New "Golden Bungee" Device to ITT Executives

by Robert W. Wood • San Francisco

Wall Street (or someone) is constantly coming up with new, sophisticated, catchy—and sometimes downright deceptive—names. Since I never entirely understood bungee jumping, maybe I don't understand the "golden bungee" term being applied to a combination of what used to be called golden parachutes and golden handcuffs. What this amounts to is simply wearing golden handcuffs at the same time one is floating down on the golden parachute. But perhaps that imagery was a bit too dour for the bouncing current Wall Street mavens. Hence, the new name: golden bungees.

The figures that have been bandied about by the press and disclosed to the FCC involving several ITT Corp. executives are rather enormous. They are slated to receive rich cash severance payments at the same time that ITT is acquired by Starwood Hotels and Resorts. That probably doesn't seem too interesting (severance payments, after all, being commonly contingent on a change in control). That is what the golden parachute rules are all about.

What is unusual in this case is that they are going to be hired by the *acquiring* company, Starwood Hotels

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and Resorts, and pick up thousands of stock options as an incentive to work for the company that is gobbling up ITT. See Binkley & Lublin, "ITT Brass to Get "Golden Bungee" in Takeover," *Wall Street Journal*, Feb. 12, 1998, p. B1.

Where's the Beef (or Gold)?

The idea that top executives would get golden parachutes is not surprising, although it can be a surprise where there have been promises to shareholders that there would not be any. What is also not unusual is that some executives will be "kept on" in the transition from acquired company to acquiring entity, and they will get something for it. Stock options in this context, or signing bonuses, are particularly appropriate.

But a package of some combination of these items does seem unusual. And, I must admit, the notion of a golden bungee that lets one down easily and then springs one back up (I guess that's the metaphor), doesn't seem entirely inappropriate.

This dual compensation arrangement is not being claimed for everyone in the ITT/Starwood deal. However, it is covering enough ITT employees that it is generating some publicity. Surely most notable is ITT chairman Rand V. Araskog, who is slated to receive $15 million in severance from ITT, and has been granted 162,500 new ITT stock options. The stock options will convert to Starwood options, according to papers filed with the SEC. See Binkley & Lublin, "ITT Brass to Get "Golden Bungee" in Takeover," *Wall Street Journal*, Feb. 12, 1998, p. B1. Moreover, Araskog's deal includes a $400,000 a year consulting contract which extends through 2003, allows him to keep his car and driver, his secretary, use of the corporate jet, etc.

I'm not even sure that a "golden bungee" could cover all this largesse. Then, there is Starwood's CEO, Barry Sternlicht. Under his 1995 compensation agreement, the acquisition triggers change of control provisions, even though he remains in charge of the combined companies. See Kirkpatrick, "Starwood CEO Sternlicht Will Be Big Winner in Deal with ITT," *Wall Street Journal*, Feb. 18, 1998, p. A4.

Sternlicht's contract states that if one-third of Starwood's stock changes hands there is a change of control and his options vest. Apart from the enormous size of Sternlicht's original pay package, one analyst commented that no one contemplated tha a technical change in control could be triggered just by a purchase of another company. *Id.*

Golden Parachute Fundamentals

Regardless of what terms one uses, the tax rules governing golden parachute payments are pretty straightforward. Section 280G of the Code makes payments of so-called "excess parachute payment" nondeductible to the paying corporation. Furthermore, it is coupled with the nondeductible 20% excise tax on excess parachute payments imposed by Section 4999(a). Between nondeductibility for the payment itself, and a 20% excise tax (that itself is ***also*** nondeductible), the cost of paying such amounts is steep.

This harsh regime applies only to "excess" parachute payments. A parachute payment is defined as any compensatory payment to or for the benefit of a disqualified person (officer, shareholder, key employee or highly compensated person performing personal services for the corporation) under the following circumstances:

- The payment is contingent on a change in the ownership or effective control of the corporation or a substantial portion of its assets, and the aggregate present value of the compensatory payments equal or exceed three times the base amount; or
- The payment is made pursuant to an agreement that violates any generally enforced securities laws or regulations.

Determining whether a payment constitutes a parachute payment is typically rather easy. Significantly, however, a parachute payment normally does not include payments to or from qualified pension and profit-sharing plans, annuity plans and simplified employee pensions. (See I.R.C. §280G(b)(6).)

Gilding to Excess?

Since it is only "excess" parachute payments that are sanctioned, the definition of excess is important. A

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parachute payment is "excess" if: (1) it is made to a "disqualified individual;" (2) the payment is contingent on a change in the control or ownership of the corporation; and (3) the present value of the payment is at least three times the individual's "base amount." This base amount is essentially annualized compensation for the individual for a five-year period ending before the date of the change in control.

One feature of such agreement that is now relatively common is some type of savings clause. A savings clause in a contract might say that, notwithstanding any other arrangement or commitment, the company will have no liability to pay an excess parachute payment that would incur the wrath of the nondeductible excise tax.

Golden Ingots?

With all these various golden icons (golden parachutes, golden handcuffs, golden bungees, etc.), being melted together, one might well question what tax rules ought to apply to this kind of arrangement. Since the golden parachute rules referred to above seek to determine the deduction by a particular payor, and the excise tax by a particular payor, I would suppose there to be relatively little that the Internal Revenue Service could do to put all of these obviously connected elements together. At the same time, some of these payments contingent on a change in control would clearly seem to generate problems.

For example, the Rand Araskog example of a combination of cash and options all from ITT would not seem to be saved by the fact that the ITT options will be converted into Starwood options. In other words, at least on first impression, it will be ITT's tax return that will need to be considered when determining whether Araskog is receiving an excess golden parachute payment or not, and assuming that he is, the extent of that excess parachute payment.

Can Gold Turn to Lead?

For the executives involved, surely the newly-coined (sorry), golden bungee is surely a wonderful thing. Indeed, it is hard to imagine anyone wanting to float down on a golden parachute (even if metaphorically speaking that does look more civilized to the top floor executive) when a golden bungee is available.

Yet, for shareholder activists, this may prove to be a new field ripe for controversy. Moreover, for the Internal Revenue Service, it may prove to be an area that the Service will want to look at closely to see that it can make a maximum use of the Section 280G nondeductibility provision and Section 4999(a) excise tax provision.

One thing more seems certain: there will probably be some other golden device invented and named shortly. All I can think of, by the way, is the "golden clone," which presumably would allow the executive to go on permanent paid golfing leave, while his new clone stays at the new/old entity and does all the work! ■