The Controversial Golden Parachute – Part 1

How and why was the first Golden Parachute established?

While highly controversial, no executive compensation package is competitive without it.

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Introduction

If there was ever a compensation area of more polarization and notoriety, I don't know of it. Golden Parachutes, also known as Change-In-Control (CIC) payments, have more critics and naysayers than any compensation program I have ever dealt with over my 36 years of consulting… and that's saying something!

It would be my very first client project when I joined KPMG Peat Marwick as their Regional Practice Leader in Dallas, Texas. I was a fresh-minted 30-year-old and I remember studying late into the night to make sure 1. I understood what they were 2. how to use them and 3. to make sure this first client of mine would be happy.

Today, three decades later, I not only utilize them, but am considered an expert on them and have been in court many times- including, but not limited to:

- I was the expert against Enron and how they egregiously designed and used their CIC packages. We won.
- In a case in another state, the plaintiff and counsel I was against, argued that all companies were de facto under some sort of imminent change-in-control threat, such that all CIC payments – there and across the country – should be paid, now! I was stunned we even got through discovery, deposition and now in a courtroom with judge and jury, but there we were. The ramifications of their position would have been horrific. Thankfully, we won.
- And in Texas, several years ago, our legislature was trying to pass the only anti-golden parachute legislation in the country; and only for the State of Texas! It was legislation that would preclude it's use for any company residing in Texas; any company incorporated in Texas; any director living here; and so much more. The Texas Bar asked me to step in as the passage of such a law was shown to be a terrible detriment to the State's attempts to

attract new companies and retain the older ones that had made Texas and its economy, strong. It was a surreal night talking with the Texas legislature that night… one of my top 10 experiences of all time. Thankfully, the legislation did not pass.

Like I said at the start, a polarizing issue.

What Is a Golden Parachute?

A Golden Parachute is defined as an agreement between a company and an employee specifying that the employee will receive certain compensation and benefits if there is a CIC of the company (such as a merger, acquisition, or takeover) and the employment of a said person is terminated, constructively or otherwise, usually within a two-year window of time. The payment includes a multiple base salary; a multiple of targeted annual incentives; the vesting of all long-term incentives and a whole host of other benefits to keep the employee whole, in the event they work themselves out of a job!

Today, they are part of the competitive landscape of what is known as Executive Compensation. Without them, I believe a company is NOT competitive with its peers that have them. However, it must be designed to be fair, reasonable, and with purpose. Unfortunately, with a program like this, we will have our "bad actors" that taint the perception of their use.

The Beginnings of The Golden Parachute

Many, many years ago, there was no such thing as a Golden Parachute! Most people attribute its origins to William Agee in 1983 while he was at Bendix. But if one digs deeper, the first use of the term "Golden Parachute" is credited to the 1961 attempt by creditors to oust the one-and-only Howard Hughes from the control of TransWorld (TWA) Airlines. The creditors provided Charles C. Tillinghast – the Chairman of TWA – an employment agreement contract that included a provision that would pay him money in the event he lost his job.

However, Golden Parachutes were still not widely used, nor even thought of. They were a rarity in executive pay. But two decades later it would become, as they say, cause célèbre! The driver, Michael Milken together with Drexel Burnham Lambert, would create a new financing technique using high yield bond structures that would precipitate an unprecedented amount of merger and acquisition activity in the 80s that had never been seen before.

As a finance person myself, I was intrigued. Drexel and Michael would arm would-be acquirers with what was known as a "highly confident letter" that promised to raise the necessary debt needed in time to fulfill the buyer's obligations. If memory serves me correct, it carried no legal status, but Milken had such an amazing standing in the financial community around the world he could literally "make a market" for any bond structure he decided to back and underwrite. In essence, these letters were as good as cash!

- Interesting note: Years later, Michael was sued for being over-compensated and being a corporate waste of assets. I was the one his lawyers called to be his expert. It was said he was making around $750 million a year. As such, I declined. It appears to have been a wise decision as Michael would later go to jail on a variety of charges. Today though, it appears he is using his money and expertise for a variety of great causes, which is great to see.

So, mergers and acquisitions were off to the races. Hostile takeovers, greenmail, and leveraged buyouts (LBO's) fostered a new era of takeovers, conglomerate breakups, and divisional selloffs. This was all being done, not just to make money by the bankers, but with the goal of industry specialization in hopes that it would make corporate America more competitive in worldwide markets. Couple all of that with "easy money" and corporate America would transform itself overnight and into an amazing bull market.

As you can imagine though, the sense of concern with executives during this time, heightened, as most top executives tended to be let go after a takeover. The purpose of the Parachute was to retain the top executives and key people while ensuring a sense of financial protection while they were working themselves out of a job and trying to maximize shareholder value via a transaction. The intent was to keep executives from fighting takeover deals that could potentially bring a large payout to the company's shareholders.

William Agee, Bendix, and the Law of Unintended Consequences

The Law of Unintended Consequences – often discussed, but rarely defined, is the actions of people and governments that have a perverse effect and/or unanticipated result. Economists and social scientists have discussed its power for centuries, but for just as long, politicians and popular opinion have ignored it.

Golden Parachutes are a Prime Example!

What happened?! William Agee and Bendix happened. And after that, The Deficit Reduction Act of 1984 was put into place to "limit" the use of Golden Parachutes. Both would trigger one of the greatest unintended consequences of all time and maybe the greatest, with respect to executive pay!

William Agee was an amazing executive by all accounts. He was appointed President & CEO of Bendix Corporation in 1976 at age 38. In 1979, he had been featured in Time Magazine's cover story as Faces of the Future" and was also named Finance magazine "Financial Man of the Year." Little did he know then that he would be the catalyst of where we are today with respect to the Golden Parachute and the change-in-control legislation that would soon follow.

Agee appears to be an executive way ahead of his time. He dramatically increased the value of Bendix stock during a significant recession. And, like Herb Kelleher (my long-time friend and client at Southwest Airlines), he was a man of the people.

In 1982, he wanted more for Bendix and decided to launch a hostile takeover of Martin Marietta. But he did not consider that Martine Marietta had no such desire to be bought as they mounted a Pac-Man defense by going after its would-be acquirer's stock! Both Agee and the CEO of Martin Marietta would not concede, it was a win at all costs! Then it got crazy. Martin Marietta enlisted the help of United Technologies while Agee and his team went to Allied Corp. I know this is starting to sound like an NFL trade of sorts with respect to quarterbacks but stay tuned.

It was intense. Unfortunately, everyone was watching this battle wage, including our government and regulators. In the end, Allied would take possession of Martin Marietta's shares that Bendix had while Bendix would become a subsidiary of Allied. As a result, Agee was asked to resign once the merger was completed.

Interestingly, Martin Marietta created 28 Golden Parachutes for its executives while Bendix issued 16. For those on the sidelines and arm-chair quarterbacking, it appeared that Bendix had positioned themselves in a "no-lose" situation where, at best, they would acquire Martin Marietta, and at worst, the execs would be well-paid for a poor decision and losing their jobs.

Here's what is fascinating – Bendix's total Parachute payment is said to have been a smidge over $15 million with Agee getting about $4 million. I know, everyone that is reading this is smiling at how small that amount is compared to payouts today, both in absolute and relative terms. But the best was yet to come… remember when we were discussing The Law of Unintended Consequences. Well, it was a year away.

Tax On Golden Parachutes and Its Unintended Consequence

In 1984, Congress would pass a special tax on Golden Parachutes known as "The Bill Agee Bill". We all know it as 280g and 4999 of the Internal Revenue Code. Its intent was to curb the use of Golden Parachutes. It legislated a special tax on awards valued at more than three times an executive's average pay over the previous 5-year term. However, it did not curb the practice; rather it gave credence to it and institutionalized it such that it would be forever part of the corporate competitive landscape. It's been said that less than 10% of companies had anything along these lines back then with payouts around one year's worth of compensation. Today, virtually all companies have them with average payouts of 2–3 times total pay. Amazing!

In essence, Golden Parachutes went from a rarity to a requirement. A great definition for economists as to The Law of Unintended Consequences!