoco's golden parachute); BENDIX CORP., NOTICE OF SPECIAL MEETING OF STOCKHOLDERS 14 (Dec. 14, 1982) (22 executives covered by Bendix's golden parachute); BENEFICIAL CORP., NOTICE OF ANNUAL MEETING OF STOCKHOLDERS 9 (April 30, 1982) (250 key executives offered golden parachute by Bendix); GULF RESOURCES & CHEMICAL CORP., FORM 10-Q: QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 8 (June 30, 1982) (21 key executives entered into golden parachutes with Gulf Resources in 1981); PENZOIL CO., FORM 10-Q; QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (Sept. 30, 1982) (11 Penzoil senior executives granted golden parachute employment contracts).

4. *See* Survey of Employment Contracts, *supra* note 3, at 3. An executive's golden parachute is triggered by a change of control in the corporation. The type of

acquiring corporation installs new management, then the outgoing executives must be paid lucrative severance packages.[5]

Shareholders call these golden parachutes a flagrant waste of corporate assets.[6] Shareholder groups have criticized them as both

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change of control necessary to trigger a golden parachute differs among agreements. *Id.*; McLaughlin, *supra* note 3, at 47. Definitions of change of control in golden parachutes include the following: a change in the directors comprising a majority of the board; the accumulation of a certain percentage of a corporation's stock by one party; the replacement of a top executive in the corporation; or the delisting of the company's stock from a major stock exchange. Survey of Employment Contracts, *supra* note 3, at 3; *see, e.g.*, Lewis v. Anderson, 453 A.2d 474, 480 (Del. Ch. 1982) (change of control under Conoco golden parachute defined as: 1) accumulation of 20% or more of Conoco stock by one party and 2) delisting of Conoco stock from New York Stock Exchange).

Corporations usually define in their proxy materials the exact circumstances that constitute a change of control sufficient to trigger the corporation's golden parachute employment contracts. Survey of Employment Contracts, *supra* note 3, at 6 annual notice to shareholders provides in part:

> For the purposes of the agreements, a "change in control" will be deemed to take place if, as a result of a tender offer or other acquisition of securities of the corporation, or a merger, consolidation, or sale of assets of the corporation, or any combination of these transactions (a "Transaction"), either (a) the persons who were Directors of the Corporation immediately before the Transaction cease to constitute a majority of the Board of Directors of the Corporation or (b) the employment of the person employed as Chief Executive Officer of the Corporation on the operative date terminates involuntarily (other than for cause). If within five years of the Transaction (1) such a change in Directors takes place during any twenty-four month period or (2) the Chief Executive Officer's employment so terminates, the change or termination will be deemed to result from the Transaction. In addition, the election at anytime of two or more Directors whose election is opposed by a majority of the Board then in office will be deemed, in itself to be a "change in control."

ACME-CLEVELAND CORPORATION, NOTICE OF ANNUAL MEETING OF SHAREHOLDERS (Dec. 23, 1982). Bendix Corporation's special notice to stockholders, on the other hand, provides in part:

> The agreements define change in control as (i) the acquisition by any person, directly or indirectly, of securities of Bendix representing 51% or more of the combined voting power of the then outstanding securities of Bendix or (ii) a change in the composition of a majority of the Board of Directors of Bendix within twelve months after any person acquires, directly or indirectly, securities of Bendix representing 25% of the combined voting power of the then outstanding securities of Bendix.

BENDIX CORPORATION, *supra* note 3, at 115. *See also* Profusek, *Executive Employment Contracts in the Takeover Context*, 6 CORP. L. REV. 99, 105-07 (1983) (examples of change in control provisions that trigger golden parachutes).

5. *See* Master, *Executives' 'Golden Parachutes' Await First Court Challenges*, Legal Times of Wash., Nov. 2, 1981, at 10, col. 1. (Golden parachutes of control do not affect an executive's salary or position; rather, they insure executives against risks incident to corporate takeovers). Accordingly, a golden parachute employment contract guarantees an executive's salary and benefits for a specified number of years following a change of control or stipulates a lump-sum payment to the executive in the event of dismissal or down-grading of the executive's position or responsibilities following a change of control. Survey of Employment Contracts, *supra* note 3, at 3.

6. *See* Lewis v. Anderson, 453 A.2d 474, 480 (Del. Ch. 1982) (Conoco shareholder brought suit contending that Conoco's golden parachutes were waste of corporate assets, illegal, fraudulent, and improper); Masters, *supra* note 5, at 10, col. 3 (golden parachutes approved on eve of takeover granting unconditional payments to

bad business and as illegal agreements. Management responds that the agreements are necessary to discourage takeovers and to preserve quality leadership. The government has become involved in this heated controversy. The Securities and Exchange Commission has passed legislation to limit their use[7] and Congress has attempted to tax unreasonable golden parachutes out of existence.[8]

Despite the frequent and varied assaults on golden parachutes, there has been no definitive ruling from the nation's judiciary on what is a justifiable parachute and what is not.[9] One court in Wisconsin[10] has restricted some uses of parachutes. This holding should be expanded and widely adopted to end the golden rip off.

The shareholder backlash and governmental attacks come at a time when executive parachutes fill the corporate skies.[11] They have refused to become extinct as some predicted. Despite dire predictions of their imminent demise the parachutes have proliferated.[12] Now, thirty-three percent of the 250 largest industrial corporations offer their executives such protection against a change in corporate

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executives can constitute corporate waste).

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

8. 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 a corporation's ability to deduct 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.

9. To date, no court has ruled on the legality of golden parachutes directly. *See, e.g.*, Schreiber v. Burlington Northern, Inc., 731 F.2d 163, 167 (3d Cir. 1984) (court found that issue of whether corporate management breached its fiduciary duty through use of golden parachutes was not properly before it); Wolgin v. Simon, 722 F.2d 389, 393 (8th Cir. 1983) (court precluded from addressing golden parachute issue on procedural grounds); Lewis v. Anderson, 453 A.2d 474, 480 (Del. Ch. 1982) (suit by dissident Conoco shareholder alleging that golden parachutes were illegal dismissed because plaintiff lacked standing). *But see* Koenings v. Joseph Schlitz Brewing Co., 368 N.W.2d 690 (Wis. 1984) (as matter of public policy, mitigation clause will be implied in every golden parachute contract).

10. Koenings v. Schlitz Brewing Co., 369 N.W.2d 690 (Wis., 1984).

11. *See* McLaughlin, *supra* note 3, at 47 (golden parachute agreements for senior executives are under consideration in one of every three public companies); Klein, *supra* note 3, at 56, col. 1 (golden parachutes are hottest new executive perk); Survey of Employment Contracts, *supra* note 3, at 1 (number of companies that protect top executives with employment contracts has increased over 1982; pure golden parachutes combined with contracts containing some kind of change of control clause are now included in forty-nine percent of all employment contracts - a fifteen percent rise from 1982); *see also* Morrison, *supra* note 3, at 82 (as result of increased merger activity more and more golden parachute clauses are appearing in executive employment contracts); Masters, *supra* note 5, at 10, col. 1 (prevalence of golden parachute employment contracts is increasing in proportion with increase in hostile takeovers).

12. *See supra* note 10.

control.[13]

This comment discusses the history and recent popularity of golden parachutes as a type of executive compensation. It then examines whether the business judgment rule, the law which governs executive compensation, should govern golden parachutes. Application of the business judgment rule to golden parachutes shows they are an arguably invalid form of compensation. Shareholder ratification and voting by disinterested directors are then briefly discussed. Additionally, the effectiveness of those safeguards against inherent conflict-of-interest that exists when one votes one's own salary will be examined. Examples of recently implemented golden parachutes will be used to highlight key points.

### *History of Golden Parachutes*

Golden parachutes are a popular newcomer to the panoply of perks available to corporate executives. Almost one-half of America's largest corporations offer golden parachutes to their key executives.[14] Their recent rise in popularity is attributable to a merger and acquisition frenzy which is sweeping the country. Since 1981, more than five thousand mergers and acquisitions have occurred.[15] Corporate executives are concerned about job security when their corporations are targets in pending takeovers. This is because a successful takeover by a raider usually displaces the preexisting management. Proponents of golden parachutes argue that they assure job security for key executives pursuant to a corporate takeover.

Golden parachute agreements yield guaranteed lucrative salaries and other varied benefits to a corporation's most valued executives.[16] The agreements become operative when a change in the con-

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13. *See* Survey of Employment Contracts, *supra* note 3, at 1. Ward Howell, Inc. surveyed the proxy statements of 665 Fortune 1,000 companies. *Id.* at 1-2. According to the survey, golden parachute clauses are becoming increasingly prevalent in executive employment contracts. *Id.* at 6, 9. The survey results reveal that golden parachute clauses appeared in 27% of the executive employment contracts dated 1979 or earlier, 37% of the 1980 contracts, 47% of the 1981 contracts, and 53% of the contracts examined in the first nine months of 1982. *Id.* at 6. The Ward Howell study attributes the growth in popularity of golden parachute agreements to the recent wave of unsolicited takeovers. *Id.* at 1, 2, 6, 9.

14. *See* Morrison, *supra* note 3, at 82 (executive recruiting firm, Ward Howell International, Inc., finding 15%; and survey by Pearl Meyer, an executive consultant at Handy Associates, a compensation consulting firm, finding 30%).

15. *Id.* at 82.

16. *See* Morrison, *supra* note 3, at 82 (survey and analysis of golden parachute contracts among Fortune 1,000 corporations). Fortune scrutinized the proxy statements of 155 companies that had adopted golden parachute employment contracts. *Id.* The Fortune survey revealed 15 corporations with golden parachute agreements that if triggered, would provide a departing chief executive with a severance package worth $2.5 million or more. *See id.* at 85 (Fortune estimates potential value of Ameri-

trol of a target corporation goes into effect. A change in control typically occurs when new management dismisses an executive, or when a raider acquires a major portion of a target corporation's stock.[17] A golden parachute purportedly serves a target corporation, discouraging hostile takeovers, and providing key executives with additional job security.

Management relies on state provisions similar to the Model Business Corporation Act (the "MBCA")[18] as authority allowing them to institute these guaranteed wage agreements. The MBCA empowers a corporation to "pay pensions and establish pension plans, pension trusts, profit-sharing plans, stock bonus plans, stock-option plans, and other incentive plans for any or all of its directors, officers, and employees."[19] Management contends that guaranteed wage agreements are permissible under the MBCA as "other incentive plans."

Management additionally relies on its common law power to establish incentive plans.[20] The courts have traditionally deferred to corporation judgment in the area of regular salaries paid to executives, as well as in the area of additional compensation, whether in the form of stock bonus plans,[21] stock-option plans,[22] or pension plans.[23] Viewed simply as another method of compensation, management argues the golden parachute is not significantly different from these traditional forms of compensation. They argue that the golden parachute is executive compensation and should be governed by the current body of law regarding compensation to corporate executives.

Corporate management asserts that golden parachutes serve three valid business purposes. First, they make management secure

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can Family Corp.'s chief executive officer's (CEO) golden parachute at $7.8 million, G.K. Technologie's CEO's golden parachute at $7.3 million, Conoco's CEO's golden parachute at $4.1 million, Thiakol's CEO's golden parachute at $4.0 million, Allied's CEO's golden parachute at $3.9 million, Penzoil's CEO's golden parachute at $3.7 million, American Medical International's CEO's golden parachute $3.1 million, Time Inc.'s CEO's golden parachute at $3.0 million, Celanese Corporation's CEO's golden parachute at $2.5 million).

17. Golden parachutes may be triggered in a variety of ways. Generally, they become effective when: 1) an executive leaves his job voluntarily after a takeover 2) or when an executive is terminated by new management. *See id.* at 85.

18. MODEL BUSINESS CORP. ACT § 4(o) (1969). The Act was developed by the Committee on Corporate Laws, which has been in existence for approximately 33 years. It has been adopted in substance by more than 25 states, and major portions have been adopted in several others. MODEL BUSINESS CORP. ACT PREFACE (1975).

19. MODEL BUS. CORP. ACT § 4(o) (emphasis added).

20. *See* Rogers v. Hill, 289 U.S. 582 (1933); Putnam v. Juvenile Shoe Corp., 307 Mo. 74, 269 S.W. 593 (1925).

21. Winkleman v. General Motors Corp., 44 F. Supp. 969 (S.D.N.Y. 1942); Comment, *Legal Aspects of Corporation Bonuses*, 41 MICH. L. REV. 501, 506 (1942).

22. Olson Bros. v. Englehart, 245 A.2d 166, 168-69 (Del. 1968).

23. *See, e.g.*, Murrel v. Elder-Beerman Stores Corp., 16 Ohio Misc. 1, 17, 239 N.E.2d 248, 256 (1968).

in their employment. Financial protection enables executives to negotiate with the shareholders' best interest at heart.[24] Executives can objectively weigh merger proposals without fear of jeopardizing their income. Second, these agreements aid in attracting, hiring and retaining key executives.[25] The prevalence of golden parachute agreements has increased so much that corporations that refuse to offer them may experience difficulty in hiring and retaining top management.[26] Third, the agreements operate as a defensive measure to a hostile takeover.[27] In corporate takeovers, the costs attend-

24. *See* McLaughlin, *supra* note 3, at 48 (some attorneys argue that golden parachutes take panic out of takeovers and give executives more objectivity in evaluating acquisition offers); Morrison, *supra* note 3, at 82 (golden parachutes provide executives with financial security necessary to strike best deal for corporate shareholders in takeover negotiations); Klein, *supra* note 3, at 56, col.1 (golden parachutes ensure that executives will weigh merger or acquisition proposals objectively without fear that change of control might jeopardize executive's income); Survey of Employment Contracts, *supra* note 3, at 2 (golden parachutes enable companies that may become targets to hire and retain top executive talent). *See also* ACME-CLEVELAND CORPORATION, *supra* note 4, at 10 (Acme-Cleveland entered into golden parachute agreements to retain senior executives and provide corporation with continuity of management in event of change of control). BENDIX CORPORATION, *supra* note 3, at 114 (one objective advanced in support of Bendix's golden parachutes was to ensure that senior Bendix officers would remain with Bendix during pendency of offers for control of Bendix).

25. *See supra* note 23.

26. *See* Profusek, *supra* note 17, at 99-112 (senior executives of target corporations may seek more secure career opportunities unless offered some form of employment security arrangement).

27. *See* Panter v. Marshall Field & Co., 646 F.2d 271, 288 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1982) (corporate management possesses not only right but duty to oppose corporate takeovers that are detrimental to corporation or corporation's shareholders); Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977) (management has duty to resist corporate takeovers that might harm corporation); Crouse-Hinds Co. v. Internorth, Inc., 518 F. Supp. 390, 408 (N.D.N.Y. 1980) (target corporation management can resist corporate takeover provided target management concludes, after reasonable deliberation, that corporate takeover is not in best interests of target corporation); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712-13 (N.D. Ill. 1969) (corporate management's responsibility is to oppose corporate takeovers that in management's best judgment are detrimental to corporation or corporate shareholders). *See also* Treadway Cas. v. Care Corp., 638 F.2d 357, 381 (2d Cir. 1980) (director's decision to oppose corporate takeover involves exercise of director's business judgment). Employment contracts that provide an executive with accelerated benefits in the event of a change of control in the executive's corporation constitute a defensive measure to a corporate takeover. *See* Anti-Takeover Proposals, S.E.C. Release No. 15,230 [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 81-748, at 80,984 (Oct. 13, 1978); BENDIX CORPORATION, *supra* note 3, at 15 (Bendix Corp.'s notice of special meeting of stockholders classified Bendix's golden parachute employment contract as antitakeover device). For a discussion of defensive measures to hostile takeovers, see also E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 219-76 (1973); E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENT IN TENDER OFFERS FOR CORPORATE CONTROL 193-206 (1977); Carey, *Corporate Devices Used to Insulate Management from Attack*, 25 BUS. LAW. 339-50 (1970); Panel, *Defending Target Companies*, 32 BUS. LAW 1349, 1349-64 (1977).

Whether golden parachute employment contracts actually deter corporate takeovers remains the subject of considerable debate. *See* Morrison, *supra* note 3, at 86 (plethora of golden parachutes may deter proposed takeover by making takeover

ant to golden parachute agreements accrue to surviving corporations.[28] Golden parachutes may therefore discourage corporate takeovers by increasing the costs of a proposed takeover.[29] Therefore, the issue to be addressed is whether these guaranteed wage agreements should be sustained in light of the justifications asserted, that is, whether such agreements provide adequate consideration to the corporation in exchange for their cost. In corporate transactions, the business judgment rule is the standard used to determine the adequacy of consideration.

### *Current Legal Status*

The same principle of law that governs other forms of executive compensation, the business judgment rule,[30] governs the validity of golden parachutes. Most legal scholars recognize that golden parachutes are within the purview of the business judgment rule.[31]

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more expensive for acquiring corporation); Klein, *supra* note 3, at 56, col. 2 (some companies advance golden parachutes as antitakeover measures); Masters, *supra* note 5, at 10, col. 3 (golden parachutes may discourage some corporate takeovers because certain golden parachutes provide valuable target corporation executives with incentive to leave acquired corporation and acquiring firm may not desire target corporation without target corporation's senior executives); Survey of Employment Contracts, *supra* note 3, at 2 (golden parachutes may discourage takeovers by increasing costs of takeovers to acquiring corporation). *But see* McLaughlin, *supra* note 3, at 48 (because golden parachutes do not appreciably increase costs of corporate takeovers, golden parachutes do not deter them); Profusek, *Executive Employment Contracts in the Takeover Context*, 6 CORP. L. REV. 99, 105-07 (1983) (golden parachutes do not deter corporate takeovers because costs involved in acquiring control of public corporation vastly exceed costs of golden parachute agreements); Herzel & Colling, *Controversial 'Golden Parachutes' Offer Protection*, Legal Times of Wash., Aug. 23, 1982, at 10, col. 1 (dollar amounts involved with golden parachute employment contracts are not large enough to deter corporate takeovers); Herzel, *Golden Parachute Contracts: Analysis*, NAT'L. L.J., Feb. 15, 1982 (special section), at 20, col. 1.

28. *See* Klein, *supra* note 3, at 56, col. 1 (golden parachute settlements are payable by acquired corporation).

29. *See* Anti-Takeover Proposals, S.E.C. Release No. 15230 [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,748, at 80,984 (Oct. 13, 1978). The Securities Exchange Commission (SEC) classifies costly employment contracts which are designed to make the dismissal of corporate executives following a change of control more expensive to the acquiring corporation as "anti-takeover" provisions. *Id.* at ¶ 80,985 n.3. Pursuant to Securities Exchange Act Release No. 15230, Bendix Corp.'s proxy material classified Bendix's golden parachutes as "anti-takeover" provisions because the agreements may, by increasing the potential costs of an acquisition, tend to discourage corporations from attempting to acquire Bendix, BENDIX CORPORATION, *supra* note 3, at 15.

30. Shlensky v. Wrigley, 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 (1941), absent showing of bad faith, court should not substitute its judgment for that of board of directors when corporate by-law directed payment of percentage of profits to corporation's officers in addition to salarie. It should be noted, however, that a golden parachute agreement is usually passed initially by the board, and then subject to shareholder ratification, instead of being adopted through by-law amendment).

31. One commentator has noted that "it appears likely the courts will (and

In general, the business judgment rule requires that courts defer to the good faith business judgment of the board of directors.[32] 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 if boards fear courts will second-guess their decisions, when the courts have the benefit of hindsight but only limited business experience.[33]

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should) follow the usual business judgment rule with regard to golden parachute contracts." *Herzel, supra* note 27, at 103 (suggesting that business judgment rule applies); Note, *Golden Parachute Agreements: Cushioning Executive Bailouts in the Wake of a Tender Offer*, 57 ST. JOHN'S L. REV., 516, 530 (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, 624 (1983) [hereinafter cited as Note, *Bail Outs*].

32. The court in *Panter v. Marshall Field & Co.* 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.

646 F.2d at 293 (citations omitted). *See also* 3A W.A. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (M. Wolf rev. ed. 1975) (discussing business judgment rule); H. HENN & J. ALEXANDER, LAWS OF CORPORATION 661 (3d ed. 1983) (same).

33. *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. MAGE, DIRECTOR: 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)(e). For example, one commentator has argued:

> It is widely believed that many compensation committees are rubber stamps, unwilling to be hard-massed 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.

Loomis, *The Madness of Executive Compensation*, FORTUNE, July 12, 1982, at 42. *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. LORIDEN, THE CORPORATE DIRECTOR 287-89 (1969). This lack of board independence, it is argued, creates a situation for 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

Under the business judgment rule, courts accept the good faith exercise of discretion of the board of directors in operating the company, as long as the board's decision appears to be fair.[34] Because courts are usually not willing to "second-guessed" the honest business decisions of corporate managers that are made in good faith and are fair, legal actions which question such business judgments seldom succeed.[35] Courts generally hold that the amount of compensation to be paid executives is a business decision with respect to which they have little or no competence[36] and the presumption of validity granted such decisions is difficult to overcome. However, evidence is mounting that a challenge to golden parachutes based on the business judgment rule could be successful.

### *Golden Parachutes as Reasonable and Adequate Compensation*

Although the business judgment rule allows the corporate board wide discretion, the rule is not an insurmountable barrier to a claim that the golden parachute constitutes excessive compensation to corporate executives. The presumption of validity imposed by the business judgment rule is not irrebuttable.[37] Compensation to an executive must bear a reasonable relationship to the executive's services.[38]

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of review. *See, e.g.*, Note, *Cushioning Executives, supra* note 32, at 535-41 (suggesting use of fairness standard); to the enactment of federal legislation, Moore, *Congress Takes Dim View of Golden Parachutes*, Legal Times of Wash., Oct. 25, 1982, at 5, col. 2.

34. McQuillen v. National Cash Register Corp., 112 F.2d 877, 833 (4th Cir.), *cert. denied*, 311 U.S. 695 (1940). The requirement of good faith is implemented by section 35 of the Model Business Corporations Act, which states that the director's duties must be discharged "in good faith, [and] in a manner [the director] reasonably believes to be in the best interests of the corporation, and with such care as an ordinary prudent person in a like position would use under similar circumstances." MODEL BUSINESS CORP. ACT. § 35 (1974).

35. *See, e.g., Shlensky*, 95 Ill. App. 2d 173, 273 N.E.2d 776.

36. *Heller*, 29 N.Y.S.2d at 680. "[S]ince there are proper motives for these contracts [golden parachutes], courts are unlikely to substitute their own judgment for those of directors except in situations involving particularly, inept or outrageous conduct." Herzel, *supra* note 27, at 23. *See supra* note 9.

37. *See* Koenings v. Joseph Schlitz Brewing Co., 368 N.W.2d 690 (Wisc. 1978) (business judgment rule not absolute defense for golden parachutes).

38. *See* Rogers v. Hill, 289 U.S. 582, 589-91 (1933) (shareholder derivative suit challenging reasonableness of executive compensation). Corporate executives possess the right to share in corporate profits; Berkwitz v. Humphrey, 163 F. Supp. 78, 90 (N.D. Ohio 1958) (corporate shareholders do not possess exclusive claim to corporate profits as against corporate executives whose labor, skill, ability, judgment and effect have made profits available); Rogers v. Hills, 289 U.S. 582, 590 (1933). Executive compensation must therefore bear a reasonable relation to the value of an executive's services to a corporation. *Id.* at 591-92 (bonus payments unrelated to value of executives services to corporation constitute gift or waste of corporate assets); Claimitz v. Thatcher Mfg. Co., 158 F.2d 687, 692 (2d Cir.) (incentive compensation must bear reasonable relation to value of services compensation is paid to obtain), *cert. denied*, 331 U.S. 825 (1947); Heublein v. Wright, 227 F. 667, 677-79 (D. Md. 1915) (executive compensation must be in proportion to executive's ability, services, time devoted to

If the compensation provided is not commensurate to the value of the services for which it is given, the deference granted to managerial decisions no longer applies.[39] The question of reasonableness requires an inquiry into the adequacy of consideration, as is the case in any contractual agreement.[40] Regardless of whether the issue is framed as one of reasonable compensation or adequate consideration, it is a question of degree which is difficult to prove one way or the other.[41]

Although the management of a corporation is given wide latitude in making business judgments, it must act loyally and honestly in its fiduciary role.[42] This duty includes utilizing the corporate as-

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company, difficulties involved, responsibilities assumed, success achieved, amounts under jurisdiction, company earnings, increase in volume or quality of business or both, and all other relevant facts); Ash v. Brunwick Corporation, 405 F. Supp. 234, 241 (D.D.C. 1975) (executive's services and value of stock options granted must constitute fair exchange); Glemore Distilleries Co. v. Seideman, 267 F. Supp. 915, 919 (E.D.N.Y. 1967) (executive's compensation should relate to executive's ability, time devoted to corporation, and corporate earnings during executive's tenure); Berkwitz v. Humphrey, 163 F. Supp. 78, 90 (N.D. Ohio 1958) (authorized compensation must reasonably equate to value of employee's services to company); Wyles v. Campbell, 77 F. Supp. 343, 348 (D. Del. 1948) (stock option plan must evidence reasonable relationship between value of employee's services to corporation and value of additional compensation accorded executives by plan); McQuillen v. National Cash Register Co., 27 F. Supp. 639, 653 (D. Md. 1939) (same); Michelson v. Duncan, 407 A.2d 211, 223 (Del. 1979) (same).

39. Kerbs v. California Eastern Airways, 33 Del. Ch. 69, 75-78, 90 A.2d 652, 656-58 (1952).

40. Olson Bros. v. Englehart, 245 A.2d 166, 168-69 (Del. 1968).

41. *Cf. id.* (it is an issue to which reasonable persons could differ in opinions).

42. *See* Pepper v. Litton, 308 U.S. 295, 306-07 (1939). Corporate directors stand in a fiduciary relationship to corporate shareholders. *Id.* at 306; United States v. Gates, 376 F.2d 65, 77 (10th Cir. 1967) (corporate directors occupy fiduciary relationship to corporation and corporate shareholders). *Accord* Perlman v. Feldmann, 219 F.2d 173, 175 (2d Cir. 1955); Seagrave Corp. v. Mount, 212 F.2d 389, 396 (6th Cir. 1954); Lachman v. Bell, 353 F. Supp. 37, 41 (S.D.N.Y. 1972); Johnson v. American Gen. Ins. Co., 296 F. Supp. 802, 809 (D.D.C. 1969); Petty v. Penntech Papers, Inc., 347 A.2d 140, 144 (Del. Ch. 1975). Corporate directors therefore must therefore manage corporations in light of the best interests of corporate shareholders. *See* Letwin v. Allen, 25 N.Y.S.2d 667, 677 (Sup. Ct. 1940) (corporate officers and directors must exercise extreme measure of candor, unselfishness, and good faith in dealings with corporation and corporate shareholders). *See generally* 6 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING §§ 127.02-127.10 (1982).

Several state corporation statutes codify the standard of care that directors owe corporate shareholders. *See generally* W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 5.02 (3d ed. 1978 and Supp. 1982). For example, the New York Business Corporation Act requires directors to perform their duties in good faith and with the degree of care that an ordinary prudent person in a like position would use under similar circumstances. N.Y. BUS. CORP. LAW § 717 (McKinney 1963 and Supp. 1982-1983). The Pennsylvania corporate statute, on the other hand, provides that directors shall stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith and with the diligence, care and skill that ordinary prudent men would exercise under similar circumstances. PA. STAT. ANN. tit. 15, § 1408 (Purdon 1967 and Supp. 1982-1983). Other states have adopted the standard of care required of directors set forth in the Model Business Corporation Act (Model Act). MODEL BUS. CORP. ACT. § 35 (1978); *accord* CAL. CORP. CODE §

sets over which it has custody in the most efficient manner possible, with all benefits accruing to the company's shareholders.[43] A portion of these corporate assets are allocated for payment of officers and directors in the form of compensation. In that allocation of corporate assets, of which golden parachutes are part, the director owes a duty of the utmost loyalty to the corporation, and all benefits must rebound to the beneficiaries.[44] Directors are well compensated for shouldering this responsibility. Directors may not justify disbursements of corporate assets which are so large "as in substance and effect to amount to spoilation or waste of corporate property."[45]

What actually constitutes a waste of corporate assets is a question involving the reasonableness of consideration flowing to the corporation. When a corporate outlay is made and the consideration which the corporation receives in return is inadequate or unreasonable, there is a waste of corporate assets.[46] Corporate executives, owing a fiduciary duty to the shareholders of the corporation, are obliged to use their best business judgment to prevent such waste. Yet, where is the line drawn between a wrongful waste of corporate assets and a legitimate payment from corporate funds? That question is a matter on which fully informed reasonable persons could differ in opinion. The deference required by the business judgment rules' presumption of validity is not absolute, for when consideration is shown to be inadequate or unreasonable, the presumption is overcome and there is a waste of corporate assets.[47]

Vague guidelines such as adequacy, fairness, waste, and reasonableness are of little help in practice when trying to determine whether corporate officials are disbursing corporate funds in an inefficient or self-serving manner. Some courts have stated that the test to be applied is whether the payments made are so large that they constitute spoilage or waste.[48] That test, however, simply defines a waste of corporate assets to be where corporate assets are wasted. Other courts have been equally ambiguous in stating that there is a

300 (West 1977 & Supp. 1982); DEL CODE ANN. tit. 8, § 141 (rev. 1974 & 1982 Supp.). Section 35 of the Model Act requires directors to manage corporations with such care as an ordinary prudent person in a like position would use under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation. *See generally* Arsht, *Fiduciary Responsibility of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652 (1979); Neasey, *Director's Standard of Care Under Section 35 of the Model Business Corporation Act*, 4 DEL. J. CORP. L. 665 (1979).

43. *See* Guth v. Loft, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939).

44. Litwin v. Allen, 25 N.Y.S.2d 667, 677-78 (Sup. Ct. 1940) (director must have "loyalty that is undivided and allegiance that is influenced in action by no consideration other than welfare of corporation").

45. *Rogers*, 289 U.S. at 591.

46. N. LATTIN ON CORPORATIONS § 77, at 266 (2d ed. 1971).

47. *Id.*

48. *Rogers*, 289 U.S. at 591.

waste of corporate assets where there is a clear abuse of discretion by those in control.[49]

The essence of a claim of a waste of corporate assets is the diversion of these assets for an improper or unnecessary purpose. Payments, which are improper or unnecessary are those that result in little or no benefit to the corporation, that is, where nonexistent or inadequate consideration passes to the corporation in exchange for some outlay of corporate assets.[50]

While the business judgment rule grants wide discretion to the corporate board, some reasonable connection must exist between the services rendered and the *quid pro quo* to be paid.[51] Anything less is considered an unauthorized gift,[52] and payments that are labelled salaries, bonuses, pensions, options, or golden parachutes, are nevertheless gifts if no consideration is provided to the corporation in return for these payments.[53] Without adequate consideration flowing to the corporation in exchange for some corporate outlay,[54] a waste of corporate assets occurs.[55]

The traditional inquiry regarding whether adequate consideration is present is based on a determination of whether there has been a bargained-for-exchange plus either legal detriment to the promisee or legal benefit to the promisor.[56] In general, something must be exchanged in a bargain-like fashion, where each party receives some type of benefit. In practical terms, it is helpful to look at those plans that are somewhat analogous to the golden parachute to determine if adequate consideration is being provided to the corporation.

For example, in a challenge to a retirement income plan where the plan was to be put into effect a short time prior to the president's eligibility for retirement, the court stated that such a plan seemed analogous to a gift or bonus.[57] Although acknowledging judi-

49. Folgelson v. American Woolen Co., 170 F.2d 660, 662 (2d Cir. 1948); *McQuillen*, 112 F.2d at 883.

50. R. HAMILTON, CORPORATIONS - BLACK LETTER SERIES 267 (1982).

51. N. LATTIN, *supra* note 46.

52. *Rogers*, 289 U.S. at 591.

53. *Id.*

54. One may wonder whether William Agee, the President of Bendix Corporation during that company's attempted takeover of Martin Marietta, carefully considered the interests of Bendix shareholders in exchange for a golden parachute which guaranteed him at least $800,000 a year for five years. Lewin, *Using Golden Parachutes*, N.Y. TIMES, Nov. 30, 1982, at 30, col. 1; Des Moines Register, Feb. 9, 1983, at 55, col. 2.

55. Kerbs, 33 Del. Ch. at 75-79, 90 A.2d at 656-59 (validity of stock option plan depends directly on existence of consideration passing to corporation; when there is sufficient consideration, there is an illegitimate gift - or waste - of corporate assets).

56. *See generally* A. CORBIN ON CONTRACTS § 109-23 (1963).

57. *Fogelson*, 170 F.2d at 663.

cial reluctance to interfere in such matters of business judgment, the court stated that courts do interfere in cases presenting so clear an abuse of discretion as to amount to spoilation or waste of corporate property.[58] Similarly, an abuse amounting to waste may exist if a newly-hired officer or director is granted a golden parachute guaranteeing twenty years of salary, and the officer or director quits the job after a successful takeover of that corporation. There is a lack of *quid pro quo* passing to the corporation in those situations. Moreover, the same analysis applied to stock-option and bonus plans. The corporation must reasonably expect to receive contemplated benefits from those plans.[59] A reasonable relationship must exist between the value of the benefits passing to the corporation and the value of the options granted.

Compensation, however, is not unreasonable simply because consideration is provided to an employee who apparently gives nothing in return.[60] Similarly, golden parachutes are not invalid simply because there is no measurable and definite consideration passing to the corporation. The relevant legal inquiry is whether such an arrangement in the long run inured to the benefit of the corporation.[61]

A pension plan is the closest parallel to the long-term employment contract labelled a golden parachute. This is evident because a pension plan appears to lack direct mutual consideration on the part of the retiree and the corporation due to the delayed payment made to the employee. Nevertheless, pension plans are not subject to question, because the result is beneficial to the corporation. Attraction and retention of personnel is enhanced, and motivation and incentive to those already employed is increased. Pension plans provide employment security upon retirement. This security theoretically enhances employee performance while employed, thereby resulting in a benefit to the corporation.

The typical pension plan is legitimate compensation, to be questioned only when it is excessive and overreaching.[62] On the other hand, a guaranteed employment contract labelled a golden parachute is not legitimate compensation. Compensation paid to a corporate executive must be in proportion to the executive's ability, service, time devoted, corporate earnings, and other relevant facts and circumstances.[63] When courts refer to overreaching, they are in-

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58. *See id.* at 662; *McQuillen*, 112 F.2d at 884.

59. *Rogers*, 289 U.S. at 591-92. *See generally* Haag v. Int'l Tel. & Tel. Corp., 342 F.2d 566 (7th Cir. 1965).

60. Freedman v. Barrow, 427 F. Supp. 1129, 1155 (S.D.N.Y. 1976); Beard v. Elster, 39 Del. Ch. 153, 160-61, 160 A.2d 731, 735-36 (1960).

61. *Freedman*, 427 F. Supp. at 1155; *Beard*, 39 Del. Ch. at 160-61, 160 A.2d at 736.

62. *Fogelson*, 170 F.2d at 662.

63. Glenmore Distilleries Co. v. Seiderman, 267 F. Supp. 915, 919 (E.D.N.Y.

quiring into the adequacy of consideration. Is the consideration provided by corporate executives in exchange for golden parachutes fair and reasonable? To answer this question one must analyze the justifications for such agreements.

*Justification for Golden Parachutes*

In response to the skepticism regarding the validity of golden parachute agreements, advocates advance three justification, arguing that each provides consideration to the corporation. The first of these justifications states that officers and directors are better able to balance the advantages or disadvantages of a proposed merger if they do not have to worry about losing their jobs following the change in management.[64] The agreements supposedly eliminate a potential conflict-of-interest, increasing officer independence by guaranteeing officers long-term compensation. Officers are then better able to act in the best interests of the target company's shareholders.[65]

Critics of golden parachutes assert that this justification is a fallacy, and, in fact, may actually cause a passive attitude by the executives who are cloaked with the agreements because regardless of what the executive do, they will be compensated.[66] The pessimistic attitude could be a response to the negative results that have occurred at some corporations following the adoption of golden parachutes for their executives.

For example, in the most fierce takeover struggle of 1982—involving Bendix, Martin Marietta, Allied, and United Technologies Corporations[67]—key executives from each firm were equipped with

1967).

64. Morrison, *supra* note 3, at 82.

65. *See* Analysis *supra* note 17 at 20, col. 1.

66. McLaughlin, *supra* note 3, at 47, 48.

67. Possibly the most infamous takeover struggle in which executive objectivity was undoubtedly 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 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 decision making. Morrison, *supra* note 3, at 84. *See also* Taub, *Haste Maketh Waste*, Financial World, Dec. 1-15, 1982, at 17; Holusha, *Bendix Chief Playing For High*

golden parachutes.[68] After attempting to buy a controlling share of Martin Marietta's stock, Bendix found itself on the defensive when Martin Marietta countered with a tender offer of its own, targeted at Bendix.[69] The result was a purchasing war for the other corporation's stock that caused each corporation to incur large amounts of debt.[70]

Although Martin Marietta remained independent after thwarting Bendix's takeover attempt, the increased debt it incurred lowered book value, increased debt leverage, reduced its bond rating, and resulted in thirty-nine percent of its stock being held by Allied (who eventually purchased Bendix).[71] The benefit to the corporation and its shareholders is difficult to discern from these facts. The golden parachute's guarantee of financial independence that was intended to insure clear-headedness among those in charge at Martin Marietta failed to keep them from fighting the tender offer to the point of harming the shareholders more than if the takeover had succeeded.

A similar result occurred in January of 1982, when Whittaker Corporation announced a hostile tender offer[72] for Brunswick Cor-

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*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 3, 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. These golden parachutes were most likely intended to serve as safety precautions against the possibility that the 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.

68. Taub, *supra* note 67, at 17.

69. *Id.*

70. *Id.* at 18.

71. *Id.* at 17.

72. The consideration proffered in the tender offer generally is cash or stock in the acquiring corporation. This consideration is usually greater than the fair market value of the securities sought. W. CASY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 842-920 at 905 (abr. 5th ed. 1980). Unless a minimum number of shares is tendered, the offeror is not obligated to complete the purchase. *Id.*

The tender offer is a mechanism for obtaining control of a corporation whose management either does not favor an acquisition and thus refuses to assent to the purchase of its shares, or does not oppose the acquisition but is nonetheless unwilling to support it. *See* 2 B. Fox & E. Fox, *supra*, at § 27.01, at 27-5; A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING 99 (1981). An acquiring company will opt for a tender offer when it does not desire to, or for some reason cannot, purchase all of the target's assets. Instead it acquires merely enough of the target's stock to exercise control. *See* 1 M. LIPTON & E. STEINBERGER, *supra*, at § 1.1.1, at 3.

During the past 3 years there has been a dramatic increase in the number of mergers and tender offers, particularly hostile tender offers. Survey of Employment Contracts, *supra* note 3, at 2. In 1981 alone there were more than 2,300 recorded mergers. McLaughlin, *supra* note 3, at 47. *See generally* 2 B. Fox & E. Fox, *supra*, at § 27.02, at 27-14 (typical target characterized by undervalued stock); Troubh, *Char-*

poration.[73] In particular, Whittaker wanted Brunswick's medical unit. Adorned with golden parachutes, the management at Brunswick not only rejected a generous $26.50-a-share offer[74] from Whittaker, but also sold the medical unit to a third party to discourage further Whittaker. The result was a smaller, weaker Brunswick, whose shares were half as much as the original tender offer price.[75]

A final example, which casts doubt on the validity of this particular justification, also arises from the Bendix takeover battle. Bendix justified the adoption of its golden parachutes as an aid to unbiased decision-making.[76] Yet, since that time, William Agee, president of Bendix Corporation, has stated publicly that he would not have done anything differently had he not had the security provided by a golden parachute agreement.[77] Statements such as these cast doubt on whether a golden parachute passes consideration to the corporation, which is necessary if the agreements are to be valid.

The second justification given by advocates of golden parachutes is that the contractual arrangements help a company attract and retain[78] key executive[79] personnel.[80] In a corporate setting

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*acteristics of Target Companies*, 32 BUS. LAW. 1301, 1301-03 (1977) (describing characteristics of target company).

73. Morrison, *supra* note 3, at 84.

74. *Id.* Brunswick shares were selling on the New York Stock Exchange in mid-January for $18 a share, significantly lower than the tender offer price. Wall St. J., Jan. 15, 1982, at 42, col. 2.

75. Morrison, *supra* note 3, at 84.

76. The company stated the agreements would cause the executives to act "in the best interest of the corporation and its shareholders with regard to the takeover offers without concern about income security." Wall St. J., Sept. 10, 1982, at 2, col. 2.

77. Morrison, *supra* note 3, at 84.

78. 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 makes the market for corporate executives an extremely competitive one. Assuming that the market is competitive, one would not expect salaries 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, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL. J. ECON. 55, 66 (1979).

The question concerning golden parachutes should not be "Do they make executives act differently?" but rather "Would executives demand other compensation to act in the same way if their golden parachutes were taken from them?" Joseph Flom, a merger and acquisition specialist with the New York law firm of 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 3, at 83.

79. Masters, *supra* note 5, at 10, col. 1.

80. Petitpas, *Good Pay Plans Can Support Strategy*, INDUSTRY WEEK., Jan. 24, 1983, at 13. Petitpas, the director of Cresap, McCormick and Paget, Inc., stated that "executive compensation is essentially determined by the market, that is, by what others are paying to people who are working at given levels of responsibility and performance." A strong argument can be made that the market for executive talent has few significant entry barriers and that there is a substantial pool of talent from which to draw. The relatively high level of executive turnover supports the competitive nature of this market. Because it is competitive, salaries would also be responsive be-

with an unfriendly takeover pending, executives may choose to leave a company for a more secure position[81] rather than await the outcome of the takeover and risk losing their jobs. In that situation, the target corporation and its shareholders have an interest in retaining those highly valued executives.[82] The guaranteed employment contract is justified under this scenario because it would provide a direct benefit to the company and thus constitute adequate consideration.[83] In fact, many corporations justify the adoption of golden parachutes in this way. It appears that Outboard Marine Corporation used this justification in granting five of its top-level executives golden parachutes in 1982.[84]

Losing one's job, however, is generally considered to be a risk inherent in any business; corporate executives are already well compensated for assuming such risks.[85] Consequently, Grael Crystal, a

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cause there would be no reason for a firm to bid more than necessary for executive services. *See* Fama, *supra* note 78; Shavell, *supra* note 78; Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231 (1983).

81. *See* Meyer, *Executive Compensation Must Promote Long-Term Commitment*, PERSONNEL ADMIN., May 1983, at 37, in which the authors stated:

> Recent studies that matched companies in the same industries facing the same stresses, the same business conditions and the same challenges, found that the quality of management and its decisions spelled the difference between success and failure. . . . [A]t the heart of corporate performance and productivity in America, then, is the retention and the consistent motivation of high-quality management.

*See also* Freedman v. Barrown, 427 F. Supp. 1129 (S.D.N.Y. 1976), which involved a shareholder challenge to Exxon's incentive program. The district court was cognizant of the needs of corporations to retain and reward executives. "Keeping the high level of motivation of these employees, retaining their loyalty in the future, and protecting their skills, experience and specialized knowledge from raids by competitors or others is the biggest single responsibility of top management, which naturally is also interested in its own compensation." *Id.* at 1136.

82. Few would quarrel with compensation exceeding one million dollars for Lee Iacocco. *CEO of the Year Awards*, FIN. WORLD, Mar. 31, 1983 at 17 described his achievement as follows:

> Five years later, against incredibly long odds, Iacocco, has done just that - he saved Chrysler. In one of the most stirring performances in business history, he has returned the company to full year profitability in the midst of a deep recession and erased all doubts about its survival. Certainly there are no doubts about his performance among the judges for Financial World's CEO of the Year Awards. Recognizing his stupendous achievement, they have named Chairman, Lee A. Iacocco of Chrysler as this year's gold award winner.

*But see Patton Why So many Chief Executive Make Too Much*, BUS. WEEK, Oct.17, 1983, at 26; *CEO of the Year Awards*, FIN. WORLD, Mar. 31, 1983, at 17:

> The top executives of a large number of the 100 largest companies, however, are administrators, not entrepreneurs. They head organizations that were already in being when they reached the top. They are selling products or services developed by others and usually remain in the top job for a very short time. Yet directors frequently pay them as though they were entrepreneurs.

83. *Cf.* Wall St. J., Dec. 29, 1982, at 3, col. 4 (suggesting that Outboard Marine Corp. implemented golden parachute agreements to provide employment security to executives).

84. Morrison, *supra* note 3, at 86.

85. *Id.*

compensation consultant, characterizes the golden parachute as a method of providing "more and more reward for less and less risk."[86] How far can management go before attempts at employee retention become a waste of corporate assets? Critics would find that several types of recently-adopted golden parachutes cross the line. For example, in 1982 at Burnup & Sims, Incorporated and in 1981 at Savin Corporation, golden parachutes were adopted which resulted in corporate executives collecting benefits without even losing their jobs.[87] In addition, many golden parachute agreements take effect even if an executive leaves the company voluntarily after a takeover.[88]

Regardless of the type of golden parachutes adopted, it is still used for the purpose of attraction and retention of personnel and is, therefore, compensation.[89] In many instances, however, golden parachutes fail in this purpose. They are excess baggage that neither adds to or detracts from the attraction and retention of personnel. As parachutes become more commonplace, the impact of a parachute becomes more diminished.

Once again, the presumption of validity under the business judgment rule makes it difficult to prove that a golden parachute fails to provide adequate and reasonable consideration to the corporation in the form of employee attraction and retention.[90] The final

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86. Klein, *supra* note 3, at 56.

87. Wall St. J., Dec. 30, 1982, at 6, col. 6.

88. Corporate directors possess the right to fix compensation of executive officers for services rendered to the corporation. *See* Cohen v. Ayers, 449 F. Supp. 298, 305 (N.D. Ill. 1978) (corporate directors possess power over matters of executive compensation), *aff'd*, 596 F.2d 733 (7th Cir. 1979); Koplar v. Warner Bros. Pictures, Inc., 19 F. Supp. 173, 188 (D. Del. 1937) (directors have power to avoid just compensation to executives).

The conclusive presumption courts accord the business decisions of corporate directors is better known as the business judgment rule. *See generally* 3A W. FLETCHER, *supra* note 33, at §§ 1039, 1040; E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75-81 (1972); H. HENN, LAW OF CORPORATIONS § 242 (2d ed. 1970); Note, *Corporate Directors' Guidebook*, 33 BUS. LAW. 1595, 1604 (1978). The business judgment rule precludes judicial inquiry into the actions of directors taken in good faith and in honest pursuit of bona fide corporate objectives. United States Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Galef v. Alexander, 615 F.2d 51, 57 (2d Cir. 1980); Abramowitz v. Posner, 513 F. Supp. 120, 125 (S.D.N.Y. 1981) *aff'd*, 672 F.2d 1025 (1982).

89. Morrison, *supra* note 3, at 5.

90. Corporations generally face great difficulty in obtaining and retaining "high caliber executive talent." Engel, *Preface* to COMPENSATING EXECUTIVE WORTH at v (R. Moore ed. 1968).

Without undertaking an in-depth analysis of executive compensation, it is possible to compare a golden parachute clause with the more traditional methods of compensation. Common forms of executive compensation include salary, stock options, bonuses, deferred compensation and special pension provisions. F. STECKMEST, CORPORATE PERFORMANCE: THE KEY TO PUBLIC TRUST 161-62 (1982). All compensation, however, must be proportionately related to the executive's ability, effort exerted and success attained, as well as to the profitability of the corporation. Gallin v. National

justification advanced for golden parachutes is that these agreements aid in thwarting unfriendly takeover bids by making them more costly. Experience has shown this to be the least persuasive justification. El Paso Company relied on that justification when adopting wage guarantees for its key executives.[91] Other firms have given the same anti-takeover justification.[92] However, substantial skepticism exists regarding how much guaranteed employment contracts will discourage takeover attempts.

Martin Lipton, a takeover strategist with Wachtell, Lipton, Rosen & Katz, asserts that a reasonable number of parachutes have "no deterrent effect whatsoever on takeovers or takeover attempts."[93] The amounts involved are not large enough compared to the size of the tender offers, to affect takeover decisions.[94] For example, after Allied had acquired Bendix, as well as thirty-nine percent of Martin Marietta, Allied had spent a total of $1.9 billion.[95] In comparison, the $4 million golden parachute provided to Agee of Bendix appears inconsequential.[96] In fact, the wage guarantee accounted for only two hundredths of one percent of the entire takeover consideration.

Thus, it seems highly unlikely that a golden parachute of relatively small value would thwart a takeover bid.[97] In addition, when the acquiring corporation has no intention of replacing the target corporation's management,[98] the deterrent effect of golden

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City Bank of New York, at 114.

When seeking quality management, particularly key executives, the board of directors considers compensation to be of secondary importance, because "the difference between merely good and outstanding talent is off-scale in relation to compensation differences." F. STECKMEST, *supra* at 162. Thus, to obtain and retain qualified executives and to provide motivation within the corporate structure, it has been argued that lucrative compensation plans are in both the corporation's and the shareholders' best interests. *Id.* at 163; Morrison, *supra* note 3, at 83. Particularly, in the context of the current volatile takeover atmosphere, golden parachutes are necessary to attract and retain superior executive talent. Survey of Employment Contracts, *supra* note 3, at 1. There is however, a unique characteristic that distinguishes golden parachutes from all other forms of executive compensation: while executive compensation and incentives generally are conditioned upon performance, golden parachute agreements are triggered merely by a change in control. *See id.* at 3.

91. Wall St. J., supra note 86.

92. Wall St. J., Dec. 24, 1982, at 2, col. 2.

93. Analysis *supra* note 27, at 22.

94. Wall St. J., Sept. 27, 1982, at 3, col. 1.

95. Des Moines Register, *supra* note 54; Lewin, *supra* note 54, at 30.

96. This statement is especially true if executive ego is as relevant as one might believe. Wall St. J., supra note 83; Morrison, *supra* note 3, at 86.

97. Morrison, *supra* note 3, at 86 (discussing acquisition of Heublein by R.J. Reynolds).

98. Z. CAVITCH, *supra* note 46, at § 127.03 [2], at 127-13. *See e.g.*, United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. at 263-64; Panter v. Marshall Field & Co., 646 F.2d 271; Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971). Under federal law, golden parachute agreements must be disclosed in a corporation's proxy statement. 17 C.F.R. § 240.14a-101 (1982). This affords shareholders the opportunity

parachutes disappears entirely. Therefore, because the question is one of adequacy of consideration, justification for golden parachutes has to resort elsewhere, and not on a claimed ability to discourage hostile takeovers.

### *Conflict of Interest*

Because the business judgment rule[99] creates a presumption of validity, a shareholder's claim of inadequate consideration would have difficulty succeeding, despite the weaknesses of the asserted justifications previously discussed. However, if there is a conflict of interest, as when a director has a personal interest in the payments disbursed, the courts should theoretically disregard the business judgment rule.[100] In its place, the courts could substitute a test of fairness, shifting the burden of proof to the executives to show that good faith has been exercised.[101]

Imposing a test of fairness would avoid the potential for self-dealing[102] where a corporate official, who acts as trustee over the shareholders assets, is also in a position to determine his own compensation. For example, the potential for abuse through self-dealing

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to review and question the business judgment of the board. Section 240.14a-101(7) concerns the renumeration of directors and executive officers, and requires the filing of certain information required by 17 C.F.R. § 229.402. Section 229. 402 requires that corporations furnish all information concerning the compensation paid to "[e]ach of the five most highly compensated executive officers or directors of the registrant as to whom total renumeration . . . would exceed $50,000, naming each such person," § 229.402(a)(1), and information regarding the renumeration of "[a]ll officers and directors of the registrant as a group, stating the number of persons in the group without naming them," § 229.402(a)(2).

If a shareholder objects to any of the material disclosed he may institute a derivative action to protect his investment in the corporation in the event that management refuses to assert a corporate claim. *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 543 (1949). The stockholder who maintains a derivative action assumes the responsibilities of a fiduciary, acting as a "self-chosen representative and a volunteer champion" of the entire class of shareholders. *Id.* at 549. There are several such suits pending with respect to golden parachutes. Survey of Employment Contracts, *supra* note 3, at 9.

99. Cohen v. Ayers, 596 F.2d 733, 739-40 (7th Cir. 1979): Strickland v. Arnold Thomas Seed Serv., 277 Or. 165, 170-74, 560 P.2d 597, 600-03 (1977).

100. *Cohen*, 596 F.2d at 739-40.

101. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 819 845-47 (1981). The board of directors is generally given the exclusive power to determine whether an acquisition is in the shareholder's best interests. *See, e.g.*, CAL. CORP. CODE § 1001(6) (West 1977). Hence, the issue usually never reaches the shareholders. Moreover, the amount of time and expertise required properly to evaluate a proposed merger or sale of assets renders this task beyond the scope of the average shareholder's abilities. Gilson, *supra*, at 846 n.101. The shareholders therefore do not have an opportunity to consider a proposed acquisition unless the board of directors has approved it by exercise of their "specialized skills." *Id.* at 846-77. The board of directors do not exercise this power, however, in the tender offer context. *Id.* at 847 & n.104.

102. Des Moines Register, *supra* note 54.

created the appearance of impropriety when William Agee left Bendix just five months after the adoption of his golden parachute.[103] A challenge based on conflict of interest has a better chance of success in these situations.

Unfortunately, the courts have failed to enforce this burden of proving fairness on corporate executives. Instead, courts have created exceptions to the rule of conflict of interest in cases of executive compensation, and continue to apply the presumption of validity of business judgment rule. The courts justify the exception because of shareholder ratification[104] or the voting of disinterested directors.[105] However, the belief that either of these acts may overcome any potential of abuse is a misconception.

The burden of proof placed on the officer or director to show fairness where a conflict of interest exists may be avoided when, after full disclosure, the payments are ratified either by a vote of the shareholders or by the action of disinterested directors.[106] Golden parachutes are included in the realm of payments that may be ratified because they are a form of compensation. Given ratifications, the business judgment rule is applicable and the difficulty of proving a waste of corporate assets once again rests upon the attacker of the payment.[107]

Shareholder ratification, though perhaps an effective watchdog against abuse in theory, is a dubious guarantee of an agreement's validity in reality. As a practical matter, corporate management is in

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103. *Beard*, 39 Del. Ch. at 160-61, 160 A.2d at 737; Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 82, 87-88, 90 A.2d 660, 663 (1952).

104. William v. Williams Insulation Materials, Inc., 91 Ariz. 89, 95, 370 P.2d 59, 63 (1962). *See also* Church v. Harnit, 35 F.2d 499, 502 (6th Cir. 1929) (employment contract held to be reasonable compensation).

105. *Cohen*, 596 F.2d at 739-40.

106. *Id.*

107. Pepper v. Litton, 308 U.S. 295; Borden v. Sinskey, 530 F.2d 478, 489-90 (3d Cir. 1976); Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (1939); *see* 6 Z. CAVITCH, *supra* note 46, at § 127.02[1], at 127-4; 3 W. FLETCHER, *supra* note 33, at § 850, at 175-76; W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 1.04, at 8; Note, *Corporate Directors Guidebook, supra* note 94, at 1599 (director should not derive "personal profit or gain or other personal advantage" by dealing in his corporate capacity with third party); *see also* Fuller, *Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors*, 26 WASH. U.L.Q. 189, 190-211 (discussing various conflicts of interest); Ramsey, *Director's Power to Compete With His Corporation*, 18 IND. L.J. 293, 295-309 (1943) (examining different areas where conflict of interest may occur).

With respect to the board, it has been argued that the primary purpose of the board of directors "is the representation and safeguarding of the stockholder's interest." M. NICHOLSON, DUTIES AND LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS 111 (1972). Similarly, officers are bound by a strict rule of honesty and fair dealing and must act solely in the corporation's interest. W. FLETCHER, *supra* note 33, at § 850, at 175-76. *See generally* J. BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS - INDEMNIFICATION AND INSURANCE ¶¶ 3.01-.07, at 3-2 to 3-24 (1981) (liability as result of status or conduct).

a position to control the shareholder ratification vote through control of the proxy mechanism. Pro-management institutional investors and others who hold large blocks of stock coupled with the passive approach of small investors to stock ownership, gives management little difficulty in securing majority approval. This assumes there is no significantly contested proxy fight.[108] The specific cases already discussed have employed this proxy mechanism to pass guaranteed employment agreements.

For example, in the Bendix,[109] El Paso,[110] and Outboard Marine[111] take-overs, the board of directors approved the golden parachute agreements, then solicited proxies to gain shareholder approval. With control of the proxy mechanism, it is highly unlikely that management could not get shareholder approval. Applying the business judgment rule under the guise of such "shareholder approval" only perpetuates the possibility for misuse of corporate funds. Requiring shareholder ratification does at least serve to expose guaranteed salary agreements and thereby allow public scrutiny, but it is not a complete and adequate safeguard.

A second judicial approach to insure sound business judgment is to require that only disinterested board members participate in making decisions when a conflict of interest is present, such as the determination of executive compensation.[112] When such a conflict exists, the burden of showing fairness of the proposal is on the other directors.[113] Consequently, most courts hold the contract voidable when a director who has an interest participates in the decision.[114]

The problem with this method is that truly disinterested and unbiased directors are hard to find. Courts have long realized that the influence of a non-participating director may be so great as to warrant close scrutiny and perhaps rescission of any agreement that is made.[115] Perceptive courts have not hesitated to look behind the board to see where loyalties and allegiances lie.[116] When officers or directors as a group are seeking to perpetuate themselves in office, it can hardly be said that any of them are truly impartial and disinterested parties. For example, Beneficial Corporation currently has two

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108. 1 WASHINGTON & ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 27 (1962).

109. Wall St. J., supra note 67.

110. Wall St. J., supra note 93.

111. Wall St. J., supra note 83.

112. *Beard*, 160 A.2d at 736-37; *Gottlieb*, 90 A.2d at 663.

113. *Id.*

114. *Michelson*, 407 A.2d at 218.

115. *See* Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 489-90, 121 N.E. 378, 379-80 (1918) (refusing to allow committee appointed by the board to decide which suits the company should pursue).

116. Zapata Inc. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

hundred and thirty-four golden parachutes protecting its executives.[117] There was undoubtedly no disinterested director available to approve these agreements, because every director had his own agreement.

At Bendix, a board of thirteen members approved salary guarantees for sixteen officers, three of whom were on the board at that time. Four of those directors eventually resigned for undisclosed reasons.[118] The independence of the other directors was not questioned since shareholder approval of the agreement was forthcoming. However, given the potential for mutual favor, and the possibility of existing or developing friendships among officers and directors, it is unlikely that any of those who approved the parachutes were in fact "disinterested."

## *Conclusion*

Golden parachutes[119] are a new form of executive compensation. They are, therefore, subject to the same standard of reasonableness and presumption of validity granted under the business judgment rule as are other types of executive compensation. Reasonableness is the adequacy of consideration, regardless of whether the particular court speaks of corporate waste, abuse of discretion, or fairness. The doctrine of adequacy of consideration distinguishes the legitimate golden parachute from the illegitimate one, just as it distinguishes the legitimate salary from the illegitimate salary.

Determining the adequacy of consideration provided to the corporation in return for a golden parachute, whether in the form of unbiased decision-making, employee attraction and retention, or discouraging takeover attempts,[120] is difficult because of its indefi-

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117. Morrison, *supra* note 3, at 86.

118. *See* Bendix Corporation, 1982 Proxy Statement, at 2-5 Wall St. J., *supra* note.

119. *See* Survey of Employment Contracts, *supra* note 3, at 4 (carefully drafted golden parachute employment contract should contain compensation and benefits clause providing departing executives with amount of compensation executive could expect to receive during duration of employment contract absent change of control); Profusek, *supra* note 4, at 103, 108-09 (most golden parachutes should withstand judicial scrutiny if contracts do not materially alter compensation and benefits that executives reasonably could expect to receive during duration of employment contract period absent change of control). Golden parachute employment contracts which provide executives with lump-sum severance payments will survive judicial scrutiny if the lump-sum payment represents the present discounted value of the executive's salary and benefits for the duration of the golden parachute employment contract. *Id.*; *see also Herzel, supra* note 27, at 22, col. 2 (right to receive lump-sum benefits can be important strategically to executives because lump-sum payments eliminate concern over disputes with acquiring corporation following corporate takeovers).

120. Courts have held that directors may approve defensive tactics to defeat a tender offer which they deem to be not in the corporation's best interest. *See, e.g.*, Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712-13 (N.D. Ill. 1969).

nite nature. Such consideration is difficult to reduce to monetary terms. The business judgment rule's deference to management decisions makes it difficult to successfully challenge a golden parachute. A challenge complaining of a conflict of interest stands a better chance of success if the courts recognize that shareholder approval and the voting of disinterested directors should not exempt parachutes from a standard of fairness.

The courts have not had a chance to pass on the legality of golden parachute as a means of executive compensation. When they do, it is likely that the courts will follow the business judgment rule and uphold the validity of these agreements, unless there is proof of overreaching. Because a director's motives are difficult to establish and proper motives for these agreements can exist, it is unlikely that the courts will substitute their judgment for those of a board of directors except in cases involving particularly inept or outrageous conduct. The problem lies in the historically passive attitude of courts toward executive compensation as a whole. To conclude that a golden parachute agreement is *per se* unlawful would require rewriting the entire body of law regarding executive compensation. In a case by case approach, however, under existing law, an argument attacking the validity of a particular golden parachute can be made, and should be acceptable to the courts.

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In *Northwest*, B.F. Goodrich Co. and Gulf Oil Corp. engaged in a joint venture. *Id.* at 708. In 1965, the companies considered having one purchase the other's interest. Before any terms were agree upon, however, Northwest Industries announced that it would commence a tender offer. Within one day, Goodrich offered Gulf 435 million for Gulf's interest, and on the following day, Goodrich's Board of Directors approved the transaction. *Id.*

Northwest Industries requested a preliminary injunction, alleging that "the consideration was grossly inflated in order to guarantee that a substantial block of stock would be held by interests friendly to Goodrich's present management." *Id.* Denying the request, the court discussed the duty of management with respect to a tender offer:

> [M]anagement has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or its stockholders. In arriving at such a judgment, management should be scrupulously fair in considering the merits of any proposal submitted to its stockholders. The officers' and directors' informed opinion should result from that strict impartiality which is required by their fiduciary duties. After these steps, the company may then take any step not forbidden by law to counter the attempted capture.

*Id.* at 712-13. The court required an impartial evaluation by management, yet ignored its observation that "whenever a tender offer is extended and the management of the threatened company resists, the officers and directors may be accused of trying to preserve their jobs at the expense of the corporation." *Id.* at 712.