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## Corporate Golden Parachutes: An Executive Bailout from Fiduciary Duty?

Lynn A. Epstein\*

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## **Abstract**

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**KEYWORDS:** bailout, parachutes, duty

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## I. Introduction to Golden Parachutes

A golden parachute is a potentially lucrative wage contract that compensates officers or other key executives of a corporation in the event of a change in control.<sup>1</sup> They are rapidly becoming a corporation's newest defensive weapon in a takeover battle. For example, if a takeover should occur which results in the replacement of existing management, the golden parachute would assure an ousted officer that he would be compensated. The ousted officer's compensation may be as high as several million dollars. Thus, an executive receives a golden profit when he "bails out" from his position.

Golden parachutes come in many forms, such as specific job titles, bonuses, or pension plans, but most often are simply a lump sum of money.<sup>2</sup> Although contractual perks for top management are not new, there is a sharp distinction between golden parachutes and other attractive executive compensation plans.<sup>3</sup> Golden parachutes are triggered when there is a change in control of the corporation. If control never changes, then the executive never receives the parachute compensation. Thus, although justified as just another type of executive compensation, the frequent implementation of golden parachutes by corporations following a wave of merger and takeover activities in the late 1970's and early 1980's clearly underlies one main objective - to fend off takeovers.<sup>4</sup>

Arguably, golden parachutes are accomplishing that objective. In 1983, for example, tender offers fell to a six year low in terms of frequency and value.<sup>5</sup> While some analysts partially credit a strong stock market for this decline, other analysts credit the increased use of effec-

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1. Note, *Golden Parachutes - Executive Compensation or Executive Overreaching?*, 9 J. CORP. LAW 346 (1984).

2. McLaughlin, *On Golden Parachutes*, 17 MERGERS & ACQUISITIONS, Summer 1982, at 23.

3. *Id.* at 22.

4. *Id.*

5. Austin & Jackson, *Tender Offer Update: 1984*, 19 MERGERS & ACQUISITIONS, Spring 1984, at 63.

tive defensive tactics by target companies as a major factor.<sup>6</sup> Therefore, it appears as though golden parachutes have had a solid impact in discouraging takeover attempts. With approximately sixty percent of the top one thousand American corporations now using golden parachutes, a strong case can be made that no executive should be without one.<sup>7</sup>

Corporate directors continue to justify golden parachutes mainly on the presumption that they attract and keep top-quality management.<sup>8</sup> Other directors question this reasoning, claiming that an executive's primary motivation during a tender offer period should derive from fighting to save their own company. Officers want to remain in command and not become part of another company.<sup>9</sup> This is the attitude that was taken by William Agee, who was the past President of Bendix Corporation. Mr. Agee claimed his golden parachute did not alter his strategy in his takeover battle with Martin Marietta Corporation and Allied.<sup>10</sup> Therefore, the existence of a golden parachute may often attract an "extremely compensation oriented director-officer who can adopt a laissez-faire attitude during a takeover."<sup>11</sup> The premise of attracting top-quality management may be just an illusion and the prevalence of golden parachutes may be the result of corporate "follow the leader games".<sup>12</sup>

Whatever the justification may be for a golden parachute, arguably those who are most adversely affected by them are corporate shareholders. A director-officer owes a fiduciary duty to act in the best interest of shareholders, especially during a tender offer period.<sup>13</sup> A golden parachute may lead a director-officer to become more concerned with his bail out bonus than in representing the best interests of the shareholders. Even with this obvious potential conflict courts and legislatures are reluctant to take any concrete measures to restrict their use. Only the Internal Revenue Service has taken a major active step to limit the

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6. *Id.*

7. *See, e.g.,* FORBES, Nov. 22 1982, at 238. However, other surveys have been more conservative, estimating 15-30 percent of major corporations. *See generally* Morrison, *Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982 at 82.

8. Morrison, *supra* note 7, at 83.

9. *Id.* at 84.

10. *Id.*

11. McLaughlin, *supra* note 2, at 24.

12. *Id.* at 23.

13. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND BUSINESS ENTERPRISES § 207 (1983).

use of golden parachutes.<sup>14</sup> Yet the question remains whether the IRS is the proper agency and is using the proper methods to resolve the issue of golden parachutes.

This note will explore the reasons that the mere existence of a golden parachute can constitute a breach of fiduciary duty and fraud. Special emphasis will be given to examining golden parachutes which are created during a tender offer period. Also, the remedies that a shareholder may have in the form of a derivative lawsuit under state law or an action under the Williams Act<sup>15</sup> under federal law will be set forth. Finally, the 1984 Tax Reform Act<sup>16</sup> will be examined to show its restrictive effect on golden parachutes.

## II. The Golden Parachute and the Tender Offer: a Breach of Fiduciary Duty

Corporations have the power to create golden parachutes by virtue of The Model Business Corporation Act.<sup>17</sup> Adopted in full by twenty-five states and in part by virtually every state, the Model Business Corporation Act provides that the power to pay pension, stock option plans, and any other incentive plans for directors, officers and employees are among the express general powers of a corporation.<sup>18</sup> Furthermore, the courts have reinforced this power by continually recognizing the importance of incentive plans to the success of a corporation, and courts will only interfere if an incentive plan is deemed to constitute a waste of corporate assets.<sup>19</sup> To constitute waste, however, there must be a clear misuse of the corporation's assets. This misuse must amount to a gift to a director with no relation to business activities.<sup>20</sup> Without such a flagrant abuse of a corporation's funds, courts are reluctant to become involved.

Most courts will simply apply the business judgment rule, a court

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14. See *infra* text accompanying notes 86-93.

15. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78 n(e)).

16. I.R.C. § 280 (G) (1984) amended by Tax Reform Act of 1984, Pub. L. No. 90-369, § 46, 98 Stat. 588 (1984).

17. MODEL BUSINESS CORP. ACT. ANN. 2D §4(k) (1971).

18. *Id.* "Besides express powers pursuant to statute or the articles of incorporation, corporations enjoy various implied powers." See H. HENN & J. ALEXANDER, *supra* note 13, § 183 (1983).

19. Rogers v. Hill, 289 U.S. 582, 591 (1933).

20. *Id.* at 591.

created concept which states that absent a showing of bad faith, the court will not substitute its judgment for that of the board of directors.<sup>21</sup> Thus, the business judgment rule allows a corporation much flexibility in managing its activities. The rule probably includes compensation arrangements such as golden parachutes. A board of directors is able to defend its activities on the basis of the business judgment rule and are often successful because courts do not want to be put in the position of "second-guessing management."<sup>22</sup> Furthermore, the courts have expanded their use of the business judgment rule by now allowing a board of directors to use the rule not only as an affirmative defense but also as a preemptive weapon for the dismissal of a shareholder's derivative suit.<sup>23</sup> When a corporation can show that a derivative suit is not in the best interest of the corporation the board of directors may be allowed to terminate the shareholder's action.<sup>24</sup> Although the preemptive use of the business judgment rule has yet to be implemented in relation to golden parachutes its application seems likely. The Model Business Corporation Act and the business judgment rule allow a corporation much freedom in the use of golden parachutes.

On the other hand, in the area of tender offers, golden parachutes become more than just a form of compensation in line with pension and retirement plans. Golden parachutes become an effective bargaining tool between the target company and the bidder. A conventional tender offer "normally consists of a bid by an individual or group to buy shares of a company usually at a price above the current market price."<sup>25</sup> When the tender offeror has acquired a controlling amount of

21. See *Heller v. Boylan*, 29 N.Y.S.2d 653 (N.Y. Sup. Ct. 1941). See also MODEL BUS. CORP. ACT ANN. 2D § 357(1) (Supp. 1977) .

22. F. BALDWIN, *CONFLICTING INTERESTS* 25 (1984). However, the business judgment rule has come under recent criticism with some courts now substituting their judgment for that of a corporation's board of directors. This result has occurred where there has been obvious board bias or where the board or shareholders have not been fully informed. See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *Smith v. Van Gorkom*, FED. SEC. L. REP. (CCH) ¶ 91, 921 at 90,552 (Del. Jan. 29, 1985).

23. Dent, *The Powers of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 NW. U.L. REV. 96, 98 n.14 (1980).

24. However, certain restrictions do apply. A board of directors must show good faith and no bias. Therefore, if the board is named as defendant in a shareholder's derivative suit, they lose their independence. Corporations have gotten around this provision by setting up special litigation committees who make an investigative report and recommend whether the suit should continue. See *Zapata*, 430 A.2d at 784.

25. H.R. REP. NO. 1711, 90th Cong., 2d Sess. 2, reprinted in 1967 U.S. CODE CONG. & AD. NEWS 2811.

shares, a takeover occurs.<sup>26</sup> However, in order to accumulate the requisite number of shares, the bidder and the target corporation may negotiate for the tender price of shares of stockholders. Since the bidder's price for the shares of the corporation is usually well above current market price, most shareholders will welcome the offer.<sup>27</sup> However, even though a director-officer must always act in the best interests of the shareholders, he may attempt to fight this profitable takeover in order to save his job.<sup>28</sup> Within one year of most takeovers the previous management is usually replaced.<sup>29</sup> It is during this tender offer period that a director-officer's loyalty may be questioned due to an inherent conflict of interest.<sup>30</sup> A breach of fiduciary duty is possible without a golden parachute because a director-officer is put in the position of choosing between his job or securing a profitable deal for his shareholders. However, the existence of a golden parachute is a strong outside factor which further weakens the relationship between a shareholder and a director-officer.

Golden parachutes can lead to breach of fiduciary duty in two main ways. First, one who is in a fiduciary position, such as an officer or key executive, "cannot serve himself first and [shareholders] second."<sup>31</sup> His loyalty must be undivided and influenced only by corporate considerations.<sup>32</sup> However, since an officer will be guaranteed a large sum of money if a takeover occurs, his incentive and motivation to inform and protect shareholders is likely to diminish. Although it is argued conversely that a corporate officer may work harder for shareholders by having the security of a golden parachute, it is questionable whether this type of person should have been hired initially because a "corporation under siege should not be manned by the unsure or insecure."<sup>33</sup> If an officer needs the assurance of a golden parachute in order to fight a takeover perhaps he does not have the self confidence that is necessary to do an effective job. Therefore, golden parachutes insure

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26. A tender offer is by no means the only way to acquire a corporation. Other methods which will not be discussed involve exchange of assets, mergers, and proxy fights. See F. BALDWIN, *supra* note 22, at 168.

27. *Id.* at 167.

28. *Id.*

29. McLaughlin, *supra* note 2, at 27.

30. Crane Co. v. Harsco Corp., 511 F. Supp. 294, 305 (D. Del. 1981).

31. Pepper v. Litton, 308 U.S. 295, 311 (1939).

32. *Id.*

33. Note, *Future Executive Bail Outs: Will Golden Parachutes Fill the American Business Skies?*, 14 TEX. TECH. L. REV. 615, 621 (1983).

security but increase self-motivation, not fiduciary motivation.

Furthermore, golden parachutes are a drain on a corporation's assets in purely economic terms. An acquiring corporation may reduce its tender offer price per share to account for the price of the golden parachute.<sup>34</sup> Ohio's Senator Howard Metzenbaum believes this is the primary reason for limitations on the use of golden parachutes. He stated that acquiring corporations "are not that stupid to not allow the price of a golden parachute to have an impact on their offering price. . . [and]. . . shareholders wind up paying for no logical reason."<sup>35</sup> However, there are those who contend that the price of a golden parachute in relation to the total acquisition price is too minimal to be a decisive factor in discouraging takeovers.<sup>36</sup> Gulf Resources Corporation, for example, has golden parachutes totalling thirteen million dollars, an amount which would undoubtedly cause substantial impact on a bidder.<sup>37</sup> It is difficult to see how golden parachutes such as these can promote the best interests of a shareholder. A shareholder's major objective is profit. Arguably, the existence of a golden parachute clearly conflicts with this objective when corporate funds are used to pay executives rather than channeled to the shareholders through profits.

### III. Shareholder's Remedies for Golden Parachutes

#### A. Derivative Actions Under State Law

One line of defense a shareholder may have against golden parachutes is a derivative suit. A shareholder has a right to bring an action on behalf of his corporation for the purpose of remedying wrongs to the corporation in the form of a derivative lawsuit.<sup>38</sup> A prerequisite

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34. Note, *Anti-Takeover Actions and Defenses*, 28 VILL. L. REV. 51 (1982). For example: "[I]f Company X was willing to offer \$20 per share for Company Y's shares, it might offer \$18 instead which would take into account the \$2 per share cost of the severance benefits." *Id.* at 70.

35. 15 SEC. REG. & L. REP. (BNA) 1956 (1983).

36. See Morrison, *supra* note 7, at 86.

37. McLaughlin, *supra* note 2, at 23. Furthermore, this corporation showed a loss of \$77.9 million in comparison to a net profit of \$12.7 million in 1981. *Id.*

38. See H. HENN & J. ALEXANDER, *supra* note 13 at 1035 which provides: Equity developed the derivative action so that the shareholder derivatively or secondarily could enforce a corporate right against insiders or directors where those in control of the corporation refused to have the corporation sue directly and thereby protect the whole community of corporate interests-creditors and shareholders, including [his] own investment in the cor-

under most state statutes is that the complainant must have been a shareholder of the corporation at the time of the alleged wrongdoing.<sup>39</sup> However, the courts have imposed further restrictions on derivative suits by consistently holding that for derivative suit purposes the complainant must have been a shareholder not only at the time of the transaction in question, but also must remain a shareholder throughout the litigation.<sup>40</sup> In the absence of such status the complainant no longer has standing to proceed with the suit.<sup>41</sup> This standing problem has become the shareholder's nemesis in golden parachute litigation. In the foremost case on golden parachutes to date, *Lewis v. Anderson*,<sup>42</sup> the Delaware Supreme Court reaffirmed its previous rulings that a plaintiff who ceases to become a shareholder by reason of a merger loses standing to continue a derivative suit.

In *Lewis*, the plaintiff sued on behalf of the shareholders of Conoco, which had been the target of a successful takeover by Dupont.<sup>43</sup> The shareholders alleged that the directors, in anticipation of a potential takeover, entered into nine golden parachute contracts with key officers valued at five million dollars each, effective when the takeover occurred.<sup>44</sup> The shareholders contended that these golden parachutes were "illegal, improper. . . and a waste of corporate assets."<sup>45</sup> However, because the shareholders had sold their Conoco stock during the takeover, the defendant corporation moved to dismiss the suit for lack of standing. The Delaware Supreme Court affirmed the trial court's granting of the motion and did not address the legality of golden parachutes.<sup>46</sup>

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poration. The derivative action, because of its procedural development, is equitable in nature and besides often involves equitable issues of breach of fiduciary duty but can involve law issues of due care and claims for damages.

*Id.*

39. *Id.* at 1058.

40. See *Braasch v. Goldschmidt*, 199 A.2d 760, 765-66 (Del. Ch. 1964); *Heit v. Tenneco, Inc.*, 319 F.Supp. 884, 886 (D. Del. 1970).

41. *Braasch*, 199 A.2d at 767 holding that "by virtue of the merger. . . the derivative rights [of a shareholder] have passed to the surviving corporation" *Id.*

42. 477 A.2d 1040 (Del. 1984).

43. *Id.* at 1042.

44. *Id.*

45. *Id.*

46. However, the court emphasized that if there was indeed a wrong committed, New Conoco (Dupont, Inc.) could bring an action against the management of Old Conoco on behalf of the shareholders of Old Conoco. But considering that New Conoco

The effect of such a dismissal for lack of standing appears to leave no apparent remedy to the shareholder in the form of a derivative lawsuit under state law. Two cases have made exceptions to the standing prerequisite of continued shareholder status throughout the litigation. One case found that an exception exists when a corporation becomes a subsidiary of another corporation.<sup>47</sup> The second case created an exception when a corporation is forced to reorganize pursuant to government antitrust laws.<sup>48</sup> No further exceptions for golden parachutes appear imminent. Despite this pessimistic forecast, distraught shareholders have continued to question the legality of golden parachutes in corporate activities by suing the corporation under a breach of fiduciary duty claim.<sup>49</sup> In light of these shareholders' absence of success, a better approach may be to attack golden parachutes as a violation of a federal securities law.

## B. Actions Under Federal Law for Violations of Section 14(e) of the Williams Act

A shareholder may have a cause of action for violation of a federal securities law under section 14(e) of the Williams Act.<sup>50</sup> The Williams Act is an amendment to the Securities and Exchange Act of 1934, and the Act's purpose is to require full and fair disclosure to a shareholder in relation to a tender offer.<sup>51</sup> To accomplish this purpose, the Act prohibits fraudulent activities in connection with a tender offer. Only the Securities and Exchange Commission has been granted express authority by Congress to act under section 14(e).<sup>52</sup> However, the Securities and Exchange Commission has sought action only under section 14(e)

joined Old Conoco in the motion to dismiss, this is an unlikely solution for the shareholders. *Id.* at 1050.

47. *Schreiber v. Carney*, 447 A.2d 17, 22 (Del. Ch. 1982). The merger in question was a mere corporation facelift and the stockholder retained his ownership interest in the corporation.

48. *Helfand v. Gambee*, 136 A.2d 558 (Del. Ch. 1957).

49. *See generally* *Schreiber v. Burlington Northern, Inc.*, 731 F.2d 163 (3rd Cir. 1984); *Wolgin v. Simon*, 722 F.2d 389 (8th Cir. 1983); *Brandon v. Chefetz*, 121 Misc.2d 54, 467 N.Y.S.2d 312 (N.Y. Sup. Ct. 1983); *Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984).

50. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78n(e)) (1968).

51. H.R. REP. NO. 91-1655, 91st Cong., 2d Sess. 3 *reprinted in* 1970 CONG. & AD. NEWS 5052.

52. *Id.* §5.

on eight occasions,<sup>53</sup> while private individuals have brought actions under section 14(e) over 300 times.<sup>54</sup> Therefore, although the Act does not expressly grant an individual shareholder the power to use section 14(e), the courts have continued to imply a cause of action for the individual shareholder under section 14(e).

Section 14(e) of the Williams Act requires the plaintiff to prove that the target company made a misleading statement or omission of a material fact or an intent to defraud third party investors in relation to tender offers.<sup>55</sup> Furthermore, the plaintiff must show that he subsequently relied on the misrepresentations and suffered damage.<sup>56</sup> Therefore, a shareholder who is seeking damages for a golden parachute may either base his Williams Act claim on negligence or fraud.

Courts have struggled with the definition of a misstatement or omission of a material fact under the Williams Act<sup>57</sup> in relation to a tender offer. Some courts have held that shareholders must prove only negligence<sup>58</sup> and other courts require the more stringent test of showing a reckless failure by directors of a corporation to make reasonable facts available to shareholders that shareholders could have discovered with reasonable effort.<sup>59</sup> This distinction may become important when examining the disclosure requirements for golden parachutes and their im-

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53. Note, *Securities Law: Implied Causes of Action Under Section 14(E) of The Williams Act*, 66 MINN. L. REV. 865, 870 n.23 (1982).

54. *Id.* at 870 n.23.

55. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78 (n)(e)) (1968). § 78 (n)(e) provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative.

*Id.*

56. See *Chris Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 373 (2d Cir. 1973), *cert. denied*, 414 U.S. 910 (1973). *Panter v. Marshall Field & Co.*, 646 F.2d 271, 283 (7th Cir. 1981), *cert. denied*, 102 S. Ct. 658 (1981).

57. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78 (n)(e)) (1968).

58. See *SEC v. Wills*, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

59. *Chris Craft*, 480 F.2d at 363.

pact on the shareholder. A shareholder may be able to discover the existence of golden parachutes with reasonable effort but the question becomes should he have to make such an effort.

The Securities and Exchange Commission is attempting to restrict the use of golden parachutes through specific disclosure provisions. Revised Item 402(e)<sup>60</sup>, an amendment to the Securities and Exchange Act of 1933, requires a separate disclosure for compensation paid to an executive triggered by a change in control.<sup>61</sup> However, there are many loopholes in this provision that may permit an omission of a material fact that would be misleading under the Williams Act. For example, the new disclosure provision requires individual disclosure of golden parachutes only for the top five employees of a corporation, and group disclosure for all executive officers.<sup>62</sup> However, United Technologies Corporation has golden parachutes for 64 of its employees, Kimberly Clark Corporation protects 80 executives, and Beneficial Corporation maintains golden parachutes for a staggering 250 executives.<sup>63</sup> These numbers of covered employees appear way beyond the disclosure requirements. Therefore, the amount of a golden parachute compensation disclosed to a shareholder may be, in reality, a mere fraction of the total price a corporation may be required to pay to its executives upon the triggering event. This omission may be sufficient to constitute a violation of the Williams Act.

Furthermore, although disclosure is required for a change in control agreement, there are many definitions of what constitutes a change of control.<sup>64</sup> Although acquisition of fifty-one percent of the shares of a corporation is a standard definition, working control in many cases may be obtained with less than a majority of shares.<sup>65</sup> Therefore, according to the provisions of a particular golden parachute agreement even a twenty percent investment block or smaller percentage of shares could trigger the payoff.<sup>66</sup> Mohasco Corporation and Olin Corporation are

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60. See *Final SEC Rules On Disclosure of Executive Compensation*, 15 SEC. REG. & L. REP. (BNA) at 1852 (Sept. 30, 1983) [hereinafter cited as *Final SEC Rules*].

61. *Id.*

62. *Id.* at 1854.

63. See Morrison, *supra* note 7, at 86.

64. See Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212, 1213-16 (1958).

65. *Id.* at 1213.

66. See generally Meyer, *Lawyer's Lament, Arbitrager's Delight*, FORBES, May 24, 1982, at 31.

examples of two companies in which a twenty percent change of ownership will trigger their respective golden parachutes.<sup>67</sup> Since the Securities and Exchange Commission's Rule 402(e) doesn't specifically define what constitutes a change in control, the shareholder is basically unaware under what circumstances the parachute may be paid. Although a specific change in control section was proposed, it has not been adopted.<sup>68</sup> The Commission felt that these disclosed matters were encompassed in other sections. Therefore, disclosure of golden parachutes can remain relatively hidden behind a myriad of ambiguous terms.<sup>69</sup> The golden parachute becomes lost among other types of bonuses when there is no specific change in control section. A company's failure to disclose its change in control terms that trigger its golden parachutes could further be a misleading omission under the Williams Act.

The major problem, however, with a shareholder pursuing a remedy for golden parachutes is that courts have held that the Williams Act is not applicable to mere breach of fiduciary duty.<sup>70</sup> A shareholder seeking to hold corporate officers liable for a negligent omission of a material fact in relation to disclosure of a golden parachute may, in reality, be alleging merely a breach of fiduciary duty. The rationale for imposing this restriction on the Williams Act is that state law governs fiduciary duty of corporations and to impose a federal standard of fiduciary duty would constitute an overlap of state and federal law.<sup>71</sup> As previously noted, however, a shareholder will most likely not be able to proceed with a lawsuit under state law because of the standing problem. Since there is no viable state remedy for a shareholder attacking a golden parachute after a takeover has occurred, a Williams Act claim under federal law used would not be usurping a state's power to govern fiduciary duty claims.

A potential problem in using the Williams Act is that courts have

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67. See Morrison, *supra* note 7, at 87.

68. See *Final SEC Rules*, *supra* note 60, at 1856.

69. However, at least one court has held that merely disclosing the formula for calculating a golden parachute is inadequate because it did not stress the importance of this compensation. See *Negligence Standard, Not Scierter, Test of Proxy Disclosure's Adequacy*, 15 SEC. REG. & L. REP. (BNA) at 1740 (Sept. 16, 1983) [hereinafter cited as *Negligence Standard*].

70. See *Altman v. Knight*, 431 F. Supp. 309 (S.D.N.Y. 1977). *Berman v. Gerber Products*, 454 F. Supp. 1310 (W.D. Mich. 1978).

71. Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 649 (1983).

ruled that section 14(e) is not applicable to some defensive tactics<sup>72</sup> because they are not sufficiently manipulative or deceptive to fall within 14(e).<sup>73</sup> To maintain an action under section 14(e) of the Williams Act it would appear that a stronger claim than breach of fiduciary duty is needed. Not only would a shareholder have to show a material omission that is misleading, but most likely would have to show fraudulent, deceptive, or manipulative acts in connection with the tender offer. But there are some golden parachutes created in anticipation of a takeover that may be fraudulent and manipulative.

A target company does not have to disclose its merger talks with a bidder.<sup>74</sup> A shareholder need only be informed once there is an agreement on price and structure.<sup>75</sup> It is possible that target management could create a golden parachute during these talks since golden parachutes require no shareholder ratification,<sup>76</sup> and the Securities and Exchange Commission does not require a corporation to disclose whether this plan was ratified by the shareholders.<sup>77</sup> Arguably then, a corporation may create golden parachutes to forestall the takeover bid or to pay themselves a bonus when the takeover becomes apparent. Although the motive may be self-interest, the result is a reduction in a shareholder's price per share due to the inclusion of the golden parachutes.<sup>78</sup> In this respect, certain golden parachutes can be viewed as a manipulative device which involves conduct that artificially affects market activity so as to mislead investors.<sup>79</sup> Market activity must be artificially affected to the extent that the activity is disguised or deliberately concealed from investors.<sup>80</sup> Therefore, the computations of golden parachutes in the offering price to a shareholder during a tender offer period may be disguised activity because their bargaining effect

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72. *Altman*, 431 F. Supp. at 314. *Berman*, 454 F. Supp. at 1318.

73. *See Mobil v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981).

74. *Greenfield v. Heublin, Inc.*, 742 F.2d 751, 756 (3rd Cir. 1984).

75. *Id.*

76. Ratification shifts the burden to the shareholder to prove unfairness of the plan and the business judgment rule then applies. Without ratification, where directors are fixing their own compensation, the burden is on the directors to show good faith and fairness. *See Cohen v. Ayers*, 596 F.2d 733, 739 (7th Cir. 1979).

77. "Ratification disclosure is not material since investors are mainly concerned with the terms of the plan and not its likelihood of shareholder approval." *See Negligence Standard*, *supra* note 69, at 1742.

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

79. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

80. *Mobil*, 669 F.2d at 374.

might have depressed the value of a shareholder's stock.

Furthermore, even if there has been full disclosure to shareholders of golden parachutes, section 14(e) can still apply, if the effect of the disclosure gives the shareholders "no real alternative than to accept the offer."<sup>81</sup> This could occur when a corporation has large blocks of institutional investors who are traditionally pro management and ultimately control the outcome of a tender offer at the expense of minority shareholders.<sup>82</sup> In essence, the minority shareholder is forced into a position of tendering his shares to the acquiring corporation. In this regard, during a tender offer period, golden parachutes can become fraudulent, manipulative devices and a shareholder may be able to maintain a cause of action under the Williams Act. However, the problems with categorizing golden parachutes as a fiduciary matter coupled with the traditional view of the Williams Act as used to control rigged sales, wash sales, or other extremely manipulative activities,<sup>83</sup> may make this federal claim more difficult.

The Securities and Exchange Commission's Advisory Committee on Tender Offers is attempting to control the use of golden parachutes during tender offer periods through specific proposals. The Advisory Committee has expressed concern about a board of directors' adoption of golden parachutes after a tender offer period has begun. As a result of this concern, the Committee has proposed a provision which would prohibit a corporation from adopting change in control contracts during a tender offer period.<sup>84</sup> Furthermore, the Committee recommends that at each annual meeting shareholders should be requested to vote on an advisory basis as to whether the corporation should continue to use golden parachutes.<sup>85</sup> By restricting the use of golden parachutes during a tender offer period and making the shareholder more aware of their existence, a board of directors may become more reluctant in creating them initially. The Advisory Committee's proposals may be the best solution to the problem of golden parachutes and would reduce the need for after the fact litigation.

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81. *Id.* at 377.

82. Note, *supra* note 1, at 356.

83. *See Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977).

84. *SEC Advisory Committee on Tender Offers Special Report*, FED. SEC. L. REP. (CCH) No. 1028 at 40 (Recommendation 38) (July 15, 1983).

85. *Id.* at 39.

#### IV. Attacking Golden Parachutes from the Back Door: The 1984 Tax Reform Act

Although the Securities and Exchange Commission may be tightening its control of golden parachutes, the Internal Revenue Service has taken an active step in restricting their use as well. The 1984 Tax Reform Act has established that "no deduction is allowed for payments to key officers under golden parachute contracts which exceed reasonable compensation and such excess payments are subject to a twenty percent excise tax".<sup>86</sup> Prior to this Act, corporations were allowed a deduction for all expenses that were ordinary and necessary to carry on business.<sup>87</sup> Inclusive in these expenses were reasonable allowances for salaries or other compensations.<sup>88</sup> Since golden parachutes had not been adjudged to be unreasonable,<sup>89</sup> the cost to the corporation of paying these change in control bonuses were deducted as an expense.<sup>90</sup>

The reason Congress has enacted this golden parachute provision is two-fold. First, the Senate Finance Committee believed that golden parachutes served no benefit to the corporation but merely permitted an "entrenched management team to stay in control."<sup>91</sup> Second, the Committee believed that golden parachutes may provide corporate funds to subsidize officers or other highly compensated executives when these individuals leave the corporation.<sup>92</sup> The Committee was "unwilling to let the tax law be used in such a manner that would encourage this subsidy."<sup>93</sup> Therefore, it was deemed necessary to impose a penalty when a corporation granted a golden parachute to a key executive.

Under the 1984 Tax Reform Act, no deduction is allowed for any compensation arrangement which is an "excess parachute payment".<sup>94</sup> An "excess parachute payment" is one that is three times greater than an individual's base amount, which basically entails his average gross

86. I.R.C., §§ 280(G), 4999 (1984), *amended by* Tax Reform Act of 1984, Pub. L. No. 98-369, §46, 98 STAT. 585 (1984) [hereinafter cited as Tax Reform Act of 1984].

87. *Deficit Reduction Tax Bill of 1984*, STAND. FED. TAX. REP. (CCH Special) No. 16 at 195 (April 5, 1984).

88. *Id.* at 195.

89. *See supra* text accompanying notes 41-44.

90. *See Deficit Reduction Tax Bill of 1984, supra* note 87.

91. *Id.*

92. *Id.*

93. *Id.*

94. *The RIA Complete Analysis of the 1984 Tax Reform Act*, Fed. Tax Coordinator 2d § 254 (1984).

income over the past five years.<sup>95</sup> For example, if an individual's base amount is \$100,000, a single payment totalling \$400,000 is an "excess parachute payment" because it exceeds \$300,000 (three times the base amount of \$100,000).<sup>96</sup> Under the Act, the \$300,000 is nondeductible (\$400,000 minus base amount of \$100,000), not just the \$100,000 that is in excess of what the Committee believes is reasonable compensation.<sup>97</sup> Also, the recipient of this golden parachute will have to pay \$60,000 in excise taxes (\$300,000 x 20%) in addition to regular income taxes.<sup>98</sup> However, a corporation will be able to reduce the amount of the "excess parachute payment" if it can show by clear and convincing evidence that the excess portion is reasonable compensation for services actually rendered.<sup>99</sup> Furthermore, although there is a standard formula for calculating excess parachute payments, any contract which the Securities and Exchange Commission classifies as violative of Federal Securities Laws or Regulations will be subject to the no deduction penalty of the Act.<sup>100</sup>

The 1984 Tax Reform Act imposes a heavy tax penalty on a corporation granting golden parachutes. It is difficult to comprehend why Congress has granted this right to the IRS to restrict golden parachutes in the form of a tax penalty. A corporation is taxed for the privilege of doing business as a corporation — a privilege created by the government.<sup>101</sup> Therefore, the government is justified in receiving income in order to distribute the cost of government fairly, and to promote economic growth, stability and efficiency which are the basic goals of the tax system.<sup>102</sup> However, the projected revenue that the IRS will receive from golden parachutes is less than five million dollars.<sup>103</sup> This pales in comparison to the 31.3 billion dollars corporations paid in

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95. *Id.* The actual formula is:

the aggregate present value of all such contingent compensation payments that equal or exceeds three times the base amount. The base amount is the average annualized compensation includable in a disqualified individual's gross income in the five-taxable-year period preceding the taxable year in which the change of ownership or control of the corporation occurs.

*Id.*, § 280 (G)(b)(d).

96. *Id.*

97. *Id.*

98. *Id.* at 97.

99. *Id.* at 99.

100. *Id.* at 97.

101. J. PECHMAN, *FEDERAL TAX POLICY* 129 (1983).

102. *Id.* at 5.

103. *Deficit Reduction Tax Bill of 1984*, *supra* note 87, at 196.

taxes in 1982.<sup>104</sup> Furthermore, the underlying reason behind the golden parachute provision in the 1984 Act is a general distain of corporations using golden parachutes as a defensive tactic to remain in control.<sup>105</sup> Arguably, the IRS should not be regulating a corporation's management decisions by imposing a tax penalty. However, it appears that Congress is unwilling to rule that golden parachutes are illegal and is unwilling to grant enforcement rights to the Securities and Exchange Commission which seems to be the proper agency to regulate golden parachutes.

It is still too early to determine whether the 1984 Tax Reform Act will cause a great reduction in the use of golden parachutes by corporations. In the opinion of one treasurer of a major corporation<sup>106</sup> listed on the American Stock Exchange, golden parachutes will continue to be used despite the tax law.<sup>107</sup> This treasurer believes that golden parachutes are still very viable because "as with any tax law there are loopholes".<sup>108</sup> A corporation could avoid the harsh effects of the tax by "basically increasing an executive's base amount thereby allowing a parachute payment to come within the three times limitation".<sup>109</sup> Alternatively, he felt that a corporation that is a frequent target may increase an employee's pension plan which is compensation that does not fall within an individual's base amount.<sup>110</sup> Therefore, it appears that just as corporations have managed to side step disclosure provisions regarding golden parachutes, they will also discover alternative methods to escape the 1984 Tax Act.

## V. Conclusion

Golden parachutes are created in many forms and encompass varying amounts. Some may be reasonably within a corporation's frame-

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104. PECHMAN, *supra* note 97, at 144.

105. *Deficit Reduction Tax Bill of 1984*, *supra* note 87. However, it is possible that this could make golden parachutes a stronger defensive weapon since an acquiring corporation would have to compute twice the amount of the golden parachute since it is not deductible as an expense.

106. This corporation is a public corporation on the American Stock Exchange and a potential target for a takeover.

107. Telephone interview with the treasurer of a corporation listed on the American Stock Exchange (Feb. 1, 1985).

108. *Id.*

109. *Id.*

110. *Id.*

work. However, golden parachutes that are created in relation to tender offers require close scrutiny. An executive who has a golden parachute is likely to have a conflict of interest which may ultimately lead to a breach of fiduciary duty or even fraud. However, an effective remedy is presently unavailable to the shareholder either at the state or federal level. The 1984 Tax Reform Act may have created a deterrence that the shareholder has been unable to accomplish. Yet the fact remains that the golden parachute is still a legal corporate creation whose ultimate victim is the shareholder.

*Lynn A. Epstein*