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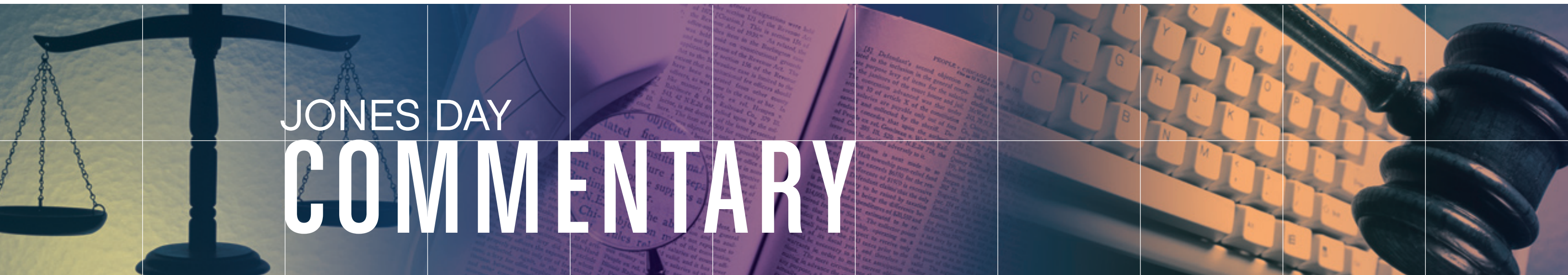

MERGERS & ACQUISITIONS

MISCONCEPTIONS REGARDING GOLDEN PARACHUTES IN AN M&A SETTING: WHO REALLY GETS THE SOFT LANDING?

While public company executives were still focused on implementing Sarbanes-Oxley governance changes, the sometimes unholy alliance of institutional shareholders and the media opened another front in a seemingly unending corporate governance assault, one focused on executive compensation.

The post-9/11 downturn in the U.S. economy caused many institutional shareholders to rethink their prior support of compensation practices that were adopted when times were good. They took particular aim at stock options (lauded in the 1990s as an appropriate means of "paying for performance"), perquisites, and severance/change-in-control benefits.

Why particular companies are targeted is not obvious. Activists and courts have yet to specifically state what constitutes excessive compensation, but it appears to be akin to pornography: We should know it when we see it. The intense scrutiny of executive compensation puts executives and directors in an awkward position with respect to an already sensitive topic. And, especially after the highly publicized Disney severance case, at least some directors think themselves obligated to question almost every dollar.

Shareholders have many arrows in their executive compensation quiver. Targeted companies know the drill: It could start with a call from a reporter, a shareholder proposal, or a withhold-vote campaign or, ultimately, it could go so far as litigation (and did, far more frequently than historically had been the case). Change-in-control arrangements, or so-called golden parachutes, received particular attention because in many instances management received substantial amounts as deals were priced much higher than the lows they had reached when the 1990s' bubble burst.

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Even some compensation consultants have seemingly been scared into submission. Criticisms regarding their close relationship with management and their use of benchmarking have in some instances caused an attitudinal U-turn, so much so that their advice, especially in the context of golden parachutes, has become far too conservative. In their efforts to be lauded as the next "politically correct" corporate governance players, some may end up performing a disservice to their corporate clients.

For golden parachutes, the question should be not "how much is too much?" but rather "is this arrangement serving its intended purpose?" The key, then, is understanding—and making sure activists and others understand—the true purposes and consequences of these arrangements.

Mainstream change-in-control arrangements are *not* contrary to the interests of shareholders. M&A multiples are based on market dynamics. That is, they are determined based upon a set of assumptions at any one time as to capital costs, inflation rates, and numerous other deal-related variables, including deal costs. For this reason, directors who think they are doing their shareholders a favor by permitting only below-market compensation arrangements are in reality shifting value to the buyer. Moreover, what shareholders receive in a particular takeover or merger is determined in the vast majority of cases by an auction market, driven by the target's competitive, technological, and human resources positions and prospects, the extent of competitive bidding, and overall financial market dynamics. Never, in our experience, are they affected in any appreciable way by whether parachute payments are one particular level or another.

This is evidenced by the fact that the most sophisticated shareowners (as contrasted to shareholders)—private equity firms—invariably establish aggressive management equity ownership plans (typically 5-10 percent of the company), "market" severance arrangements, and incentive-based divestiture programs, with the payments to management increasing as the value to shareholders increases, whenever they initiate a process to harvest one of their own investments. They know from real-life experience that auction dynamics are heavily influenced by how management approaches the auction process. Undue conservatism, possibly induced by fear of job loss, can have significant adverse effects in the auction environment—if potential buyers conclude there may be an issue after due diligence meetings with, for example, a new product manager, the forecast will be discounted.

As such, change-in-control compensation arrangements are not really about compensation in the first place. Analyzing them based on peer group standards tied only to who in each category gets how much as a multiple of cash compensation and other analyses proffered by today's compensation consultants misses the point almost entirely.

We also believe, as out of step as it may seem in today's generally anti-management climate, that it's simply not fair to ignore the fact that it isn't just severance for a senior officer of a public company. Yes, there are many instances in which senior managers have gone on to even greater careers, and additional wealth, post-takeover. But, putting aside the handful of merger-related headline deals, in most instances, the sale of a company is a career-capping event. In this sense, severance should be regarded as much more than a bridge to the next job—it's also compensation for lost expectations, a career cut short in order to maximize shareholder wealth.

The attack on executive compensation and, in particular, golden parachutes, has the very real risk of going too far. Even the most strident shareholder activists seem to recognize the importance of change-in-control arrangements. One of the most vocal players in the executive compensation free-for-all is, of course, the California Public Employees' Retirement System, or CalPERS. CalPERS has indeed opposed some corporate transactions due to what it perceived as excessive severance payouts. For example, CalPERS publicly opposed Anthem's acquisition of WellPoint because of its view on the executive compensation packages likely to be earned by WellPoint executives. But CalPERS is not opposed to all such arrangements. Instead, CalPERS recommends support of such arrangements providing an "acceptable" level of benefits. Accordingly, earlier this year, CalPERS sponsored at least one proposal (at AT&T) that sought to require shareholder approval of any severance payout that exceeds 2.99 times the sum

of the executive's base salary and bonus. Most pension and union funds, too, recognize the need for competitive change-in-control arrangements—to enable management to continue making decisions in the best interests of a company and its shareholders regardless of their own welfare in the event of a corporate transaction.

And a study of trends relating to change-in-control agreements conducted by Equilar shows that three times base and bonus is still the predominant multiplier in change-in-control agreements at publicly traded companies in the *Fortune* 100. Contrary to what many compensation consultants are advocating, even golden parachute excise tax gross-ups are still the norm.

Overall, directors need to step back and apply some rationality to their compensation-related decisions. Caving in to pressure from activists and being at the forefront of compensation cuts can have a real, negative impact on the business of their companies and the morale of management. Change-in-control arrangements and even equity awards should not be viewed as windfalls; rather, they should be considered in light of what they are: a means to more perfectly align shareholder and management interests.

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