The Controversial Golden Parachute - Part II

Exploring The Pros and Cons, And Key Considerations When Drafting Golden Parachutes

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I was Deloitte & Touche's national partner in charge of performance management compensation. Several partners were in a conference room with me discussing a merger of two large energy companies we had been hired to work on. As we discussed the particulars, I asked if the target had a golden parachute and was promptly told by the audit partner "no." That seemed odd as almost 100% of energy companies I knew, had them. It was almost impossible not to since it was a key element of executive pay.

So, I asked other members of the M&A team if we could go visit the target and just discuss this oddity. The team agreed and we set off – me, along with another tax and audit partner. We arrived and promptly got to it. When I asked about their lack of change-in-control protection, the CEO smiled and said, "Well we do have one, you just don't see it in our filings." Perplexed, I asked, "How?" He proceeded to explain that before filing their proxy, they would cancel their change-in-control plans. Once filed, they would reinstate! He assured me a well-known law firm had signed off on this approach. I'm not sure how long my mouth was open, but Deloitte may have lost an audit partner that day.

Golden Parachutes – Not for The Faint of Heart

A golden parachute is simply a term used to describe compensation payable to top executives of a company due to a merger and their "constructive termination" within a specific period of time, post-merger. It is not unusual for executives to lose their jobs after a merger since there is a desire by the acquirer to cut out redundancy in an attempt to keep executives on task while knowing they may be working themselves out of a job. They are promised certain compensation and benefits to compensate for their loss. Compensation can include a multiple of base salary, a multiple of target bonus, long-term incentive vesting acceleration, insurance, and a whole host of other benefits. Usually, these arrangements are embedded in the employment agreements. However, they can be constructed as a stand-alone document as well.

Advantages Of Golden Parachutes

1. **They are part of the competitive landscape.** Without a golden parachute agreement, a company's ability to hire top talent may suffer. A golden parachute acts as a safety net for executives in today's volatile market where mergers and acquisitions are part of every company's strategic thinking. It also allows them to look for good deals for shareholder value creation, even though they may lose their job.
2. **Align with shareholders.** The last thing a shareholder wants is an insecure executive during the M&A process. Without a golden parachute, you sure could have the temptation to not pursue the deals presented. Golden parachutes help executives make the right decisions, they can actually overcome personal bias and fear.
3. **Discourage hostile takeovers.** Golden parachutes can be a big expense to the acquiring company – sometimes between 5-10% of the overall deal. The acquirer usually has to "eat" this charge as part of "doing business." So, acquirers have to really run the "cost-benefit" analysis before they pull the trigger.
4. **Ex-executives behave after termination.** Golden parachutes are lined with verbiage that ensures good behavior by the executives terminated. Retaliation and disparagement can be dangerous, so would-be acquirers want this buttoned up.

Bottom-line, there is a great business reason to have them.

Disadvantages Of Golden Parachutes

As much as I personally like golden parachutes, they still are surrounded by controversy and have some negatives, specifically:

1. **May cause resentment among those who don't have a parachute.** For public companies, parachutes have to be disclosed in the proxy. This can sometimes lead to resentment towards leadership.
2. **Executives with parachutes may not be motivated to perform.** It takes a special person to not be affected by a parachute. They may not see the need to work as hard. They may become reluctant to make tough choices – including increasing shareholder value by finding a perfect buyer.
3. **Parachutes may be so large; that they prevent any thought of a takeover.** Several years ago, a special committee of the board hired me to do a change-in-control analysis. They were shocked when I reported that the top two execs, upon change-in-control would get 21% of the purchase price. I went on to say that this would hinder the company's ability to ever pressure a strategic transaction and be bought. Today, that company still has had no suiters.

Probably the most important aspect of the golden parachute, in my opinion, is understanding that it's all about a numerator and a denominator. It's that simple. The complexity comes in what ends up in both. The amount triggered, due to change-in-control, is the numerator. The denominator is the “base amount”, or the average annual compensation paid to the individual over the past five years.

To not be considered “excessive” for IRS purposes (which has another 20% added to federal and state taxes), you have to be at a ratio of 2.99 or lower. You can actually add to the denominator – which is rare and probably not in the shareholder’s best interest – or you can make sure you deal with the numerator within the guidelines the IRS has. There are several ways to handle this, but it usually requires a sound team of advisors. The savings involved can be in the hundreds of millions of dollars – which benefits the existing shareholders, the executives, and the acquiring company. A true win-win-win!

Keys To Remember When Drafting Golden Parachutes

1. **These arrangements are part of the competitive landscape.** Put them in place proactively when they are not expected to be needed anytime soon.
2. **Make sure you re-evaluate yearly**. Circumstances change and golden parachutes need to be reviewed to ensure they still are serving their intended use and are beneficial to shareholders.
3. **Triggers: What needs to happen to pay out?** This is where carefully crafted double triggers are key – (1) The sale of the company and (2) the involuntary constructive termination of employment.
4. **Definition of change-in-control is critical**. Every company should review the competitive landscape and then tailor it to your company and its culture and strategies.
5. **Length of the protection period**. Usually, two years after the change-in-control is effective.
6. **Commonly seen elements:**
    - Lump-sum salary payout; usually 2-3 years.
    - Estimated cash bonus payout, usually on actual and/or target. Also 2-3 years.
    - Long-term incentives having 100% of vesting accelerated.
    - Continuation of benefits, typically 2-3 years.
    - Accelerated vesting of non-qualified deferred compensation plans.
    - Agreeing to non-disparagement; non-compete; indemnification and non-solicitation language.
    - Post change-in-control consulting/on-call arrangements.
    - Additional fringe benefits – like office space and/or outplacement for a specific period of time.

Conclusion

Incredibly powerful, yet complex – golden parachutes are here to stay, AND when correctly constructed, can help in the creation of long-term shareholder value. I could write for a year on just this one issue. The key is to make sure you understand them fully and have great advisors that specialize in them. If you do, well then you have done your team and your shareholders a great service.