GOLDEN PARACHUTES IN CORPORATE GOVERNANCE

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As a company grows, a clearer separation becomes apparent between ownership of the capital, in the hands of shareholders, and the control wielded over the company by senior management. This situation may give rise to a conflict of interests between ownership and control. In order to ensure senior executives act according to shareholders’ wishes, there are a number of control mechanisms that go a long way to avoiding the discrentional performance of managers, although these mechanisms do sometimes fail. The existence of golden parachutes clearly testifies to this.

Golden parachutes are the clauses senior executives subscribe in their personal contracts and which, in the event of dismissal, entitle them to receive both monetary and non-monetary compensation, even when they have not delivered a suitable performance. The reasons inducing these executives to negotiate these golden parachutes are as follows.

Firstly, these clauses are arranged to compensate an executive who, after a number of years’ service in a company, renounces a series of acquired rights. An executive who chooses to leave a position that has already been consolidated negotiates a compensation package with the new company to cater for possible dismissal, as the period of service in that company is uncertain.

In Spain, senior management contracts are governed by Royal Decree 1382/85. This employment relationship is of a special nature and different from the rest of the workforce. Within the sphere of the company, an executive has a unique position in terms of powers and duties. Hence the law provides ample leeway when this relationship is agreed between the parties.

The fact is that in agreements of this kind the executive has less legal protection compared to the salaried staff working in the company. In the event of unfair dismissal, whereas normal employees on the payroll are entitled to compensation amounting to 33 days per year worked up to a maximum of 24 months’ wages, executives in these same circumstances would receive compensation equal to 20 days per year worked up to a maximum of 12 months’ wages.

There are also differences in terms of the taxation of this compensation: in the case of normal employees, any compensation is exempt from tax up to the limit specified by Spain’s Workers’ Statute (Estatuto de los Trabajadores), but this is not the case for senior management, where the entire compensation is liable to taxation.

A further difference lies in exclusivity and non-competition agreements. Exclusivity clauses are very frequent in senior management contracts, so executives negotiate financial compensation in exchange for that exclusivity. A contract may also contain a clause whereby once it has been terminated and for a period of no more than two years, the executive is barred from working for the competition, with this being another reason for compensation.

Furthermore, senior executives can potentially be sued for any improper or poor management that might compromise shareholders’ interests, so they often negotiate to ensure the clauses contain civil liability insurance. This insurance will be used in the event the professional faces legal proceedings,
thereby putting them in a position to pay any damages that may be claimed for their management performance.

What’s more, senior executives who sit on the board as internal directors are subject to the regulations contained in Spain’s Bankruptcy Law (Ley Concursal). This Law enables judges to order the precautionary or preventive seizure of property and assets belonging to the company’s directors or those people who have held such status in the two years prior to the date of the declaration of bankruptcy. If the company is wound up and there are insufficient assets to clear all the debts, a judge may rule that the directors are to settle part of the debt not covered by those assets. Furthermore, it provides for directors to be disqualified from representing or managing any other person or property for a period of between two and fifteen years depending on the seriousness of the circumstances. In addition, Spain’s Organic Law 5/2010 of 22 June regulates, for the first time, the criminal liability of legal entities. This affects the people who govern such companies as they might be found guilty by the courts of the offences attributable to their company.

Another important matter involves the person or persons charged with negotiating and approving these golden parachutes, and whether shareholders have sufficient information on the remuneration of their senior management. In 2004, the European Commission issued a recommendation designed to provide shareholders with a clear and comprehensive picture of their company’s remunerations policy. The board of directors is required to draft a report on salary policy in which it gives information on issues such as the compensation provided for in senior management contracts in the event of dismissal. The policy on remunerations and golden parachutes approved by the board of directors has to be submitted to a vote at the AGM, albeit purely on a consultation basis, as the last word still lies with the board. The consultation vote does not affect the validity of the remuneration agreements reached by the company, but it may constitute a vote of confidence or no-confidence regarding the directors’ management.

Regardless of the arguments listed above, from a strategic perspective golden parachutes are a requirement that executives at the highest level end up imposing upon companies. Their worth and scarcity enable them to lay down terms that companies accept in order to recruit their services. Nevertheless, at a time of economic recession, such as the present one, agreements of this nature have been put into question, as the governments of the world’s leading industrialised nations have had to rescue large financial companies from bankruptcy in order to avoid the system’s meltdown. Society wonders whether it is fair that a senior executive should receive a large amount of money for poor management, especially when there are companies that have received public money, and part of those salaries and compensation is financed with taxpayers’ cash.

In the USA, following the Wall Street collapse due to subprime mortgages, the CNBC TV channel estimated that around a dozen senior executives had received golden parachutes to the tune of 500 million dollars after leaving their posts. For example, Stanley O’Neal, president and CEO of Merrill Lynch received 161 million dollars after resigning his position in October 2007, after the financial institution he headed had recorded losses of 8 billion dollars. After heading the company for less than a year, his successor, John Thain, received compensation for dismissal amounting to 9 million dollars. Finally, in September 2008 the company was sold to Bank of America.

On 15 September 2008, Lehman Brothers, the fourth largest investment bank in the US filed for bankruptcy after 158 years in business. Nevertheless, its president Richard S. Fuld received a 53 million dollar pay-off. Another example is that of Martin J. Sullivan, who headed AIG (American International Group), the world’s largest insurance group. Sullivan received a golden handshake amounting to 22 million
dollars in June 2008, even though the Federal Reserve had to inject 85 billion dollars into the company to avoid it going under.

In February 2009, US President Barack Obama announced “the need to control executive compensation for companies that are taking money from the federal government”, and then “we’re going to be demanding some restraint in exchange for federal aid”. Obama decided to apply a cap of 500,000 dollars per year to the salaries of those executives in companies receiving public funds, and heavily restrict the golden parachutes in senior management contracts. In addition, he wanted shareholders to have a say on executive remuneration. Some Wall Street analysts were quick to criticise the measure capping senior management salaries. They believe this may lead to a mass exodus of the most qualified and brilliant executives to companies that have not received public funds and are not therefore subject to those limitations.

In Europe, the first to react to this situation was the German government. Towards the end of October 2008 Angela Merkel put an annual cap of €500,000 on senior management salaries in those companies that had been bailed out with public funds. Likewise, the French President, Nicolás Sarkozy, reached an agreement with the banks to introduce an “ethical code” that would regulate executive salaries. In October 2008, France’s Minister of Economic Affairs, Christine Lagarde, declared, following the bailout of a financial institution called Deixa, that its senior executives would not receive golden parachutes. France and Belgium each contributed 3 billion euros to this rescue, with Luxemburg adding a further 376 million euros.

The British Prime Minister Gordon Brown also intends to curtail the salaries in the main banks in the country that required financial assistance. Gordon Brown insisted there would be “no rewards for failure”. On the other hand, the Prime Minister has decided to abolish the compulsory requirement to compensate executives, even when a company files for bankruptcy.

Likewise, Spain’s Minister of Economy and Finance, Pedro Solbes, has affirmed that if the state has to invest in the capital of any financial institution, then certain limits would logically have to be placed on the salaries of senior executives.

**Question:** Analyse and discuss the pros and cons of golden parachutes in listed companies.