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## CORPORATIONS-OFFICERS AND DIRECTORS-STOCK OPTION INCENTIVE EMPLOYMENT CONTRACTS FOR CORPORATION EXECUTIVES

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CORPORATIONS—OFFICERS AND DIRECTORS—STOCK OPTION INCENTIVE EMPLOYMENT CONTRACTS FOR CORPORATION EXECUTIVES—In the past few decades considerable attention has been directed toward “piecework payment” for corporate executives; that is, compensation based largely upon results rather than upon past or expected performance. The stock option incentive employment contract<sup>1</sup> is one of the means utilized to achieve that desired objective.<sup>2</sup>

Although both large and small corporations have used stock option contracts to a substantial extent,<sup>3</sup> there has been relatively little litigation involving either their adoption<sup>4</sup> or their operation. Although in some respects such contracts are susceptible to the same types of attack as are leveled with much more frequency against analogous forms of

<sup>52</sup>H.R. 5693, 80th Cong., 2d sess. (1948). The present English statute also seems to provide the solution suggested in this comment. Bankruptcy Act, 1914 (4 & 5 Geo. 5, c. 59) §§ 16(16), 33(7). No cases under this act, or under prior English statutes, seem to have presented the Vogel type fact situation. It is not clear how this proposed amendment would affect the type of case discussed in note 41, *supra*.

<sup>1</sup> It will not be possible here to deal with problems arising from deviations from the basic structure of stock option contracts, such as purchase warrants and stock trusts.

<sup>2</sup> For discussions of other forms of incentive compensation see BAKER, *EXECUTIVE SALARIES AND BONUS PLANS* (1938); Washington, “The Corporate Executive and His Profit-Sharing Contract,” 50 *YALE L.J.* 35 (1940); Dawson & Coultrap, “Contracting by Reference to Price Indices,” 33 *MICH. L. REV.* 685 (1935).

<sup>3</sup> See Baker, “Stock Options for Executives,” 19 *HARV. BUS. REV.* 106 at 121 (1940).

<sup>4</sup> See 41 *YALE L.J.* 109 at 110 (1931); 32 *MICH. L. REV.* 672 (1934).

incentive compensation, in other respects the problems presented are more or less indigenous to stock option plans. For that reason this comment will deal separately with those problems which are common to nearly all incentive plans and with those which are more or less peculiar to stock option contracts.

### A. *Typical Stock Option Contract Provisions*

The principle of the stock option incentive contract is quite simple and is perhaps best exemplified by the recent case of *Wyles v. Campbell*,<sup>5</sup> the facts of which are as follows: In 1932 a large corporation, in poor financial condition and in need of new managerial talent, induced defendant to enter its employ as manager and president. An employment contract was entered into with the following provisions: For the duration of the contract, which was five years, defendant was to receive an annual salary of \$30,000, with an option to purchase 20,000 shares of the common stock of the employer corporation at par value of one dollar per share. In the event of a capital reorganization, the number of shares subject to the option was to remain proportionate to the total amount of authorized common stock of the corporation. At the time of the contract the market price was less than fifty cents. The entire contract was renewed in 1937 without change, except to increase defendant's salary. The contract was renewed again in 1942 with the following changes: (1) Defendant's annual salary was again increased, to \$40,000. (2) The number of shares covered by the option was increased to 26,000 as a result of a capital reorganization. (3) Although the contract repeated the statement in prior agreements that the salary was "full compensation," it omitted the recital that the option was "in further consideration for the agreement of the manager to [undertake or continue] his employment."

In 1946 defendant exercised the option for the first time, taking the entire 26,000 shares when the market was approximately \$11.25 per share.<sup>6</sup> A minority stockholder brought a derivative suit to avoid the issuance of the option stock, relying mainly upon allegations of want of consideration and excessiveness of the amount received by defendant.

### B. *Problems Common to Incentive Plans*

1. *Insufficiency or failure of consideration.* In the *Wyles* case, plaintiff presented these arguments on the issue of consideration:

<sup>5</sup> (D.C. Del. 1948) 77 F. Supp. 343.

<sup>6</sup> See discussion, *infra*, note 37 et seq.

(1) The employment contract did not absolutely bind defendant to remain in the employ of the corporation for the full five-year period; thus the option could not be deemed given in return for future services. (2) The contract recited that the salary paid to defendant was "full consideration"; thus it appears on its face to be a gift which cannot stand against a non-assenting stockholder's objections.<sup>7</sup> (3) If not intended as a gift, the option was given in return for past services rendered under options then expired, and, as compensation for past services, it fails for want of consideration and is an actionable waste of corporate assets.<sup>8</sup>

The court found for defendant in each instance, upon the following reasoning: (1) Although an employment contract is not specifically enforceable, the law is clear that it may constitute valid consideration for a promise to issue stock of the employer corporation.<sup>9</sup> Since the option was exercisable only while defendant was actually serving the corporation, there was no failure of consideration on this ground.<sup>10</sup> Furthermore, uncontroverted evidence tended to prove that defendant would have neither commenced nor continued his employment in return for the salary alone, and that the option in fact served as a *sine qua non* of defendant's initial and continued employment, as was well known to the board of directors at the time each contract was made. (2) The omission of the recital that the option was "further consideration" was merely inadvertant, in view of the evidence last recited. Since this was merely a continuation of the prior contracts, the statement that the salary was "full compensation" could be given no more effect than it had in the past;<sup>11</sup> thus the contract properly interpreted did not evidence a gift. (3) Admitting that past services are not valid consideration and conceding that this was merely a continuation of expired agreements, the above conclusions rendered a decision on plaintiff's third contention unnecessary.

<sup>7</sup> Natl. Loan & Inv. Co. v. Rockland Co., (C.C.A. 8th, 1889) 94 F. 335. Cf. Whitfield v. Kern, 122 N.J. Eq. 332, 192 A. 48 (1937).

<sup>8</sup> Richardson v. Blue Grass Mining Co., (D.C. Ky. 1939) 29 F. Supp. 658; 1 WHITE, NEW YORK CORPORATIONS, §27, p. 329 (1929).

<sup>9</sup> Am. Distr. Co. v. Hayes Wheel Co., (D.C. Mich. 1918) 250 F. 109 at 115, rev. on other grounds, (C.C.A. 6th, 1918) 257 F. 881, cert. den., 250 U.S. 672, 40 S.Ct. 13 (1919); Holthusen v. Budd Mfg. Co., (D.C. Pa. 1943) 53 F. Supp. 488.

<sup>10</sup> Baltimore Breweries Co. v. Callahan, 82 Md. 106, 33 A. 460 (1895). But see Diamond v. Davis, 263 App. Div. 68, 38 N.Y.S. (2d) 103 (1941), to the effect that the option may be valid although exercisable after employment has ceased.

<sup>11</sup> The court here relies upon the principle that consideration furnished by one party is presumed to support all of the covenants of the other party. 1 PAGE, CONTRACTS, 2d ed., §525 (1920). See also 9 WIGMORE, EVIDENCE, 3d ed., §2431 (1940); Koplav v. Warner Bros. Pictures, (D.C. Del. 1937) 19 F. Supp. 173 at 181.

It is unusual to encounter an allegation of want of consideration under circumstances of this sort, for the services in question here were rendered pursuant to a written contract which clearly contemplated a bonus in the form and amount received by defendant. Most of the cases in which the question of consideration has been raised have involved situations in which officers and directors, upon notice that the corporation has realized substantial and sometimes unexpected profit, have taken the opportunity to manifest corporate gratitude to themselves in the form of large cash or stock bonuses.<sup>12</sup> These bonuses are then charged as corporate expense, although not contemplated during the fiscal period in which the services were rendered, with a consequent reduction in the sums available for dividends. Such a retroactive bonus may be equally devoid of valid consideration where, although the employment contract anticipates a bonus, it leaves the amount thereof to be fixed at the end of a given accounting period.<sup>13</sup> Inasmuch as stock options are given at the inception of the employment relationship, are explicit in terms if properly drawn, and are usually unassignable and exercisable only during the term of employment contemplated by the option contract, there is very little likelihood of a successful attack on grounds of failure or want of consideration, as the *Wyles* case indicates.

2. *Excessiveness of amount as a separate ground for attack.* This phase of incentive compensation is perhaps the most fruitful parent of litigation involving executive incentive plans.<sup>14</sup> In practice, it proves to be a multiple charge, unquestionably based in part upon lack of consideration but also implying or accompanied by allegations of breach of directors' fiduciary obligation to the stockholders, bad faith, or waste of corporate assets.<sup>15</sup>

<sup>12</sup> In *re* Franklin Brewing Co., (C.G.A. 2d, 1920) 263 F. 512; *Balch v. Inv. Royalty Co.*, (D.C. Okla. 1934) 7 F. Supp. 420; *Stafford's Est. v. Progressive Natl. Farm Loan Assn.*, 207 La. 1097, 22 S. (2d) 662 (1945). See also MERWIN, *TEMPORARY NATIONAL ECONOMIC COMMITTEE MONOGRAPH 15* (1940); *Putnam v. Juvenile Shoe Corp.*, 307 Mo. 74, 269 S.W. 593 (1925).

<sup>13</sup> *Holmes v. Republic Steel Corp.*, (Ohio, Cuyahoga C.P. 1946) 69 N.E. (2d) 396.

<sup>14</sup> Surprisingly enough, the most successful and popular period for this type of attack was in the early middle 1920's and not, as might be expected, during the depression years. See WASHINGTON, *CORPORATE EXECUTIVES' COMPENSATION* 255, 256 (1942).

<sup>15</sup> In general, see *Mason v. Richardson*, 262 App. Div. 186 at 187, 28 N.Y.S. (2d) 537 (1941); *BALLANTINE, CORPORATIONS* 408 (1927); 5 *FLETCHER, CYC. CORP.*, perm. ed., pp. 421 et seq. (1931); 46 *HARV. L. REV.* 828 at 831 (1931). But see Wood, "Survey and Report Regarding Stockholders' Derivative Suits, for the Special Committee on Corporate Litigation, Chamber of Commerce of the State of New York," at p. 36 (1944), to the effect that bad faith, though often alleged, is very seldom found.

There is no doubt that the amount of compensation is inconclusive, although it may serve as evidence of unfair or improper practices.<sup>16</sup> Furthermore, the courts seldom consider the ratio between the compensation paid and the earnings or profits of the corporation for the fiscal period in which it was paid as an index to the propriety of the payment. Nevertheless, the decisions seem to indicate several factors which will bear upon the results of a charge of excessiveness. The following appear to be encountered most often: (1) the compensation received by executives in equivalent positions in the industry or in comparable industries;<sup>17</sup> (2) the compensation received by persons who held defendant's office prior to his employment or elevation to that office;<sup>18</sup> (3) the financial condition of the corporation before and after defendant assumed his duties;<sup>19</sup> and (4) the publicity given to the adoption and payment of the bonus in issue.<sup>20</sup>

No case has been found in which any or all of such factors has been conclusive of the reasonableness of the amount of compensation. More often they serve as an explanation or rationalization of the result, while the true *ratio decidendi*, expressed or not, seems to turn upon the part played by the defendant in the corporation's award of the assailed compensation. A recent study indicates that although some payments have been upheld despite a showing that the executive-payee participated in and voted upon the corporation's deliberations leading to his contract or bonus, seldom has an allegation of excessiveness been sustained where the compensation was contracted for in an arms-length transaction.<sup>21</sup> It appears that proof of self-dealing will shift the burden of reasonableness from the plaintiff to the

<sup>16</sup> See *McQuillan v. Natl. Cash Register Co.*, (D.C. Md. 1939) 27 F. Supp. 639 at 654, *affd.*, (C.C.A. 4th, 1940) 112 F. (2d) 877, to the effect that the courts will not consider the highest potential profits possible under an option as equivalent to fixed monetary payment. Cf. *Atwater v. Elkhorn Valley Coal-Land Co.*, 184 App. Div. 253, 171 N.Y.S. 552 (1918), *affd.*, 227 N.Y. 611, 125 N.E. 912 (1919), where a bonus of \$4,000 was found to be excessive. It is nevertheless true that there must be some reasonable relation between the compensation received and the services rendered therefor. *Holthusen v. Budd Mfg. Co.*, (D.C. Pa. 1943) 52 F. Supp. 125 at 128. See also dissent of Swan, J., in *Rogers v. Hill*, (C.C.A. 2d, 1932) 60 F. (2d) 109 at 114.

<sup>17</sup> *Koplar v. Warner Bros.*, (D.C. Del. 1937) 19 F. Supp. 173; *Gallin v. Natl. City Bank*, 152 Misc. 679, 273 N.Y.S. 87 (1934).

<sup>18</sup> *Church v. Harnit*, (C.C.A. 6th, 1929) 35 F. (2d) 499, *cert. den.*, 281 U.S. 732, 50 S.Ct. 247 (1930); *Cahall v. Lofland*, 12 Del. Ch. 299, 114 A. 224 (1921), *affd.*, 13 Del. Ch. 384, 118 A. 1 (1922).

<sup>19</sup> *McQuillan v. Natl. Cash Register Co.*, (D.C. Md. 1939) 27 F. Supp. 639, *affd.*, (C.C.A. 4th, 1940) 112 F. (2d) 877; *Shera v. Carbon Steel Co.*, (D.C. W.Va. 1917) 245 F. 589.

<sup>20</sup> *Lyon v. Holton*, 172 Misc. 31 at 36, 14 N.Y.S. (2d) 436 (1939).

<sup>21</sup> WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 258 et seq. (1942).

defendant, even though the court may not hold it to be conclusive of impropriety. Thus, it seems clear that the real purpose of examination by the court is not to substitute its discretion for that of the managers, but rather to investigate the situation for possible indications of fraud, improper self-enrichment, secret deflection of corporation profits or gross abuse of what amounts to a very broad discretion.<sup>22</sup> The aim is not to forbid the employment of high-priced executives when less expensive talent is available, but only to provide a judicial answer to the ancient maxim, "Who will watch the watchdogs?"

### C. *Stock Option Contracts as Deterrents to Litigation*

For several reasons, stock option contracts tend to discourage stockholders' derivative suits. First, so long as authorized and unissued or treasury stock is available to fulfill option obligations, no cash outlay by the corporation is necessary, for whatever the optionee receives is derived from his outside sale of the option stock. Although the optionee's new interest may tend to dilute the proportionate interests of those who owned stock prior to the exercise of the option, this seems less likely to invite a stockholder's action than would the payment of large sums out of the profits or surplus which would otherwise be available for current dividends.<sup>23</sup> Secondly, the contracts under which options are created are amenable to simple and concise language and provisions, and when properly drawn will give very little opportunity for attacks grounded on verbal ambiguities. Thirdly, there is no opportunity for miscomputation or the raising of hotly-contested accounting questions, which have caused a great deal of litigation with respect to plans based upon a percentage of "profits" or similar complex determinations.<sup>24</sup> Finally, the publicity requirements of the Securities and Exchange Commission tend to reduce the probability of attempted secrecy

<sup>22</sup> The so-called "business judgment" rule is applied here. See *McQuillan v. Natl. Cash Register Co.*, (D.C. Md. 1939) 27 F. Supp. 639 at 651, *affd.* (C.C.A. 4th, 1940) 112 F. (2d) 877; *Abrams v. Allen*, 36 N.Y.S. (2d) 174 (1942), *affd.*, 266 App. Div. 835, 42 N.Y.S. (2d) 641 (1943); 32 CALIF. L. REV. 88 at 91 (1944); Uhlman, "The Duty of Corporate Directors to Exercise Business Judgment," 20 *BOST. UNIV. L. REV.* 488 at 500 (1940).

<sup>23</sup> But it is notable in this regard that the *Wyles* case, (D.C. Del. 1948) 77 F. Supp. 343, *supra*, note 5, arose apparently at the instigation of one whose attempt to purchase a controlling interest in the employer corporation was severely hampered by the option stock issue.

<sup>24</sup> E.g., *Mann v. Luke*, 44 N.Y.S. (2d) 202 (1943); *Winkelman v. Genl. Motors Corp.*, (D.C. N.Y. 1942) 44 F. Supp. 960; *Epstein v. Schenk*, 35 N.Y.S. (2d) 969 (1939).

which, once discovered, can be expected to incite the wrath of righteous stockholders.<sup>25</sup>

If the stockholder is determined to bring an action, the very nature of stock option incentive contracts will present substantial obstacles to the success of the suit. Since the option price is often set somewhat below the market price at the time of the contract, any profit realized therefrom must be accompanied by a commensurate improvement in the corporation's prosperity, thus suggesting at the outset that the executive is worth his keep.<sup>26</sup> This also makes it difficult to point to the actual amount received as evidence of bad faith, since the speculative nature of option contracts makes it as possible in foresight for the optionee to achieve no benefit from his option as to realize spectacular gain.<sup>27</sup> Furthermore, option contracts are perhaps most often used to bring the expensive talent of outsiders into the corporation, with the two-fold effect of reducing the possibility of self-dealing and of justifying large executive incomes as a necessary competitive expense. Finally, although executives on an average appear to receive somewhat larger compensation under incentive plans than under fixed salary agreements alone, corporations using such plans also usually achieve proportionately greater financial success.<sup>28</sup> These litigation-deterrent aspects of stock option incentive compensation plans may make them particularly attractive to the corporation and to the executive in view of the prohibitive costs of litigation and the unavoidable injury to character and goodwill which will no doubt result from such actions.

#### D. *Problems Peculiar to Stock Option Incentive Plans*

1. *Effect of state statutes.*<sup>29</sup> State legislatures have been far from uniform in their treatment of stock option incentive compensation plans, and it is possible here only to indicate some of the more usual problems and aids which are presented by the various state statutes.

In considering the advisability of adopting a stock option plan for a particular corporation one of the most imposing obstacles which may

<sup>25</sup> For an example of a stockholder's desire to be fully informed, see *Dottenheim v. Emerson Electric Mfg. Co.*, (D.C. N.Y. 1947) 7 F.R.D. 195.

<sup>26</sup> See e.g., *Koplar v. Warner Bros.*, (D.C. Del. 1937) 19 F. Supp. 173 at 180.

<sup>27</sup> See 19 HARV. BUS. REV. 106 at 118 (1940), for a case in which a very able executive involuntarily served for five years without compensation, because his employer's stock failed to rise sufficiently to make his option profitable.

<sup>28</sup> See BAKER, EXECUTIVE SALARIES AND BONUS PLANS 41 et seq. (1938).

<sup>29</sup> The effect of state "blue sky" laws and stock issuance taxes, etc., may be extremely important in some cases, but such statutes are so dissimilar from state to state as to preclude adequate treatment here.

be encountered is the presence of outstanding stock with preemptive rights unconditioned for options.<sup>30</sup> These rights<sup>31</sup> may not be enforceable if the option stock is part of the originally authorized but unissued stock of the corporation, but the courts are not in complete agreement on the point.<sup>32</sup> Of course, the difficulty may usually be avoided by procuring the approval of all stockholders concerned, if the number of outstanding shares is not prohibitive, and several statutes provide that an affirmative vote of two-thirds<sup>33</sup> or a majority<sup>34</sup> of such stockholders will constitute a waiver of the rights of all. Some of these statutes<sup>35</sup> give the dissenters the right on petition to have their shares appraised and purchased by the corporation, and if they represent a large amount of stock the cost of buying them out may destroy the effectiveness of the stock option contract. It is also notable that such statutes impliedly raise the need for full disclosure of the option provisions to the stockholders, which might entail considerable delay and inconvenience.<sup>36</sup>

Another problem which must be considered with respect to the adoption and execution of stock option contracts is statutory regulation of the consideration for which the stock may be issued. The statutes in this field present a rather complex picture, varying considerably in their effect according to the type of stock which is to be used for satisfaction of the option and according to the form of consideration received for issuance of the stock. At the outset a distinction should be recognized between the consideration to be received for the option and that which the statutes will allow for the issuance of the stock, for what

<sup>30</sup> This issue has not apparently been raised directly in litigation, but for cases in which preemptive rights have not applied to option issues, see *Kingston v. Home Life Ins. Co.*, 11 Del. Ch. 258, 101 A. 898 (1917); and *Yasik v. Wachtel*, 25 Del. Ch. 247, 17 A. (2d) 309 (1941). Note also the possible effect of laches or implied stockholder approval. *Stokes v. Continental Trust Co.*, 186 N.Y. 285, 78 N.E. 1090 (1906).

<sup>31</sup> A problem very similar to that raised by express preemptive rights is suggested by the rule which provides that the holders of outstanding shares of the corporation are entitled to purchase the treasury stock pro rata according to their holdings before it is offered for sale in other markets. See Morawetz, "The Preemptive Right of Shareholders," 42 HARV. L. REV. 186 (1928).

<sup>32</sup> See 40 MICH. L. REV. 115 (1941); Drinker, "The Preemptive Right of Shareholders to Subscribe to New Shares," 43 HARV. L. REV. 586 (1930); *Dunlay v. Ave. M Garage & Repair Co.*, 253 N.Y. 274 at 279, 170 N.E. 917 (1930). But see N.Y. Stock Corp. Law (McKinney, 1940) §14, suggesting that, although an employee's option stock issue will not give rise to preemptive rights, the granting of the option itself might do so. See also *Albrecht, Maguire & Co., Inc. v. Gen. Plastics, Inc.*, 256 App. Div. 134, 9 N.Y.S. (2d) 415 (1939), 25 CORN. L.Q. 124 (1939).

<sup>33</sup> E.g., Calif. Corp. Code Ann. (Deering, 1948) §§1107, 1108.

<sup>34</sup> E.g., N.Y. Stock Corp. Law (McKinney, 1940) §14.

<sup>35</sup> *Ibid.*; and see *In re Stockwell*, 210 App. Div. 753, 206 N.Y.S. 834 (1924).

<sup>36</sup> Cf. the Delaware statute as discussed in *Garner & Forsythe*, "Stock Purchase Warrants and Rights," 4 S. CALIF. L. REV. 375 (1931).

will suffice for the former often will be insufficient for the latter.<sup>37</sup> In the great majority of states, future services will not be acceptable consideration for the issuance of stock, although "labor done" will be allowed for that purpose.<sup>38</sup> Because of this latter requirement it is advisable, wherever possible, to provide for cash payment by the optionee to the extent of the minimum consideration required by law for each type of stock.<sup>39</sup> Thus, if the option provides that par value stock is to be used for its satisfaction, it will be necessary in most states to fix a cash price not lower than the par value of the stock issued.<sup>40</sup> Although this may constitute an unwelcome impediment to price negotiations in the adoption of the contract, it is perhaps the safest course. If treasury stock is to be used, there is no real problem as to fixing a price; such shares, having already been issued and therefore not subject to "issuance" statutes, are treated as an asset of the corporation, and it is only necessary that fair value be received therefor.<sup>41</sup> Although it is generally said that no-par stock may be issued for whatever price is deemed advisable, it is also the rule that the executives of a corporation are under a fiduciary obligation to the stockholders to procure as large a return as is feasible when the stock is sold.<sup>42</sup> Thus, it is at least arguable that any cash price below market value, if money constitutes the entire consideration given for the stock, will be subject to attack by stockholders. Clearly, the purpose of the option would be destroyed if the market price in cash were demanded of the optionee; therefore, the margin between market and option prices must be considered to be provided by the services of the optionee. If, then, the option is exercised prior to completion of the employment contract, at least some of those services will be executory and insufficient as consideration under the statutes above mentioned. This question has never been directly decided by a court of last resort, although one court has expressed an

<sup>37</sup> For example, the court held in *Diamond v. Davis*, 263 App. Div. 68, 38 N.Y.S. (2d) 103 at 113, (1942), that an option could validly be given as inducement to a valued executive to remain in the employ of the corporation. This would clearly not suffice as consideration for the issuance of the stock itself.

<sup>38</sup> See 18 C.J.S., Corporations, §241.

<sup>39</sup> Although many states require that the consideration for stock must be "fixed" by the persons authorized by the charter to do so, this requirement will probably be satisfied by the establishment of a readily ascertainable standard, without the necessity for naming a definite monetary amount. See *Holmes v. Republic Steel*, (Ohio, Cuyahoga C.P. 1946) 69 N.E. (2d) 396.

<sup>40</sup> See, e.g., Del. Rev. Code (1935) c. 65, §14. But cf. Md. Code Ann. (1939) art. 23, §45(8).

<sup>41</sup> See Morawetz, "The Preemptive Right of Shareholders," 42 HARV. L. REV. 186 at 189 (1928).

<sup>42</sup> *Ibid.*; *Bodell v. Genl. Gas & Electric Co.*, 15 Del. Ch. 119, 132 A. 442 (1926).

opinion that the optionee could exercise his option only to the extent that his services were completed.<sup>43</sup> This would necessarily preclude the purchase of at least some of the option stock before the last day of the employment contract. This will certainly be far from the contemplation of the parties to the option in most cases, for it is usually believed that the option is exercisable in full at any time during the period of its effectiveness. Conceivably, this problem might also rise with stock having par value, where the par value is not wholly paid in cash upon the exercise of the option. It seems that the only complete solution to this perplexing question is enactment of statutes permitting issuance of stock for future services.<sup>44</sup>

A few states have accorded complete statutory sanction to "employees' stock option plans."<sup>45</sup> Such legislation expressly authorizes the issuance of stock or stock agreements in return for future services, and usually adds one or more of the above provisions favorable to such plans. It is not certain, however, that all such statutes apply as well to officers and directors as to non-executive employees, although no doubt some of them do.<sup>46</sup> Moreover, it seems clear that a stock option contract not part of a "plan"<sup>47</sup> for "employees" may not be within the scope of the provisions of the option plan statutes. Probably the presence of such statutory plans will nowhere preclude the use of options not connected with employees' plans, but the statutes may be indicative of public policy in requiring, for example, that stockholders or a given proportion of them must approve stock bonus contracts.

2. *Federal regulations pertinent to stock option incentive contracts.* The provisions of the Securities Exchange Act of 1934<sup>48</sup> may

<sup>43</sup> *McQuillan v. Natl. Cash Register Co.*, (D.C. Md. 1939) 27 F. Supp. 639 at 649, 650, *affd.*, (C.C.A. 4th, 1940) 112 F. (2d) 877.

<sup>44</sup> Although several states have enacted statutes of this sort, they are usually included in statutory employees' option plan statutes. See note 45, *infra*. It is likely that this question has not always been raised when it might have been, for the decisions often do not describe the characteristics of the option shares. See *Koplar v. Warner Bros.*, (D.C. Del. 1937) 19 F. Supp. 173.

<sup>45</sup> See Cal. Corp. Code Ann. (Deering, 1948) §§1107, 1108; Colo. Stat. Ann. (1935) c. 41, §40; Idaho Code (1948) §30-120(7); Ill. Stat. Ann. (Smith-Hurd, 1935) c. 32, §157.24; Mich. Comp. Laws (1948) §450.24; 1 N.J. Rev. Stat. (1937) §14:9-1; N.Mex. Stat. Ann. (1941) §54-313; N.Y. Stock Corp. Law (McKinney, 1940) §14; Ohio Gen. Corp. Law (Baldwin, 1948) §8623-36; Penn. Stat. Ann. (Purdon, 1938) tit. 15, §138; Mass. Laws Ann. (1948) c. 158, §§26-28; Fordham, "Some Legal Aspects of Employee Stock Purchase Plans," 8 N.CAR. L. REV. 161, 163 (1929).

<sup>46</sup> See WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 87 (1942).

<sup>47</sup> It is uncertain what facts will turn a contract or a series of contracts into a "plan" within the meaning of these statutes. But see *Rogers v. Guarantee Trust Co.*, 288 U.S. 123, 53 S.Ct. 295 (1933).

<sup>48</sup> 15 U.S.C. (1934) §78a-78j.

constitute one of the most serious limitations on the effective use of stock options for corporation executives. Section 16,<sup>49</sup> which deals with transactions in securities by the officers, directors, and beneficial holders of ten per cent or more of the stock of the issuing corporation, has two subsections; the first requiring publicity of such transactions, and the second pertaining to "Insiders' Profits." Section 16(b) is of the most immediate importance here, for under its provisions the described "insiders" are liable to the corporation for any profit made on a purchase-sale or sale-purchase cycle which is completed within a six-month period.<sup>50</sup> Section 16(a) requires that reports be rendered by insiders at the close of any month in which there has been a change of their ownership of any of the stock of the employer or issuing corporation.

The effect of these regulations upon a given stock option plan will depend in a large measure upon the purpose for which the plan was adopted. The act will have little effect on those options designed primarily to induce the executive to acquire a permanent ownership interest in the employer corporation by offering him a bargain purchase. If, however, the option plan was adopted in lieu of a larger salary with a view toward immediate financial realization on exercise of the option, the regulations will have a profound effect; it is with the latter situation that this comment largely deals. One of the advantages of these inherently speculative option plans is that the optionee may choose the precise moment at which he believes he will achieve the greatest benefit from the option. Under these regulations he will realize only a paper profit for the six-month period and is faced with the problem of financing the purchase for that interim. Furthermore, he will be taxed on the paper profit and not upon the actual profit which he may realize at the end of six months.<sup>51</sup>

Finally, there is an unusual opportunity for unwelcome litigation here, inasmuch as stockholders may bring derivative suits against the optionee if, after six weeks following the completion of the cycle, the corporation refuses to sue for the profits,<sup>52</sup> and such a transaction will

<sup>49</sup> *Id.*, §78p. See 2 C.C.H. FED. SEC. SERV., ¶25,853-1, for a draft of a proposed amendment to Rule X-16B-3, which would exempt certain stock bonus contracts from the provisions of Rule 16. To date this has apparently not been introduced in Congress.

<sup>50</sup> See *Parke & Tilford, Inc. v. Schulte*, (C.C.A. 2d, 1947) 160 F. (2d) 984, as to the measure of damages recoverable from the executive.

<sup>51</sup> See discussions, part D-3, *infra*.

<sup>52</sup> Rule 16b, 15 U.S.C. (1934) 78p (b), note 49, *supra*. See also *Grossman v. Young*, (D.C. N.Y. 1947) 72 F. Supp. 375.

appear clearly upon the records which are required to be submitted to the Securities and Exchange Commission.<sup>53</sup>

3. *Income tax effects of stock option agreements.* The regulations<sup>54</sup> provide that all transfers of property by an employer to an employee are taxable as income to the extent of the margin between market price and purchase price. In the case of a stock option, the market value of the stock is determined as of the time the option is exercised by the employee, regardless of the time of its actual resale by him.<sup>55</sup> In the event of a subsequent sale of the stock, the adjusted basis of the stock for capital gains purposes is the market price at the time of purchase.

It is doubtful whether an optionee under a stock option plan will be able to take advantage of the code provision whereby compensation received in a lump sum for personal services rendered over a period in excess of thirty-six months may be allocated over the period in which the services were rendered.<sup>56</sup> That exception to the usual rule of taxation in the year of receipt is available only if the sum so received constitutes at least eighty per cent of the total compensation for personal services during the period. This places the optionee in an awkward position; unless he can realize considerable theoretical gain from his option in proportion to his other compensation for personal services the entire amount will be taxed as income in the year received; and if he does show an inordinately large paper profit on the transaction an irate stockholder may be only too willing to see that he does not keep it. The optionee's position may be aided somewhat by a contract under which no salary is received and a large option profit is anticipated, but aside from the obvious need for regular income there is always the risk that the anticipated profits will not be realized.<sup>57</sup> In any event, this tax provision may indicate the advisability of drafting options in such form that they may be exercised after more than thirty-six months have elapsed from the beginning of employment, and the advantage of await-

<sup>53</sup> Note also that there must be disclosure of the option itself upon the granting thereof. Schedule A, Securities Act of 1933, 15 U.S.C. (1934) §77aa; and Securities Exchange Act of 1934, §12(b)(1)(H), 15 U.S.C. (1934) §78 1(b)(1)(H).

<sup>54</sup> TREAS. REG. 105, §§29.22(a)-1, 29.22(a)-3. See TREAS. REG. 105, §29.42-2, for the effect of the constructive receipts doctrine here. Cf. *Comm. v. Smith*, 324 U.S. 177, 65 S.Ct. 591 (1945), which indicates the rule prior to April 12, 1946, when these regulations became effective.

<sup>55</sup> *Van Dusen*, 8 T.C. 388 (1932).

<sup>56</sup> I.R.C., §107; TREAS. REG. 105, §§29.107-1, 29.107-2.

<sup>57</sup> *Supra*, note 27; and see *McQuillan v. Natl. Cash Register Co.*, (D.C. Md. 1939) 27 F. Supp. 639 at 654, *affd.*, (C.C.A. 4th, 1940) 112 F. (2d) 877.

ing the passage of such period before exercising the option or advising its exercise.

In most cases the corporation will be permitted to deduct, as an administrative expense of doing business, an amount equivalent to that taxed as income to the optionee, so long as that amount is reasonable.<sup>58</sup> Most cases involving the commissioner's disallowance of compensation expense as unreasonable appear to have been decided in favor of the corporate taxpayer, possibly because the burden lies with the commissioner to prove the unreasonableness and possibly because the Tax Court seems to be quite liberal in such matters.<sup>59</sup> In determining excessiveness for tax purposes the courts seem to look to much the same economic factors as are considered in stockholders' derivative suits, but the propriety of the employee's actions in fixing the amount and the degree of publicity it receives do not seem to be proper considerations.<sup>60</sup> Where the compensation agreement is made some time in advance of the actual payment, the question of reasonableness will be decided as of the time the agreement is made, and not the time of payment pursuant thereto.<sup>61</sup> This seems to place the option contract in an extremely favorable light as to the probability that the corporation will be allowed to deduct the entire amount of payment, especially where the option price is below the market price when the contract is adopted.

### *E. Conclusions*

It seems clear that, for one reason or another, stock option incentive contracts are much less subject to attack and somewhat easier to defend than are most other plans for executives' incentive compensation. The advent of state statutes expressly approving employees' option plans indicates the popularity of their use and may serve as an indication of the public policy of a given state as to the probable validity of option contracts, especially with respect to the formalities of their adoption. However, the increasing statutory reference to employees'

<sup>58</sup> I.R.C., §23(a)(1); TREAS. REG. 105, §29.23(a)-6. Note that, at least in theory, the business judgment rule does not apply here: *Schepp Co. v. Comm.*, 25 B.T.A. 419 (1932). This also presumes that the compensation is in fact purely for personal services. See TREAS. REG. 105, §29.23(a)-6.

<sup>59</sup> See Wolder, "Facts and Figures on Reasonable Compensation," 24 TAXES 150 (1946).

<sup>60</sup> See *id.* at 156 et seq., listing 100 factors which may be material with respect to the question of reasonableness for tax purposes. No case has been found in which a judgment of reasonableness or unreasonableness for tax purposes has been attempted to be introduced in a stockholder's suit, or vice versa.

<sup>61</sup> *N.Car. Equipment Co. v. Comm.*, C.C.H. FED. TAX REP. Dec. 14603(M), ¶161.138 (1946). See also *Austin v. United States*, (C.C.A. 5th, 1928) 28 F. (2d) 677.

stock trust systems<sup>62</sup> might suggest a shift in emphasis from the use of option plans as a means of securing added money income to the employee to their utility in employees' ownership participation plans. Practically, it may be that the real answer to the scarcity of litigation involving option contracts lies in the fact that they lend themselves less to improper manipulations than do some other systems, and that by encouraging executives to achieve overall corporate success rather than large periodic profits they tend to mollify otherwise belligerent stockholders.

*A. B. Perlin, Jr., S. Ed.*

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<sup>62</sup> See statutes cited, note 45, *supra*.