

## CASE IN POINT: EMPLOYMENT CONTRACTS

# What colour is your parachute?

## BACKGROUND

### Not all executive agreements enforceable

A "golden parachute," also known as a change of control agreement, is an employment contract providing for enhanced severance or other compensation to an organization's senior executives. In most cases the parachute is triggered and the executives are paid upon a fundamental change in the business (for example, a significant change in shareholdings or in the composition of the board of directors, privatization of a public company and sale of substantial assets) followed by a cessation of employment.

The number of takeovers of Canadian businesses over the past several years, together with initial public offerings, mergers and other business combinations, have led to an increasing use of golden parachutes. Negotiation of these arrangements — including severance — is a legitimate function of any business, as is retention of management. Golden parachutes serve a number of purposes.

- They discourage hostile takeover bids by making a change of control more expensive.
- They act as a recruitment device, attracting and retaining key executives with experience, knowledge and skills — especially in businesses which are susceptible to takeovers.
- They provide security to executives concerned about future employment following a change of control or during a takeover attempt, allowing executives to remain available to make decisions objectively and in the best interests of the business.
- They compensate and reward executives for past service.

Courts have traditionally given businesses substantial leeway to determine what is in their own best interests. Absent fraud, bad faith, abuse of discretion or gross overreaching, courts will not lightly interfere with such agreements.

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compensation (including a US\$420,000 per year salary, signing bonus, stock option grant, market capitalization bonus and pension credit for eight years' service) and liberal change of control and severance provisions.

The parachute could be triggered by a change in the constitution of Repap's board of directors. In August 1999 Repap's shareholders elected new directors. Berg was not nominated to stand for re-election. As permitted by his contract and given the change in directors, Berg terminated his employment and claimed the payment due to him, totalling US\$27 million.

Shocked by this, the corporation, through its newly elected board of directors, applied to the court to nullify the parachute. The court agreed with the corporation concluding, notwithstanding that the contract had been approved and executed by the corporation through its previous board of directors, it was so oppressive that no payments were owing. The corporation was discharged from all of its obligations and Berg was not entitled to any of the payments nor to any severance whatsoever.

The court reviewed the circumstances surrounding the entering into of the contract, the benefit for whom the contract was entered and, most importantly, the process by which the contract had been approved and implemented. This is a textbook example of how to ensure a contract will not be enforceable due to the following:

- Berg exercised an oversight role on

### The decision: The *Repap* case

The prevalence of golden parachutes, combined with their higher costs and increased publicity, have led to increased challenges to their enforceability. A recent decision of the Ontario Superior Court of Justice, *UPM, Kymmene Corp. v. UPM – Kymmene Miramichi Inc.* (the "*Repap* case"), shows judicial deference is not unlimited and suggests a higher level of care and attention in implementing such agreements may be warranted.

*Repap* involved a golden parachute between an executive, F. Steven Berg, and his employer, Repap Enterprises

Inc. Repap was a Canadian public company in the forest products industry. Berg was Repap's largest individual shareholder and an employee, director and chairman of the board for Repap for about eight months in 1999.

At the time Berg joined the organization, Repap was highly leveraged, bearing a debtload of \$1.5 billion despite having drastically downsized its workforce and disposed of the majority of its assets. Berg believed that Repap was "virtually bankrupt" with "no prospect for survival" without immediate debt-restructuring. Despite this, Berg and Repap entered into an executive employment agreement for a five-year term with renewal provisions, generous

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# Fair, reasonable parachutes always open

The *Repap* case does not necessarily mark a change in the legal standards governing golden parachutes. Such contracts will continue to be generally enforceable, but they will be struck down if they, or the methods by which they are implemented, are patently unfair.

In order to enhance enforceability, keep these guidelines in mind:

- Parties must be able to demonstrate the valid business reasons for the parachute as well as the rationale justifying that its provisions are in the best interests of the employer and its shareholders.
- An independent committee of the board of directors (that is, independent from the executive) should approve the contract.
- Payment obligations should bear a relationship to the executive's abilities, responsibilities and years of service.
- Payments must bear a reasonable rela-

tionship to the total assets of the business and not imperil its viability.

•Consider post-employment restrictions or other items of benefit to the corporation — such as confidentiality, non-competition and non-solicitation covenants — which justify payments beyond the executive's departure.

•Consider whether the executive can unilaterally or voluntarily resign following change of control in order to qualify for payment. If so, the parachute is more vulnerable to attack.

•The timing of the parachute may be relevant in determining whether it was concluded for self-interest or in the shareholders' best interest. For example, was it entered into on the eve of a takeover?

•Expert legal, human resources and compensation advice must be obtained. The corporation and its board of directors must exercise due diligence to ensure the parachute is within generally ac-

cepted industry and legal standards.

*Repap* should act as a wake-up call for employers and executives. Neither shareholders nor the court will defer unquestioningly to the judgment of management or a board of directors.

Golden parachutes — and any employment contracts — should be fair, reasonable and drafted to protect the legitimate interests of the parties. Contrary to an executive's first instincts, the object should not be to negotiate for as much as possible as this may result in an unenforceable contract.

There are many examples of unenforceable employment contracts and severance provisions where the terms are overly harsh to the employee. *Repap* demonstrates that courts will intervene to remedy any imbalance to the detriment of the employer or its shareholders if there is evidence of a lack of good faith.

— Joe Comforti

## COMMENTARY

# Compensation and severance inappropriate

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behalf of the corporation with respect to the drafting and negotiating of his own parachute and the amounts payable to him.

•Berg retained the lawyer who drafted the parachute and who explained it to the board and the compensation committee. The corporation did not retain its own independent legal advice.

•Although an independent compensation consultant had been retained, the analysis was done on a hurried basis without any research, benchmarking or analysis of comparable companies. The limited analysis that had been prepared was not provided to the board until the meeting approving the parachute.

•The board of directors that approved the parachute were not aware (and Berg

failed to inform them) that an earlier and differently-constituted board had raised very serious questions about the propriety of the contract and had specifically refused to approve it.

•The types and amounts of compensation and severance were wholly inappropriate and not in the best interests of Repap. The board of directors approved the parachute knowing full well Repap would unlikely be able to afford the required payments.

•In approving the parachute, the board of directors did not exercise any reasonable due diligence. It did not consult legal expert advice, did not inform the shareholders of prior deliberations or comments of previous board members, did not obtain a compensation consultant's report before making its recom-

mendation and the compensation analysis that was made available was reviewed in a cursory way.

•The trigger for the change of control was broadly drafted. Effectively, Berg would be entitled to full payment even if he left voluntarily following a change of less than 10 per cent of the shareholdings.

The court concluded the parachute unfairly disregarded the interests of Repap's shareholders and the manner in which Berg negotiated and presented the contract breached his own fiduciary duties as an officer and director. It also found Repap's board of directors and its compensation committee failed to establish a prudent or reasonable process with the result that the corporation had signed a contract that was not fair and reasonable to it. The contract was void.