Michigan Law Review

Volume 41 | Issue 3

1942

CORPORATIONS - LEGAL ASPECTS OF CORPORATION BONUSES

H. Marshall Peter
University of Michigan Law School

CORPORATIONS — LEGAL ASPECTS OF CORPORATION BONUSES — It would clearly be inaccurate to say that the percentage method of compensation represents a modern idea. Its rationale is so simple that there must have been instances of its utilization in early history. Be that as it may, it is a device which attained little prominence in this country before the beginning of the present century and which has grown since then with amazing rapidity.[1] Along with the growth of bonus plans in some form or another, perplexing problems have arisen —economic, social and perhaps even moral as well as legal. The emphasis of this comment will be upon the law and these other considerations will be viewed primarily in that light.

The courts have traditionally, in compensation cases, considered the relationship between the directors and officers of a corporation on the one hand, and its shareholders on the other, as being of a fiduciary nature.[2] Some have even termed the relation that of trustee and cestui

[1]Europe was earlier to recognize the advantages of percentage payments than was this country. See Taussig and Barker, "American Corporations and Their Executives; A Statistical Inquiry," 40 Q. J. ECON. 1 at 40-43 (1925). A good idea of the rapid growth of bonus plans can be gained by comparing this work at 29-30 with the more recent BAKER, EXECUTIVE SALARIES AND BONUS PLANS, c. 9 (1938). As the latter treatise shows, however, this growth suffered a substantial setback as a result of the depression of 1929. The effects of the 1929 depression are also referred to in 21 CAL. L. REV. 358 (1933).

[2] Seitz v. Union Brass & Metal Mfg. Co., 152 Minn. 460, 189 N. W. 586 (1922); Calkins v. Wire Hardware Co., 267 Mass. 52, 165 N. E. 889 (1929); Rogers

que trust.[3] Attempts at clarification have been made by the use of such adjectives as "faithful," "loyal," "diligent" and the like. However little helpful these expressions may be, they are important in that they manifest an attitude which goes to the very heart of the present problem. They stem from a practical recognition of the fact that, especially in the case of large corporations, the stockholders are generally unorganized, uninformed and indifferent concerning the internal operations of the business in which they have invested. To the extent that the law is able, it feels called upon to protect them.

Our concern here will be with the compensation of the executive officers of corporations. (Cases have arisen in which directors have been paid in their capacity as such, but they are comparatively infrequent.[4] The law involving this situation is more stringent,[5] although the governing principles are the same.)

As was stated in the case of *Rogers v. Hill*,[6] "Compensation to an officer for his services constitutes a part of operating expenses deductible from earnings in order to ascertain net profits." It is, however, an operating expense which is subject to more than ordinary judicial scrutiny. There must be a valuable consideration for it. In the absence of contract, by-law, article of incorporation or resolution to the contrary, there must be no compensation for services already rendered.[7] It has even been held, too, that without such authorization, executive officers are not entitled to any compensation for their services.[8] There must be no self-dealing in the fixing of salaries or bonus awards.[9] The remuneration of officers is voted upon by directors and, in the event that a

v. Guaranty Trust Co., (D. C. N. Y. 1932) 60 F. (2d) 114; Rinn v. Asbestos Mfg. Co., (C. C. A. 7th, 1938) 101 F. (2d) 344; Winkelman v. General Motors Corp., (D. C. N. Y. 1942) 44 F. Supp. 960.

[3] Bosworth v. Allen, 168 N. Y. 157, 61 N. E. 163 (1901); Carr v. Kimball, 153 App. Div. 825, 139 N. Y. S. 253 (1912); Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 123 N. E. 148 (1919); Bingham v. Ditzler, 309 Ill. App. 581, 33 N. E. (2d) 939 (1941). See also Uhlman, "The Legal Status of Corporate Directors," 19 BOSTON UNIV. L. REV. 12 (1939).

[4] WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION, 206 (1942).

[5] 3 THOMPSON, CORPORATIONS, 3d ed., § 1841 (1927).

[6] 289 U. S. 582 at 590, 53 S. Ct. 731 (1933).

[7] Church v. Harnit, (C. C. A. 6th, 1929) 35 F. (2d) 499; Wineburgh v. Seeman Bros., (N. Y. S. Ct. 1940) 21 N. Y. S. (2d) 180; 3 THOMPSON, CORPORATIONS, 3d ed., §§ 1833, 1881 (1927); BALLANTINE, MANUAL OF CORPORATION LAW AND PRACTICE, § 127a (1930); Boyum v. Johnson, (C. C. A. 8th, 1942) 127 F. (2d) 491.

[8] 3 THOMPSON, CORPORATIONS, 3d ed., § 1841 (1927); BALLANTINE, MANUAL OF CORPORATION LAW AND PRACTICE, § 127a (1930).

[9] 3 THOMPSON, CORPORATIONS, 3d ed., § 1830 (1927); BALLANTINE, MANUAL OF CORPORATION LAW AND PRACTICE, § 127a (1930); 5 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 2129 (1931). See also 2 UNIV. CHI. L. REV. 482 (1935).

single man holds both of these positions, he must not vote upon the issue nor exert pressure upon those who do vote. Affirmative ratification by the stockholders may be a necessary step in the procedure,[10] and, even if an overwhelming majority approve, this will not bar the smallest shareholder from protesting action amounting to fraud. The precise form which the mode of compensation takes is immaterial.[11] There may be fixed salaries, percentage plans, stock option contracts, to mention a few, or any combination of them.

The question whether the corporation executive is getting more for his services than he is worth is most apt to attract the attention of the layman. There can be no denying that the figures are sometimes stupendous. In 1929 the combined salary and bonus of Eugene Grace, director and president of Bethlehem Steel, totalled over one and one-half million dollars.[12] In 1930 the president of the American Tobacco Company received more than one and one-quarter million dollars in salary, bonus, and "special credit," though in the recent years of 1939 and 1940 he averaged less than half a million dollars.[13] The three Warner brothers of the motion picture industry about twenty years ago were under contract for $10,000 a week.[14] This, too, has now dropped greatly. During the years 1927, 1928, and 1929, Mitchell, chief executive of the National City Bank of New York City, averaged over one and one-quarter million dollars.[15] In 1936, Sloan and Knudsen of General Motors received over half a million in cash and stock awards.[16] These figures were selected because they are outstanding, not because they are by any means typical. Nevertheless, the fact remains that executives of large corporations have received compensation strikingly in excess of that enjoyed by the vast preponderance of successful businessmen.[17] What a man is "worth" is no more than speculation. There are too many factors to allow any uniform system of evaluation. The courts refuse to be drawn deep into such a quagmire. The statement of Judge Coleman in the *National Cash Register* case is illustrative:

> "It may be conceded that, prima facie, judged by appropriate standards of the worth of the services of any individual for any

[10] WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION, 206 (1942). See also 41 YALE L. J. 109 at 110-111 (1931).

[11] That there is no objection to the percentage bonus form of compensation is too well settled to require the citation of cases. See 3 THOMPSON, LAW OF CORPORATIONS, 3d ed., § 1862 (1927).

[12] WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 267 (1942).

[13] Id. 271, 276.

[14] Koplar v. Warner Bros. Pictures, (D. C. Del. 1937) 19 F. Supp. 173.

[15] WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 280 (1942).

[16] Id. 290.

[17] See WASHINGTON, "The Corporation Executive's Living Wage," 54 HARV. L. REV. 733 (1941). Also 32 MICH. L. REV. 672 (1934).

particular industrial executive position, a salary of $100,000 a year appears to the average person of average business experience and responsibilities, to be more than liberal compensation. However, courts are not permitted to be controlled by this test, any more than by what the average judge familiar with cases of the present kind, might himself conclude to be adequate compensation. We must distinguish between compensation that is actually wasteful and that which is merely excessive. The former is unlawful, the latter is not."[18]

We cannot assume that courts have abandoned considerations of size. Various tests have been applied. Comparisons have been made between the industry in question and similar industries, between the compensation under consideration and that given other executives in the business.[19] The ratio of salaries, bonuses, etc. to dividends paid to shareholders has been a factor.[20] Moreover, it is quite customary to make at least a superficial appraisal of the executive's abilities and of the corporation's need for a person of such abilities.[21] The important thing to remember is that the strong presumption is in favor of the board of directors when size alone is attacked. "We may not readjust the salary without a yardstick applicable to the particular circumstances and not even then upon mere differences of opinion from that of the board of directors, but only upon concrete proof that the salary evidences wrongdoing or inexcusable oppression to the point of being fraudulent."[22]. The recent case of *Winkelman v. General Motors*[23] demonstrates admirably the reluctance of courts to find a "wasting of assets"

[18] McQuillen v. National Cash Register Co., (D. C. Md. 1939) 27 F. Supp. 639 at 653, affd, (C. C. A. 4th, 1940) 112 F. (2d) 879.

[19] These tests as well as several others are given in WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 256-257 (1942).

[20] Shera v. Carbon Steel Co., (D. C. W. Va. 1917) 245 F. 589. Though we may consider the shareholders as entitled to primary consideration in the distribution of profits, there is no argument of fairness for saying that their right should be exclusive. "We have long since passed the stage in which stockholders, who merely invest capital and leave it wholly to management to make it fruitful, can make absolutely exclusive claim to all profits against those whose labor, skill, ability, judgment and effort have made profits available." Gallin v. National City Bank of N. Y., 152 Misc. 679 at 703, 273 N. Y. S. 87 (1934).

[21] This was done in the following cases: Booth v. Beattie, 95 N. J. Eq. 776, 118 A. 257, 123 A. 925 (1922); Seitz v. Union Brass & Metal Mfg. Co., 152 Minn. 460, 189 N. W. 586 (1922); Putnam v. Juvenile Shoe Corp., 307 Mo. 74, 269 S. W. 593 (1925); Nahikian v. Mattingly, 265 Mich. 128, 251 N. W. 421 (1933); McQuillen v. National Cash Register Co., (C. C. A. 4th, 1940) 112 F. (2d) 879; Heller v. Boylan, (N. Y. S. Ct. 1941) 29 N. Y. S. (2d) 653 (1941), affd. (App. Div. 1941) 32 N. Y. S. (2d) 131; Boyum v. Johnson, (C. C. A. 8th, 1942) 127 F. (2d) 491; Winkelman v. General Motors Corp., (D. C. N. Y. 1942) 44 F. Supp. 960.

[22] Nahikian v. Mattingly, 265 Mich. 128 at 132, 251 N. W. 421 (1933).

[23] (D. C. N. Y. 1942) 44 F. Supp. 960.

through excessive compensation, though it demonstrates equally well that this continues to be a subject of judicial inquiry.[24]

Most often judicial disfavor is incurred either by failure to make full disclosure to shareholders, or by "self-dealing" or by administration and computation of the bonus at variance with the terms under which it was established. A few examples taken from leading cases may help show the sort of situations that arise.

The full disclosure problem is illustrated by the *Winkelman* case. When General Motors determined to terminate its contract with the Managers Securities Company, an organization through which the bonus was indirectly paid, earlier than the contract provision for termination in December, 1930, there was nothing wrong in this per se. Yet, as the transaction was actually carried out, the stockholders were left uninformed until actual litigation of an equalization payment made to "compensate" Managers Securities participants for this early termination. No mention of it was made in the report to stockholders for 1930.[25] Another instance[26] of nondisclosure from the same case involves the "reawarding of forfeited bonus stock." The original bonus plan mailed to the stockholders prior to the August 27, 1918 meeting provided that if a bonus beneficiary left the service of the corporation "that portion of his bonus represented at the time by the debit balance of his account shall revert to the corporation." In the bonus plan in effect in 1929 there is a provision that the so-called forfeited stock "shall revert to the Bonus Fund." This alteration is present in the terminology of the 1936 and 1938 plans. None of these amended plans, however, was mailed to the stockholders nor were the amendments set forth in the annual reports.

The presence of "self-dealing" is regarded in some jurisdictions as making the contracts or resolutions for compensation voidable and in others wholly void.[27] Everywhere evidence of this sort is considered evidence of fraud. In *Gallin v. National City Bank of New York*,[28] the court said: "A relatively simple case is presented when the entire board, or an overwhelming majority, vote, as directors, compensation *to themselves* as officers. . . . Such action is presumptively fraudulent and voidable at the instance of a minority stockholder, and the burden in such cases is on the directors to show that their acts were fair and

[24] The court there seems influenced by the capabilities of the bonus beneficiaries though it admits that, were it not barred by the New York Statute of Limitations, it would be inclined to hold that some of the bonuses prior to 1930 were so large as to constitute a waste of the corporation's assets.

[25] Winkelman v. General Motors Corp., (D. C. N. Y. 1942) 44 F. Supp. 960 at 974.

[26] Id. at 1003.

[27] WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION 197-206 (1942).

[28] 152 Misc. 679 at 707, 273 N. Y. S. 87 (1934).

reasonable." That the court in the *Winkelman* case was also on the alert for such an element is apparent from Judge Leibell's discussion of the equalization distribution referred to above. He points out in his opinion that nine of the twenty-one directors who attended the 1931 board of directors meeting and approved the distribution received 15,829 shares thereof.[29]

More complicated and difficult than either "nondisclosure" or "self-dealing" are the instances where the bonus has been improperly administered,[30] where action has been taken which simply was not contemplated at the time of the instigation of the plan. This is ordinarily a problem of definition or interpretation. Not infrequently it would appear to be a matter of accounting rather than of law. Unless the agreements or resolutions are drawn up with painstaking precision and in considerable detail, they will invariably contain ambiguities. Perhaps the most important example of this lies in the words "net earnings." These are generally the basis of computing bonus payments.[31] In his book entitled *Executive Salaries and Bonus Plans*, Mr. Baker gives some of the definitions that have been employed in practice:

> ". . . income after deducting depreciation, interest and dividends on preferred stock paid or accrued during the year, but before Federal taxes; income after deducting all expenses and losses, such depreciation provisions and the reserve for trade obligations as the board of directors may determine, and preferred stock dividends; income before interest premiums and discount charges, but after provisions for Federal taxes and after reserves set aside for the reasonable requirements of the business; income after all taxes and interest charges, but before any charges for depletion and depreciation; income after all charges and $2 per share on outstanding common stock."[32]

The opinions in *Heller v. Boylan*,[33] the recent American Tobacco case, and the *Winkelman* case both deal largely with accounting problems. In the former case the particular emphasis of the court seemed to be on the fact that earnings meant only those earnings resultant from the manufacture and sale of tobacco, in other words "operating earnings."[34] For this reason, a reduction of taxes by the establishment

[29] Winkelman v. General Motors Corp., (D. C. N. Y. 1942) 44 F. Supp. 960 at 975.

[30] A simple matter of faulty administration occurred when General Motors made erroneous equalization payments to five of the participants of the plan. Winkelman v. General Motors Corp., (D. C. N. Y. 1942) 44 F. Supp 960 at 976.

[31] BAKER, EXECUTIVE SALARIES AND BONUS PLANS 226 (1938).

[32] Id.

[33] (N. Y. S. Ct. 1941) 29 N. Y. S. (2d) 653, affd. (App. Div. 1941) 32 N. Y. S. (2d) 131.

[34] Numerous other examples are included in the same case. Heller v. Boylan, (N. Y. S. Ct. 1941) 29 N. Y. S. (2d) 653.

of a subsidiary was not includable in the bonus base. The same held true, among other things, of dividends on treasury stock and profits resulting from the dissolution of a tin company, subsidiary to the American Tobacco Company. The *Winkelman* case presents a wide variety of problems of interpretation and accounting. Should non-operating profit resultant from the sale of shares of stock to an affiliated corporation be part of the bonus base? [85] Should the profit from the sale of treasury stock be included? [86] Should bonus cost be considered as an expense in determining net earnings? [87] Did "capital employed" (an item deductible in part from the bonus) include earnings of the corporation currently reinvested in the corporation's business in the course of any calendar year? [88] The court answered "no" to all of these questions—to the detriment of directors as far as the first two were concerned. On the other hand, it determined that dividends and interest received by the corporation from its affiliate on its stock and unpaid balances of the affiliate's indebtedness were properly part of the bonus base.[89]

The writer has obviously not attempted to give a complete, rounded picture of the infinite numbers of ways in which "nondisclosure," "self-dealing," and faulty computation or administration can occur. This could only be accomplished in a work of hundreds of pages. Even with such a work, the fact would remain that each case presents peculiarities and individualities which distinguish it from others and may lead to a diametrically opposed result. The exact phraseology and punctuation of a resolution, the fullness of a report, the degree of influence one director may have on another—all of these may be decisive elements. The effort has been to point out that these elements, unexciting as they may appear, are much more apt to affect the court than the more dramatic factor of size, pure and simple.

What the future of percentage compensation will be is hard to say. That it will operate in a greatly restricted field during the present war is certain.[40] If this war leaves behind it a residue of peacetime increased

[85] Winkelman v. General Motors Corp. (D. C. N. Y. 1942) 44 F. Supp. 960 at 980-988.

[86] Id. at 989-994.

[87] Id. at 999-1003.

[88] Id. at 995-997.

[89] Id. at 997-998.

[40] "But in every industrial country the transition from a peace to a total war economy means the eclipse of the authority and control of the corporation managements. The managers are being dethroned. In a total war economy they are not much more than technical experts. Like the 'specialists' of early Communism, they are entrusted with the technical problems of production; but the political and social decisions of economic life are being taken over rapidly by the government. It is the government which decides what to produce, how much, whom to hire and at what wage. What is

governmental control through regulation and taxation as did the first one, that field will remain restricted. The bonus device in some form will undoubtedly continue. This certainly is to be hoped for, inasmuch as those qualified to judge are, for the most part, convinced that it is calculated to bring about the highest degree of efficiency, loyalty, and enterprise in corporate work.[41] It submitted too that, modified as the new arrangements may be, the same considerations will determine judicial decisions on compensation problems as shaped them in the past.

H. Marshall Peter

---

going on today is not the beginning but the liquidation of the Managerial Society." Drucker, "The Future of the Corporation," 185 HARPERS 644 (Nov. 1942).

[41] Zwolanek v. Baker Mfg. Co., 150 Wis. 517, 137 N. W. 769 (1912); Putnam v. Juvenile Shoe Co., 307 Mo. 74, 269 S. W. 593 (1925); Rogers v. Guaranty Trust Co., (D. C. N. Y. 1932) 60 F. (2d) 114. Taussig and Barker, "American Corporations and Their Executives," 4 Q. J. ECON. 1 at 48-49 (1925), make very strong arguments to this effect. See also 41 YALE L. J. 109 (1931). The contention is not being made, however, that the earnings which ordinarily constitute the bonus base are due solely and purely to the executives' abilities. See BAKER, EXECUTIVE SALARIES AND BONUS PLANS 227 (1938).