The Impending Collapse of Golden Parachutes

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Executive compensation practices in the United States have become an important target of corporate governance concern. Even after the SEC's recent adoption of expanded mandatory disclosure of the types and totals of compensation, activist institutional investors have stepped up the campaign. Even the President of the United States has weighed in.[1]

In looking for the likely directions of change in US compensation practices, the UK experience with shareholder advisory votes on executive compensation provides some useful insights. Beginning in 2002 UK corporate law required a shareholders vote on the report of the remuneration committee, a report similar in content to the new SEC requirement of a compensation discussion and analysis report.[2] The vote does not affect the legal status of any existing compensation contract; it's a confidence vote, and the vote has been negative on only a handful of occasions. Nevertheless the threat of a negative vote has led firms to discuss compensation packages with UK institutional investors much more than previously. Moreover, the UK institutional investor community is much more cohesive than in the US, and the relevant institutional investor councils and corporate governance advisory groups issued best practice guidelines. This has led to some definite changes in practice.

The clearest lesson to emerge is the aversion to large golden parachutes, those contracts providing for large payments to the CEO upon a change in control or upon termination without cause. Indeed, one of the few actual negative votes came in response to a golden parachute arrangement with the CEO of GlaxoSmithKline, for $35 million – small potatoes compared to recent controversial payouts at Home Depot and Pfizer. In response to shareholder pressure, the parachute was cut back by two thirds. In other respects pay practices have not deviated much from the US model, meaning levels

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[1] Speaking before an audience of financial leaders in New York City on Jan 31, 2007, President Bush said:

> "Government should not decide the compensation for America's corporate executives, but the salaries and bonuses of CEOs should be based on their success at improving their companies and bringing value to their shareholders. America's corporate boardrooms must step up to their responsibilities. You need to pay attention to the executive compensation packages that you approve. You need to show the world that American businesses are a model of transparency and good corporate governance."

"State of the Economy" address, Jan. 31, 2007, available at www.whitehouse.gov. (major speeches).

[2] See SEC Rel. No. 33-8732A , 71 FR 53158 (Sept. 8, 2006). See generally Executive Compensation: If There is a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis," 30 J. Corp. Law 675 (2005) (discussing disclosure approach and UK advisory vote system).

of performance-based pay, including stock-related compensation, that still raise the hackles of those motivated by equality concerns.

In the United States, a coalition of public pension funds and labor related pension funds are trying to achieve the UK process of shareholder advisory votes through self-help. For the current proxy season, the coalition has targeted 44 large corporations, including Pfizer and AIG, with bylaw amendment proposals that would provide for shareholder advisory votes on executive compensation. A working group of funds and issuers has been meeting to negotiate a resolution of this issue. This is a potentially important change with far-reaching consequences. My prediction is that the affect on pay practices will be similar to the UK result: aimed mostly against golden parachutes, not against stock-related compensation more generally.

So what's the problem with golden parachutes?

Here a little history is in order. Golden parachutes arose as an adaptive response to the hostile takeover movement of the 1980s. There are two ways to tell the story. On the bright side, golden parachutes compensated target managers, who typically faced displacement after such a takeover, for the loss of what an economist would call firm specific human capital investments. But why should a laid-off CEO receive such compensation, and so generous, when a laid-off rank and file worker – also having made firm specific human capital investments, often of equal or greater relative net worth -- usually does not?

That brings us to the dark side. The courts, Delaware most importantly, gave managers what might be called a takeover-resistance endowment – that is, the right to fight a hostile takeover using corporate resources, including the power to "just say no." One way to solve this dilemma is to structure compensation to align managerial and shareholder incentives in the face of a hostile bid – that's the polite way to describe the resulting golden parachute arrangement. So if the CEO receives approximately 3 times salary and bonus and the accelerated vesting of a large stock option grant to boot, the chance to become truly rich in a takeover solves the problem of mangers fighting off hostile bidders.

But the devil is in the details, and the triggers for these 'chutes were crafted for more broadly than the core case of the takeover where the CEO loses his job. Most notably, the 'chutes broadened into a general severance arrangement that covered not only takeover situations, but virtually any case of termination without cause.[3] This then leads to the $200 million nightmare cases like the dismissed CEOs of Pfizer and Home Depot – not "pay for performance," not the CEO getting a share of the upside when the

[3] Of course, firing a CEO is arguably just a lower cost way to achieve the result of a significant fraction of hostile deals which seek gains in the replacement of inefficient managers. The CEO's loss of human capital in such a case is equivalent to the actual takeover. The only difference is in the CEO's resistance right, which in the firing case comes from managerial control over the proxy machinery that has been a source of the CEO's ability to stack the board with allies. The corporate governance changes that have undercut the CEO's ability to dominate the board selection process are parallel to other changes in the corporate control markets that have reduced the anti-takeover endowment.

firm is sold at a premium, but "pay for failure" so egregious that even a chief executive who has on occasion awarded the Medal of Freedom despite failure feels obliged to take notice.

So my prediction is that following the UK example, golden parachutes will come in for serious scrutiny and revision.

Now, you might say, what about the original impetus for the golden parachutes, the need to buy back the judicially granted takeover-resistance endowment? Here is where things become really interesting. My claim is this: that golden parachutes consist of two distinct elements, one part that is genuinely compensatory for the risk to human capital in taking a CEO job; another part that consists of this special shareholder payment to overcome control market impediments. And further: that the rise of hedge funds and private equity funds as activist shareholders has begun seriously to erode the takeover resistance endowment in ways that will soon eliminate the need to make the special payment. In other words, golden parachute payments will shrink significantly.[4]

The core of this story is the way that economically motivated activists can catalyze first the formation of what might be called a "wolf pack" of other economically motivated shareholders and then gather the pension funds and mutual funds into an implicit majority coalition. All of this can happen without triggering the formation of a "group" under the definitions of the federal securities laws that have been imported into the triggering provisions of the poison pill. The pill is the key to the takeover-resistance endowment. As it loses effectiveness, the need to pay the non-compensatory element of the parachute disappears.

The evidence of hedge fund success is quite remarkable. An Oct. 2006 study by April Klein and Emanuel Zur of the Stern School of Business at NYU reports that hedge funds pursuing shareholder activist strategies achieve objectives set forth in their public filings[5] in 60% of the cases.[6] When they undertake a proxy fight, they win representation in 72% of the cases; even the mere threat of a proxy contest produces a board seat 57% of the time. This is a remarkable result in light of the low frequency and poor success rate of insurgent proxy contests reported by prior research.[7]

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[4] A complementary factor is that the new SEC disclosure will make clear the inefficiency of golden parachute contracts, meaning the mismatch between the cost to the firm vs. the value to the CEO. This is particularly affected by the excise tax provisions of IRC § 162(m) and the common practice of "grossing up" parachute payments to cover the CEO's tax obligations. One knowledgeable compensation consultant has estimated that, on average, it takes $10 of after-tax corporate expenditure to produce $1 of after-tax benefit benefit to the recipient.

[5] Schedule 13-D under the 1934 Securities Exchange Act.

[6] April Klein & Emanuel Zur, Hedge Fund Activism, WP Oct 2006, available on SSRN at http://ssrn.com/abstract=913362, Table 5.

[7] See, e.g., Lucian Bebchuk, The Myth of Shareholder Franchise, Harv. L&Econ. WP No. 505 (Nov. 2006), available at http://ssrn.com/abstract=829804 (1996-2005 data).

Thus my prediction: golden parachutes will be the target and they will substantially change. Other elements of compensation that have payoffs when shareholders too are in the money, such as generous stock option plans that require longterm holding after exercise, will remain. The willingness of private equity funds to enter into large, stock-option laden compensation contracts with for senior managers after a takeover suggests strong market effects at work,[8] as does a recent paper that links the six-fold increase in average executive compensation at large firms to a comparable increase in firm size over the same period.[9] But the peculiar arrangement of a "golden parachute" seems more the product of a regulatory anomaly than a market-based term. Its supra-compensatory "payment for failure" is a red flag.

[8] Of course, such contracts entail close monitoring by the private equity investors, who presumably offer such contracts only after screening for managerial effectiveness, and which contracts generally provide for no exit without a profitable exit.

[9] Xavier Gabaix & Augustin Landier, Why Has CEO Pay Increased So Much? (July 2006). MIT Econ WP No. 06-13, available at SSRN: http://ssrn.com/abstract=890829.