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A CORPORATE QUANDRY: SEARCH FOR AN ADEQUATE METHOD OF EXECUTIVE COMPENSATION

LESTER A. KLAUS*

LEVELING CORPORATE TAXES: RAISON D'ETRE FOR SOME EXECUTIVE COMPENSATION PLANS

Management may have many reasons for the particular type of executive compensation plan chosen, but certain to be one is the leveling of corporate taxes. It is not the purport of this effort to describe the extremely technical process of leveling corporate taxes except to alert the reader that various executive compensation plans used in the past have served this end. Changes in form of business association have occurred not only to take advantage of the leveling devices, but also to utilize the tax favors granted by certain compensation plans.

A business operated as a partnership with a high variable income will throw its income into what might be the higher tax brackets of its owners in extremely profitable years. Yet, the same peak profits earned by a corporation can be leveled out for the individual stockholders by dividends, bonus plans, and accounting methods. Corporate profits of an extremely good year may be distributed as dividends over a number of years, thereby reducing the income of shareholders currently in top brackets. Also, under executive profit-sharing plans, corporate profits earned in peak years can be prorated and paid over a period of several years.¹

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¹INT. REV. CODE of 1954 § 162; Treas. Reg. § 1.162-1. Deductions of contributions made by an employer under pension, annuity, stock bonus, and profit-sharing is permitted within certain limits. Such contributions are primarily in the nature of additional compensation for personal services rendered by the covered employees and represent a business expense. The plan (contribution) must show that it represents an ordinary and necessary expense paid or incurred in carrying on a trade or business to be a legitimate business deduction. In order to be deductible under §404(a) plan contributions must be deductible either under §162 (above) or under § 212 relating to expenses for the production of income.

Admittedly, there may be an apparent problem in the profit sharing plans because of the overlapping of accounting methods used by the corporation and the individual. However, if the corporation is on the accrual basis and the executive on the cash basis, year end bonuses paid shortly after the end of the year may be deducted by the corporation in the tax year ended and reported as income in the year received in cash by the owner-executive.² An accrual basis taxpayer may take the deduction in the year the plan is established. This is so, even if the "funding" of the plan does not occur until after the current tax year, provided it is within the time allowed for filing the return.³ Also, dividends covering the profits for the current year may be declared at year end and paid to the recipients in the following year. Moreover, interest may likewise be deducted by the corporation in the year incurred (accrued) and paid out early in the following year. In this case, the corporation deducts the interest paid in the current year and the recipient reports the income in the following year.⁴

²INT. REV. CODE of 1954, § 404 (a) (6); Treas. Reg. §§ 1.404(a)-1(a) (1) — 1.404(a)-1(c). A deduction for profit-sharing plans is generally allowed only if the payment is actually made during the taxable years. However, contributions made by an accrual basis taxpayer, after the close of the taxable year, to a qualified plan or trust may be deducted if paid not later than the time prescribed by law for filing the yearly return. For time extensions, see Rev. Rul. 55-670, 1955-2 CUM. BULL. 233, Rev. Rul. 56-674, 1956-2 CUM. BULL. 293.

³See Rev. Rul. 55-640, 1955-2 CUM. BULL. 231. A written contract to make contributions may constitute a "plan" corpus. This is true if under local law, such a promise is binding without other consideration. See also, Rev. Rul. 57-419, 1957 INT. REV. BULL. No 38, modifying Mim. 5958, 1946-1 CUM. BULL. 72, in relation to filing a return.

⁴INT. REV. CODE of 1954, § 461, 770(a), regarding periodic accounting treatment on cost and accrual basis. Deductions must be taken by a taxpayer on the cash basis in the year in which the payment is made or its equivalent. In *Helvering v. Price*, 309 U.S. 409 (1940), a taxpayer's note was held not to be the equivalent of cash. So, if a cash basis taxpayer gives his note in payment, he is not allowed the deduction until actual payment is made, even if secured by collateral. However, a taxpayer reporting on an accrual basis must take all the deductions at the time they accrue. Consequently, there must be an actual liability incurred before any amount may be accrued. See also for cash basis accounting and the discount method, *Mass. Mut. Life Ins. Co. v. United States*, 288 U.S. 269 (1933), and *Higginbotham-Bailey-Logan Co.*, 8 B.T.A. 566 (1927).

With the foregoing introduction setting the impending discussion in a proper tax perspective, we may now proceed to analyze the judicial treatment of a unique management innovation — a deferred compensation unit plan.

JUDICIAL ANALYSIS — SOMEWHAT MURKY

It is not unusual that the bulk of the pertinent case law to be considered here was decided in Delaware, since that state is the mecca of incorporation.

A corporate stockholder sued to enjoin the continued operation of a "Deferred Compensation Unit Plan," on the ground that the capital gains provision of the plan was not reasonably related to the value of the services rendered by those included within it.⁵ Upon the death or retirement of a key executive, there was to be credited to his "unit account" an amount equal to the net increment in market value of one share of common stock, from the date the "units" were assigned, multiplied by the number of "units" assigned. Payment of the amount was to be made over a ten-year period following the executive's death or retirement. On cross motions for summary judgment, the Court of Chancery, New Castle, Delaware, held for the defendant where the court contended that it cannot be said that appreciation of the market price of common stock is unrelated to the efforts of the individuals included within the plan.

Until recently, *Berkwitz v. Humphrey*⁶ was the only other case which had been litigated testing the validity of the so-called "unit" plans. It was concluded there that a plan almost identical to the one in question, was per se invalid. It was reasoned that, since the market price of common stock is subject to many extraneous forces, i.e., fortunes of the economy, speculation, etc., there is no reasonable relation between it and the value of a key executive's services.⁷ In the *Koppers* case, however, it was pointed out that earnings are the chief determinative factor of a stock's market price, at least in the long run. There being no question that an

⁵ *Lieberman v. Koppers Co.*, 149 A.2d 756 (Del. Ch. 1959).

⁶ 163 F. Supp. 78 (N.D. Ohio 1958).

⁷ *Id.* at 86.

executive's services are related to corporate earnings, the court felt that it was unable to say that there is no relation between those services and the market price of the corporation's stock.

The latter view seems to be the better one. Compensation must be reasonably related to the value of an executive's services, but the determination of what is reasonable is usually left to the discretion and business judgment of the board of directors.⁸ In order to prevail, therefore, the plaintiff should have to show that a reasonable man would find the "unit" plan indefensible. Yet the "unit" plan is not unlike stock option plans which have found approval in the courts.⁹ The financial reward in each plan is identical, both being based on the increase of the market price of the corporation's stock. It is difficult, therefore, to understand why the "unit" plan is more unreasonable than a stock option plan. In the opinion of this commentator, the view expressed in *Lieberman v. Koppers Co.*¹⁰ is clearly justifiable.

The summary presentation just given was designed, more or less, to acquaint the reader with the procedural manner in which the unit plan has been contested, giving the courts the opportunity to scrutinize the mechanics of its scheme.

DETAILED CHARACTERISTICS EXPLORED

A substantially novel method of deferred compensation for corporate executives and other key employees, which would give them many of the advantages of a stock option without having to put up capital, was upheld by the Supreme Court of Delaware in *Lieberman v. Becker*¹¹ against objections that it imposed unlimited liability on the company, and that it led to unreasonable

⁸ *Wyles v. Campbell*, 77 F. Supp. 343, 349-351 (D. Del. 1948); *Clamitz v. Thatcher Mfg. Co.*, 158 F.2d 687 (2d Cir. 1947); *Heller v. Boylan*, 29 N.Y.S.2d 653, 680 (1941).

⁹ *Wyles v. Campbell*, *supra* note 8; *Clamitz v. Thatcher Mfg. Co.*, *supra* note 8.

¹⁰ *Lieberman v. Koppers Co.*, *supra* note 5.

¹¹ 155 A.2d 596 (1959), affirming the summary judgment for the defendant granted by the Chancellor below in a derivative action to have the plan declared invalid, to enjoin its operation and to render an accounting, *Lieberman v. Koppers Co.*, *supra* note 5.

diversion of corporate assets due to its dependence on the price of the stock on the [stock] market.

This so-called Deferred Compensation Unit Plan, adopted by the Board of Directors and ratified by the majority of stockholders of Koppers Company, is administered by a committee of three or more directors, who are ineligible to participate. A total of 100,000 units is available for distribution in the discretion of the committee. A participating employee is credited with cost-free units, representing a corresponding number of Koppers common stock. There is a ceiling of 5,000 units per person, and at the termination of employment they become available for re-distribution. Each unit has most of the attributes of a share of stock. Dividends earned by actual shares of stock and stock splits or mergers are all reflected in the employee's unit account. Upon his retirement, disability, or death, the employee receives in cash in 40 quarterly installments not only such dividend accumulations but also any market appreciation of the shares, computed as of the time of retirement, death or disability, or as of any date within three years thereafter at the option of the employee or his beneficiary, so long as the delayed computation is based on a market price not exceeding the highest price reached by the stock between the date of assignment of the unit and the date of termination of employment. To be eligible for participation, the employee must agree to remain with the company for at least five years from the date units are first awarded to him (or until his retirement) to be available for consultation for a period of ten years following termination of his employment and to refrain from competing with the company. The plan may be terminated at any time by the Board of Directors prospectively, and if such termination occurs within five years from its effective date, no market appreciation credit is to be made thereafter to the account of any participant. Furthermore, the Administrative Committee may at any time prior to a participant's termination date reduce the number or cancel all units standing to his credit to the extent that they do not represent past dividend accumulations.

At the outset, the court drew a distinction between the question of existence of legal consideration for the plan and the problem of the reasonableness of compensation, and thus steered

away from much of the confusion present in this field. Indeed, the failure to keep in focus the basic difference between the search for the "missing peppercorn," which involves considerations of a formal nature in the law of contracts, and the need for checking the power of corporate directors and majority stockholders to dispose of corporate assets without obtaining a fair equivalent for the corporation as a matter of the law of corporations, has resulted in the past in a unitary treatment of the entire subject,¹²—a practice tending to promote waste of argument and laxity in systematic analysis. The importance of this distinction is further enhanced by the difference in consequences dependent on the characterization of the problem. For, if there is no legal consideration supporting the particular compensation contract, minority shareholders may rightfully complain that its performance would constitute a gift of corporate property; but if there is formal consideration, the courts will not ordinarily disturb the business judgment of the directors (especially when confirmed by majority stockholder approval) as to the equivalency of the corporate expenditure and anticipated benefits, unless the objector is able to show that "no person of ordinary sound business judgment would say that the consideration received (by the corporation) . . . was a fair exchange for (the compensation) granted."¹³

¹²This has been particularly so in Delaware. For example, in *Rosenthal v. Burry Biscuit Corp.*, 30 Del. Ch. 299, 306, 60 A.2d 106, 109 (1948), a stock option case, the rule was stated as follows:

While a corporation may under proper conditions grant an option to its officers to purchase its stock, the corporation must receive some consideration in return, and if that consideration is to be in the form of services, their value must bear some reasonable relation to the value of the right given.

See also *Kerbs v. California E. Airways, Inc.*, 33 Del. Ch. 69, 90 A.2d 652 (1952). On the other hand, Chancellor Seitz nearly separated the two questions in *Kaufman v. Shoenberg*, 33 Del. Ch. 211, 220, 91 A.2d 786, 791 (1952).

¹³*Kaufman v. Shoenberg*, *supra* note 12, at 220, 91 A.2d 786, 791.

" . . . [T]he court should only 'second guess' the corporate determination if it be shocking in the light of the total picture presented." *Id.* at 226, 91 A.2d 794.

See also the following cases: *McPhail v. L. S. Starrett Co.*, 257 F.2d 388, 394 (1st Cir. 1958); *McQuillen v. National Cash Register Co.*, 112 F.2d 877 (4th Cir. 1940); *Wyles v. Campbell*, 77 F. Supp. 343,

In the principal case, the main thrust of plaintiff's argument was directed against the reasonableness of the market appreciation feature of the plan.¹⁴ Since the directors had already obtained majority stockholder approval, and in the absence of an allegation of self-dealing or bad faith on the part of the directors in the complaint,¹⁵ there was a heavy burden on the plaintiff to show

349 (D. Del. 1948); *Gropper v. North Cent. Tex. Oil Co.*, 114 A.2d 231 (Del. Ch. 1955); *Schiff v. R.K.O. Pictures Corp.*, 104 A.2d 267 (Del. Ch. 1954); *Fidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 279-80, 92 A.2d 311, 321 (1952); *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 179, 91 A.2d 57, 58 (1952); *Kerbs v. California E. Airways*, 33 Del. Ch. 69, 75 n.2, 90 A.2d 652, 656 n.2 (1952); *Davis v. Louisville Gas. & Elec. Co.*, 16 Del. Ch. 157, 142 A. 654 (1928). Cf. H. BALLANTINE, CORPORATIONS § 76, at 193 (rev. ed. 1946).

In *Lewis v. Hat Corp. of America*, 150 A.2d 750, 754 (Del. Ch. 1959), the court stated that the allegations of excessive salaries do not set forth that type of intracorporate action which is not subject to stockholder ratification. Literally taken, this statement relinquishes all judicial control over excessive compensation of corporate officers to the detriment of minority stockholders. It is unlikely, however, that the court meant to depart from so generally recognized a rule in a casual way; and one may venture the guess that the court merely used too broad language in emphasizing the limitations of judicial review in this field.

¹⁴The question of legal consideration was not pressed by the plaintiff in the principal case and it was summarily dismissed by the court. *Lieberman v. Becker*, *supra* note 11, at 598. If the dividend factor under the plan was subject to the same termination and cancellation reservations for the benefit of the corporation as was the market appreciation factor, which it was not, the existence of legal consideration might have been more earnestly at issue, since the corporation promise would have been illusory. An interesting case on this point is *Kaufman v. Shoenberg*, *supra* note 12, at 222, 91 A.2d 792, where the court conceded that the failure of the corporation to make a binding promise would render the employment contract invalid, but it found consideration in that the employee had received options immediately exercisable and also in that the Board's power to cancel options in the future had to be exercised reasonably. A similar question was raised but not answered in *Frankel v. Donovan*, 120 A.2d 311, 316 n.9 (Del. Ch. 1956). Cf. *McPhail v. L. S. Starrett Co.*, *supra* note 13, at 393, where it was stressed that absence of consideration may make the contract unenforceable but not illegal.

¹⁵The court felt that either of those elements would have been sufficient to shift the burden of proof from the directors to the objector. *Lieber-*

clearly the shortcoming of the plan. In his uphill fight, he borrowed heavily from Judge McNamee's arsenal against a similar plan in *Berkwitz v. Humphrey*,¹⁶ when he charged that the market value of common stock is too speculative an element to form a reasonable basis for determining executive compensation, and that the plan, by imposing unlimited and indefinite liability on the corporation, went beyond the dictates of elementary prudence.¹⁷

Starting from the premise that stock option compensation plans are proper, the court persuasively rejected both the following contentions of plaintiff.

With reference to the reasonableness of the relation between the amount of compensation and the value of services in the unit plan, the court felt that a stock option, concededly proper, is equally subject to the vagaries of the market. Assuming that the plan is administered competently and in good faith, a guess of the future prospects of the stock would normally be one of the factors considered in assigning units.¹⁸ Finally, the court by its silence refused to ascribe any significance to the distinction drawn by the plaintiff between stock options and unit assignments based on the fact that the former requires capital investment on the part of the employee with all the risks inherent in speculation while, in the latter, the employee does not put in jeopardy any property of his own.¹⁹ Such a distinction has little relevance in the present context, but in any event the employee who has received an option is in a position very similar to that of the unit holder, since he pays nothing until he decides to exercise the option, thus enjoying all the windfalls of rapid appreciation without any real risk of loss of capital. As a holder of a valuable option at the time of appre-

man v. Becker, *supra* note 11, at 601.

¹⁶ *Supra* note 6, at 90-93.

¹⁷ The plaintiff made no attempt to challenge the plan as involving the issuance of stock options or shares of stock at the time the units were assigned and therefore subject to all the formalities necessary for such issuance. A similar argument by the plaintiff in the *Berkwitz* case failed to impress the court, since the unit assignment involved no proprietary interest, no voting rights, and no power of alienation, and required no change in the capital structure of the corporation. *Id.* at 89.

¹⁸ *Lieberman v. Becker*, *supra* note 11, at 600.

¹⁹ *Id.* at 599.

ciation, it is unlikely that he will meet with difficulty in obtaining credit to put up the necessary capital before the sale of the stock. Once he has exercised the option, any delay in selling the stock is unrelated to the plan and involves independent speculation by the employee. In fact, there is merit to the suggestion made²⁰ that the unit plan is more reasonable and beneficial to the corporation than the stock option alternative, at least to the extent that it better insures the retention of the employee's services by not subjecting him to the temptation of leaving the company after realizing his market gains. Furthermore, the unit plan is less geared to the individual wealth of the employee (which is usually unrelated to his abilities) and more to the value of the services of the employee to the particular corporation. From another angle, the interests of minority stockholders are better protected in the case of the unit plan, because such stockholders can always obtain judicial relief in extreme cases of waste due to error in judgment by the directors. Since Section 157 of the Delaware General Corporation Law provides that the judgment of directors as to consideration, and its sufficiency, for the issuance of rights or options to purchase stock shall be conclusive in the absence of fraud,²¹ and since Section 152 of the same statute makes such judgment equally conclusive with respect to the value of the consideration received for the issuance of the stock itself²² judicial interference with director action is much more limited in the case of stock options than in the case of other compensation arrangements, such as the unit plan.²³

The tax aspects of the unit plan also present decisive advantages

²⁰ 20 OHIO ST. L. J. 147, 148 n.3 (1959).

²¹ DEL. CODE ANN. tit. 8, § 157 (Supp. 1956). Cf. MONTANNA REV. CODES ANN. § 15-801 (1955); N.Y. CORP. LAW § 69; PA. STAT. ANN. tit. 15, § 2852-612 (1958).

²² DEL. CODE ANN. tit. 8, § 152 (1953).

²³ Section 157 has been interpreted to immunize only such corporate director judgment as regards the reasonableness of what the corporation received in exchange for the option and not to preclude judicial review of the question of existence of legal consideration. *Frankel v. Donovan*, *supra* note 14, at 316. Although Section 157 in terms applies only to stock options, it serves as a good illustration of a more general principle affecting other compensation plans, which calls for the exercise of the utmost judicial restraint in reviewing the judgment of corporate directors.

for the corporation. The corporation may deduct from its own gross income all payments under the unit plan as compensation to employees,²⁴ provided that such compensation is not found unreasonably high,²⁵ whereas it may not deduct the profits of employees made by the exercise of stock options and the subsequent sale of the stock on the open market.²⁶ From the point of view of the employee the unit plan may not have the capital gains treatment available in the case of restricted or qualified stock options,²⁷ but at least it allows substantial tax benefits by postponing the receipt of compensation until a time when the employee is more likely to belong to a lower income tax bracket.²⁸

The general arguments that these stockless units differ materially from stock options in that they impose on the corporation unlimited and indefinite liability have failed to sway the courts in favor of the plaintiffs. In concluding that the liability assumed by the corporation was not unreasonable, the courts took notice of the various flexible procedures for termination of the entire plan or for cancellation of the market appreciation factor in the units of a particular individual, and that a substantial block of unissued but authorized stock was set aside as a reserve. Indeed, the courts implied that the question had been prematurely raised

²⁴INT. REV. CODE of 1954, § 404(a)5; Treas. Reg. § 1.404(a) 12. Pomeroy, *Real Contingencies Important in Unqualified Pension Plan— and Beware of Funding*, 10 J. TAXATION 110 (1959); Shelmerdine, *Shadow Stock Deferred Compensation Arrangements*, N. Y. U. 17th INST. ON FED. TAX 933, 946 (1959). See also 3 CCH Stand. Fed. Tax Rep. P. 2662.261; P-H Corporation Guide P. 25,076 at 25,367, *obs.* 1, *supra* notes 1 through 4.

²⁵INT. REV. CODE of 1954, §§ 404(a), 162(a)1; Treas. Reg. § 1.404(a) 1(b) and 1.162.7 (b) 3.

²⁶INT. REV. CODE of 1954, §§ 421(a)2, 422.

²⁷INT. REV. CODE of 1954, §§ 421, 422. See also Shelmerdine, *supra* note 24, at 945.

²⁸INT. REV. CODE of 1954, § 451; Treas. Reg. §§ 1.451-1(a), 1.451-2(a). Cf. Shelmerdine, *supra* note 24, at 945; P-H Corporation Guide P. 1731, at 25,076. The doctrines of constructive receipt or economic benefit which would have made the credits currently taxable to the employee are not applicable, owing to the contingent nature of his rights. Rev. Rul. 60-31, INT. REV. BULL. No. 5, at 17. See also Pomeroy, *supra* note 24, at 111, and 3 CCH 1966 Stand. Fed. Tax Rep. P. 2662.263, 2697, e.g. 2.

and that potential liability alone would not warrant judicial interference before it crystalized into actual amounts due, the payment of which would constitute waste of corporate assets.²⁹ In fact, the liability assumed by the corporation under a unit plan is only superficially more extensive than that under stock option arrangements.³⁰ When stock options are granted to employees, the corporation may either reserve an equal number of authorized but unissued shares (or treasury shares), or wait until the options are exercised. In the latter case, the shares needed may be either purchased in the open market or then and there be authorized and issued. If a corporation adopts a unit plan, it may similarly set aside at the outset a reserve of shares equal to the number of units assigned or wait until its obligation accrues and then use a sum of money equal to the market value of the corresponding shares or sell in the market newly authorized stock. In other words, in both instances an adequate reserve of shares fully protects the corporation, and in the absence of such a reserve the unit plan corporation has either to spend an originally indefinite sum of money or issue new stock. However, in stock options, only a certificate need be issued, whereas in the "unit plan" *cash* must be available. Thus if there is no market demand for stock, the "unit plan" company will be adequately prepared by having saved up a stockpile of shares, while in a "stock option" company there is complete financial safety by virtue of the stockpile of shares. Similarly, in both instances the danger of the corporation being unable to meet its obligations is extremely remote, since *ex hypothesi* the liability of the corporation would increase with the market appreciation of its stock and such appreciation would certainly make it easy for the

²⁹ See, e.g., *Lieberman v. Becker*, *supra* note 11, at 601.

³⁰ See 72 HARV. L. REV. 375, 376 (1958). *Contra*, 28 U. CIN. L. REV. 86, 91 (1959), where the view is expressed that the unit plan violates one of the established principles of stock compensation, because when a stockholder sells at a profit, he receives that profit from another's purchase at the open market, while the unit holder's gains come from the corporate till and constitute an additional cost of operating the business. It may be pointed out, however, that the gains of the stock option holder who exercises his option and sells his stock at the open market are in reality gains which would have accrued to the corporation had the options not been granted and stock of the same amount been issued; thus, the corporation foots the bill to the same extent in both cases.

corporation to float a reasonable amount of new stock for the purpose of raising the necessary funds. Although it is true that most companies, both large and small, do hesitate to turn to the open market to float a small amount of new stock because of registration, publicity, and pre-emptive stock rights. These do make *sale* of stock to the public in small quantities relatively infrequent. However, the unit plan should make it easier for the corporation to make plans for the discharge of its obligation since the date of an employee's retirement is more predictable than the date he will exercise an outstanding stock option.

In upholding the validity of the Koppers compensation scheme, the court pursued the iron logic dictating that the unit plan, being so similar to the admittedly valid stock option plan, should not be treated differently in so far as legal consequences are concerned. If one wishes to leave for a moment the narrow question at issue and to reconsider the soundness of the rule allowing the use of the market price of stock as a measuring rod of incentive compensation, he may be slightly disturbed by the wide range of discretion enjoyed by directors and majority stockholders in this area, especially in view of the modern trend toward more and more self-perpetuating management groups. Tightening judicial controls, presently limited to situations where the incentive compensation plan, at its inception, is so out of balance that no reasonable man would have adopted it³¹ or where a plan, reasonable on its face, has produced a monstrosity of compensation in a particular case,³² may

³¹ See note 13 *supra*.

³² In the famous case of *Rogers v. Hill*, 289 U.S. 582 (1933), an incentive compensation plan centered around corporate profits, and thus valid at its inception, had come to a point, by reason of the success of the company, where the directors were receiving a lion's share from the profits. The Supreme Court held that such excessive compensation amounted in effect to a spoliation and waste of corporate property. The *Rogers* rule has been followed in the over-whelming majority of cases involving a similar question. It is subject, however, to qualifications which limit the number of situations where the courts will upset corporate compensation arrangements. Thus:

(a) In passing upon the reasonableness of compensation determinable by reference to variable indexes, such as corporate profits, market price etc., the courts will not treat the situation as if the arrangement originally provided for the definite payment of the sum so determined

not be the best answer. Instead, establishing a ceiling for market appreciation which is either fixed in dollars and cents or determinable by reference to a percentage or multiple of some more

in a particular instance, but they will take into consideration the uncertainty of payment assumed by the employee at the time of the adoption of the plan. *McQuillen v. National Cash Register Co.*, 27 F. Supp. 639 (D. Md. 1939), *aff'd*, 112 F.2d 877 (4th Cir. 1940), *cert. denied*, 311 U.S. 695 (1940); *Wyles v. Campbell*, 77 F. Supp. 343, 350 (D. Del. 1948). In the words of the leading writers in the field:

Even though an option may represent large potential profits, the courts have shown no inclination to regard the highest potential profit as equivalent to fixed monetary compensation and will hardly strike down the form of compensation for 'unreasonableness' merely because profits are greater than the fixed salary which might otherwise have been paid.

G. WASHINGTON & V. ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 123 (rev. ed. 1951).

(b) The courts have been refusing to strike down excessive compensation unless it reached the heights of incongruity or other circumstances made it clearly unjustifiable. *Koplar v. Warner Bros. Pictures Inc.*, 19 F. Supp. 173 (D. Del. 1937); *Heller v. Boylan*, 29 N.Y.S. 2d 653, 669, (Sup. Ct. N. Y. County 1941), *aff'd without opinion*, 263 App. Div. 815, 32 N.Y.S. 2d 131 (1st Dept. 1941) ("Now even a high-bracketer would deem these stipends munificent . . . To others they would seem immoral, inexcusable unequal . . . The figures . . . are immense, staggeringly so. Even so, is that enough to compel the substitution of the Court's judgment for that of the stockholders? Larger compensation has been judicially approved.") *Gallin v. National City Bank*, 152 Misc. 679, 704, 273 N.Y.S. 87, 115 (Referee 1934), *approved*, 155 Misc. 880, 903, 281 N.Y.S. 795, 821 (Sup. Ct. N.Y. County 1935) (The rule is established that directors of a corporation acting as a body in good faith have a right to fix compensation of executive officers for services rendered to the corporation, and that ordinarily their decision as to the amount of compensation is final except when the circumstances show oppression, fraud, abuse, bad faith or other breach of trust.") *Cf. Gamble v. Penn Valley Crude Oil Corp.*, 104 A.2d 257, 262 (Del. Ch. 1954).

In other words:

The courts, while recognizing that compensation in very large amounts may be excessive per se and a waste of corporate funds, have found justification on the merits for allowing the agreed upon amounts to stand, either by comparison with the compensation of executives in other enterprises in the same branch of industry, by finding that the board of directors acted independently and in the exercise of its best business

reliable indicator such as salary or even corporate profits, may allow an easy ascertainment of the validity of a particular plan in advance. Another possible solution would call for shareholder approval.³³ If market appreciation is found objectionable as unreliable and substantially unrelated to the services of the employee,³⁴ (which is a highly debatable proposition especially in situations like the present where the plan is a long-term arrangement), a search for a better index may prove fruitless³⁵ unless one is willing to limit oneself to the traditional favorite, corporate profits.

PROGNOSIS FOR THE UNIT PLAN

The court's approval of the Koppers Deferred Compensation Unit Plan as providing for compensation reasonably related to the services of the employees and as not imposing potentially unlimited liability on the company, is strongly supported by the rationale of decisions upholding the validity of stock option plans. This result is particularly welcome in the principal case, since the

judgment or by concluding that the executives must be worth their pay judging from the success with which the corporation was managed.

G. WASHINGTON & V. ROTHSCHILD, *supra* at 415-14.

An interesting comment by Justice Cardozo in his dissenting opinion in the case of *Rogers v. Guaranty Trust Co.*, 288 U.S. 123, 150 (1933), to the effect that shareholder assent to a compensation plan should not be deemed to extend to situations where such compensation becomes in fact excessive at a later date, failed to grow roots in subsequent judicial opinions.

³³ 1 G. HORNSTEIN, *CORPORATION LAW AND PRACTICE* 549 n.41 (1959).

³⁴ *See* *Berkwitz v. Humphrey*, 163 F. Supp. 78, 91 (N.D. Ohio 1958), where Judge McNamee stressed the necessity of finding an index which would fluctuate in response "solely" to the quality of the employee's services. Since this is next to impossible, a substantial relation between the index and the services should be deemed sufficient. The market price of stock, while not reflecting precisely the value of employee's services, is sensitively responsive to it, especially in modern times when extraordinary manipulations of the market have been seriously curtailed by law.

³⁵ The book-value appreciation index, provided for in the Heinz Company plan, which received the nod of Judge McNamee in the *Berkwitz* case, may be more stable than market appreciation but certainly does not reflect the growth prospects of the company, which prospects are closely related to the quality of the services of its personnel.

Koppers plan, which allowed realization of the market appreciation factor only at retirement, was effectively designed to prevent employee market speculation and still give them an incentive for staying with the company. Furthermore, the plan operated to the tax benefit of the corporation and, to some extent, to that of the employees. While incentive compensation geared to market appreciation of company stock is sound in principle, some ceiling to the benefits that may accrue to the employee, or some other way of checking in advance the possibility of excessiveness, may in some circumstances be desirable.

Despite all the considerations discussed, the unit plan can be a great benefit to corporate management in their quest for a scheme to adequately compensate executives.³⁶ To some degree, it may achieve an amalgamation of some of the choicest characteristics of stock option plans with the unique "unit allocation" technique of the unit plan. If conceived with clarity and used with caution, the unit plan allows management to join together the best of two worlds.

³⁶The following are additional comparisons and contrasts between unit plans and stock options:

a. The "unit plan" may offer less chance to grant employees a "proprietary interest," because the employee is never forced (as through expiration of an option) nor permitted (as through voluntary early exercise of an option) to acquire an ownership interest in the employing company. Thus the "unit plan" lacks the employee proprietary interest of options, and the proprietary interest an employee receives is often said to be an important justification for options.

b. The unit plan, since it pays off in cash, eliminates dilution of present control. In closely held companies, existing shareholders might appreciate this advantage in the unit plan over stock option plans.

c. The unit plan, since it pays off in cash, obviates the need to increase authorized stock, to comply at any time with state or federal blue sky and securities regulation laws, attendant publicity of corporate affairs, etc.

d. As previously noted, the need to make a cash outlay is a significant factor against the unit plan.

e. The other significant drawback, as brought out in the text, is the lack of capital gain treatment in unit plans.

f. A slight advantage of the unit plan might be safety from 16(b) violations of the Securities Exchange Act of 1934.

g. Perhaps obvious, but worth mentioning is that unit plans are not likely to be used by companies whose stock is not regularly quoted in a securities market. This drawback is not present in option plans.