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Corporations - Compensation of Management - Bonus Plan

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CORPORATIONS—COMPENSATION OF MANAGEMENT—BONUS PLANS—Defendant corporation's board of directors adopted a profit-sharing retirement plan which was never ratified by the shareholders.[1] The plan assigned to key employees "units" having a fixed dollar value equal to the current market value of the corporation's common stock.[2] The company promised to pay each unit holder, upon termination of employment, a sum equal to the number of units held times the increase in market value of the stock from the time the units were issued to the date employment terminated or any date within five years thereafter selected by the employee.[3]

[1] In 1951, 90% of the shareholders ratified a management proposal to finance the plan with a reserve of 200,000 shares of the company's authorized but unissued stock. Although the shareholders were notified of its basic features, this was held not to be effective ratification of the plan. Principal case at 93-94.

[2] The market value of the common stock at the time of the plan's adoption in 1946 was $18 per share. In 1951 it ranged from 37⅞ to 51. MOODY'S INDUSTRIALS 210 (1952). At the end of 1957 it was $95 per share, adjusted for a 3:1 stock split in 1956. The number of units received by each employee varied from 400 to 10,000.

[3] A 1951 amendment required an employee electing the second alternative to notify the company ten days in advance of the selected date, and a 1956 amendment reduced the period in this alternative to two years.

The right of each unit-holder to receive the increased value of his units vested only after five years of employment. In a derivative action brought by plaintiff shareholder to restrain further operation of defendant's plan, *held,* defendant is enjoined from making further agreements under its plan.[4] Payments to be made under a plan based on increase in market value of the employer corporation's common stock bear no reasonable relation to the value of the employee's services and thus would constitute a wasting of corporate assets. *Berkwitz v. Humphrey,* (N.D. Ohio 1958) 163 F. Supp. 78.

A corporation may validly compensate its executives with corporate stock[5] or stock options.[6] The plan in the instant case gave executives all the financial benefits of stock ownership[7] in the form of "units" rather than stock, but this difference does not alter its substance.[8] While the plan might produce disparate results between two executives,[9] this may also be true of stock option plans.[10] The decisive question as to validity should be whether under the plan benefits which accrue to a particular executive are unreasonably greater than the value of his services.[11] In the instant case it is difficult to ascertain the benefits accruing to a particular executive because of the contingent character of his rights under the plan.[12] This determination could be made by analogizing the plan to a

[4] The court did not invalidate agreements already in existence at the time of suit because those unit-holders were not before the court.

[5] WASHINGTON AND ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 98 (1951).

[6] Kerbs v. California Eastern Airways, 32 Del. Ch. 219, 90 A. (2d) 652 (1951).

[7] In addition to the increase in market value the unit-holders also received annual amounts equal to the cash dividends they would have received had they held shares equal in number to their units. In case of a stock dividend or a stock split the units were to be increased proportionally. The plan did not, however, give the unit-holders such non-financial benefits as the right to vote at shareholders' meetings, inspect corporate books, initiate suit on the corporation's behalf or transfer units without the corporation's consent.

[8] The Texas Company has a unit plan much like that involved in the principal case except that stock equal to the increased value of his units is issued directly to the unit-holder at the time his employment terminates. WASHINGTON AND ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 99-100 and appendix LL (1951).

[9] Compare the effect on unit-holder *A* who works five years and retires when the market value of defendant's stock is high with the effect on unit-holder *B* who works thirty years and retires when the market value is low. See principal case at 91.

[10] Under the hypothetical facts of note 9 supra, assume that *A* and *B* are given stock options instead of units and exercised the options at the same time. If *A* sold his stock after five years and *B* did so after thirty years the same disparity in compensation would occur.

[11] Rogers v. Hill, 289 U.S. 582 (1932).

[12] There are here two underlying questions to be considered. (1) As of what time should the market value of the stock which will determine the amount of compensation the executive will ultimately receive finally be determined: the date on which units were assigned, the date at which each executive's rights under the plan became vested, the date of trial, or some speculative date in the future at which the executive is likely to retire? (2) Over what period is any increase in market value to be spread? The intervals between the above dates suggest the possibilities as to this question.

stock[13] or stock option plan.[14] In determining the value of an executive's services relevant factors are the character of those services, the financial success of the corporation,[15] its relative size, and amounts paid by corporations of similar size. In the instant case, however, the court eschewed the above analysis in favor of an inquiry into the soundness in general of market value of stock as a measure of the value of an executive's services.

The market value of corporate stock depends in part upon factors unrelated to the value of an employee's services: the confidence of investors, the cost of money, the supply of stock available on the market, and inflationary or deflationary trends in the economy.[16] These factors may also affect corporate earnings; yet the courts have readily approved bonus plans based on a percentage of corporate earnings.[17] Any difference in the relation to the value of an employee's services between corporate earnings on the one hand and increase in market value of stock on the other is largely one of degree. The extent of the difference depends on the current condition of the economy, a question normally left by the courts to the discretion of the directors.[18] The principle which upholds plans permitting executives to share reasonably in corporate earnings could easily be extended to uphold a plan permitting executives to share reasonably in increases in the market value of corporate stock.[19] The principle has in fact been so extended in the case of stock option plans which enable cor-

[13] Under this analogy the date at which the market value of the stock is finally determined would normally be the date at which the executive's rights vested. The period over which any increase in value is spread would normally be the interval between assignment and vesting. WASHINGTON AND ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 98 (1951). Defendant Love, for example, received 10,000 units in 1946 when the market value of the stock was $18. His rights vested in 1951 when the market value was $51. Thus he received a $330,000 benefit for five years work or $66,000 per year. The difficulty with this analogy is that the executive cannot "sell" his units as he could stock without quitting his job.

[14] Under this analogy the date at which market value is finally determined would normally be the date of suit. The period over which any increase in value is spread would normally be the interval between assignment and suit. Wyles v. Campbell, (D.C. Del. 1948) 77 F. Supp. 343 at 349-351. Applying this analogy to the example in note 13 supra, since the market value in 1957 was $95, defendant Love received $770,000 for eleven years or $70,000 per year.

[15] Defendant corporation was formed by merger of two corporations which were in bad financial straits. The new corporation has prospered from the outset and has paid dividends annually. For additional background see principal case at 82-83.

[16] Principal case at 90.

[17] 5 FLETCHER, CYC. CORP. 557 (1952); STEVENS, PRIVATE CORPORATIONS 756 (1949). But in Rogers v. Hill, note 11 supra, a bonus plan based on earnings which paid the corporation president $842,507 in 1930 was held unreasonable.

[18] See Heller v. Boylan, 29 N.Y.S. (2d) 653 at 680 (1941); BALLANTINE, CORPORATIONS 200 (1946).

[19] "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 profits against those whose labor, skill, ability, judgment, and effort have made profits available." Gallin v. National City Bank, 273 N.Y.S. 87 at 113-114, 152 Misc. 679 (1934), cited in principal case at 90.

porate executives to share in the benefits of inflation and to hedge against it as well as to share in the corporate prosperity to which their efforts have contributed.[20] It is surprising that the reasonable-relation-to-services test which has been held to permit a wide variety of executive compensation plans should be applied to enjoin the further operation of a substantially similar plan.

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20 See comment, 47 MICH. L. REV. 1179 at 1191 (1949). See also Clamitz v. Thatcher Mfg. Co., (2d Cir. 1947) 158 F. (2d) 687.