Executive Compensation Plan Invalid for Lack of Reasonable Relation to Services Rendered

Marsh, Rick E.

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EXECUTIVE COMPENSATION PLAN INVALID FOR LACK OF REASONABLE RELATION TO SERVICES RENDERED

Berkwitz v. Humphrey,
163 F. Supp. 78 (N.D. Ohio 1958)

In a stockholder's derivative suit, plaintiff objected to the Management Unit Plan, a profit sharing and pension plan adopted by the Pittsburgh Consolidation Coal Company for the benefit of its top level executives. Under the plan, certain key employees were assigned a designated number of units. Upon retirement at age sixty-five or upon termination of employment at any time due to sickness or death, the company agreed to pay the unit holders a sum equal to the increased value of the units to which an employee was entitled measured by the increased value, if any, of an equal number of shares of capital stock. Thus an employee who participated in the plan for five years would be given a bonus upon retirement equal to the number of units he held multiplied by the rise in the market value of the capital stock during the period in which he participated in the plan.

The federal district court for the northern district of Ohio held that such a plan was unreasonable per se and invalid because the method of computing the compensation bore no reasonable relation to services rendered and was therefore a misuse of corporate funds.¹

The court, having acknowledged the fact that it was dealing with a singular case of first impression, began its examination of the plan by stating the well settled principle that the "authorized compensation must bear a reasonable relation to the value of the services of an employee."² The first objection to the plan raised by the court was that the market value of the capital stock of a corporation is an unreliable index of the value of services rendered by its key employees as it is governed by many aleatory considerations.

This same problem was discussed in Gruber v. Chesapeake & O. Ry.³ where the court said:

³ 158 F. Supp. 593, 597 (N.D. Ohio 1957). The principal case and the Gruber case were both decided by the federal district court for the northern district of Ohio. The Gruber case was cited by the defendants in their motion to dismiss but was not referred to in the opinion. It involved a stock option plan whereby certain executives were given the opportunity to purchase company stock at prices below market value. Such a plan bears a resemblance to the Management Unit Plan in that whether the executive makes a profit above and beyond the discount given him at time of purchase, depends upon the subsequent conduct of the market value of the stock. The obvious difference is that the executive may sell his stock at any time whereas the executive assigned units must wait until
It has become a business custom that corporation executives are given a proprietary interest in the company for which they work, through the granting of common stock at its present market price. The executive's "benefit" materializes when the stock which he has received rises in price on the market through increased efficiency in management and operation of the company.

The court in the *Gruber* case clearly indicated that there is some reasonable relation between services rendered and the market value of the stock, whereas the court in the principal case held that there is no reasonable relationship between market value and services rendered.

The court held the plan unreasonable per se, thus ignoring the fact that the retirement bonuses paid out from 1947 to 1952 amounted to only 1.71 per cent of the dividends paid to stock holders. The court employed the familiar device commonly known as "the parade of the horribles" to show just what sort of incongruous results might be reached by the use of such a plan. Again the court shut its eyes to the actual results achieved by the plan during the first five years of operation.

In stockholders derivative suits such as this, the courts place the burden of proof on the stockholder who challenges the plan and require him to sustain it by showing that the excessive compensation stems from fraud or bad faith practiced by the directors. Reasonableness of executive compensation is clearly a relative matter and lies in an area where the courts have not required exact precision but have been satisfied with rough approximation. In the principal case, plaintiff does not object to the retirement bonuses as being "excessive" but only as being "unreasonable." However, it is apparent that plaintiff's real objection is that, in the future, the plan may result in excessive compensation for the participants, thus cutting into plaintiff's right to the profits by way of dividends.

Generally, the courts have not considered compensation plans to be excessive per se, but have compared the amounts with benefits paid by other companies. In *Kalmanash v. Smith* the court required the continued

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4 Brief for Defendant, p. 19, Berkowitz v. Humphrey, 163 F. Supp. 78 (N.D. Ohio 1958). During the five year period from 1947 to 1952 the dividends paid to stockholders amounted to $32,391,000.00. The retirement bonuses paid out to employees amounted to $55,408.00.


plaint to state the amounts received by the executives and the services performed as part of the factual showing of excessiveness. The court relied heavily upon Rogers v. Hill, probably the most famous of all stockholder litigation and the source of the principle that compensation must be reasonably related to services. However, that case held that the amount paid to the president of The American Tobacco Company was unreasonable, not that the plan whereby the figure was computed was unreasonable. In the Kalmanash case the court said that in a stockholder's derivative action, allegations that the corporation's payments to certain officers thereof amounted to spoilation or waste of corporate funds did not plead an actionable wrong in the absence of allegation of facts showing bad faith or fraud practiced by the officers. Such a statement as this is the result of the application of the "business judgment rule," whereby the courts defer to the honest judgment of the directors on questions of corporate management and policy.

In the principal case there is a conspicuous absence of any proof of excessiveness of amount of the bonuses or of fraud or bad faith on the part of the directors. The plan had been in operation only a few years. To say that in the future these retirement bonuses will be excessive is to substitute the business judgment of the court for the business judgment of the corporation. This is the very thing that the business judgment rule was designed to prevent. When the soundness of a management decision is questioned and the results of that decision are in futuro, the business judgment rule requires that the court "render unto Caesar that which is Caesar's." In a situation such as this, a holding that the decision

7 291 N.Y. 142, 51 N.E.2d 681 (1943).
8 289 U.S. 582, 591 (1933). "As the amounts payable depend upon the gains of the business, the specified percentages are not per se unreasonable.... [T]he payments under the by-law have by reason of increase of profits become so large as to warrant investigation in equity in the interest of the company."
9 "[T]he court will not interfere with the internal management of corporations, and therefore will not substitute its judgment for that of the officers and directors." Otis & Co. v. Pennsylvania R.R. 61 F. Supp. 905, 911 (E.D. Pa. 1945); aff'd, 155 F.2d 522 (3d Cir. 1946). "Questions of policy of management, of expediency of contracts or action, of adequacy of consideration not grossly disproportionate, of lawful appropriation of corporate funds to advance corporate interests, are left solely to the honest decision of the directors.... To hold otherwise would be to substitute the judgment and discretion of others in the place of those determined on by the scheme of incorporation." Ellerman v. Chicago Junction Ry., 49 N.J. Eq. 217, 232 (1891). See Merriman v. National Zinc Corp., 82 N.J. Eq. 493, 89 Atl. 764 (1914); CCH 1 Pension Plan Rulings ¶ 10201 (1954); Carson, Current Phases of Derivative Actions Against Directors, 40 Mich. L. Rev. 1125, 1128-1131 (1942); See also 5 Fletcher, Private Corporations §§ 2126, 2129 (perm. ed. rev. repl. 1952).
10 In Gottfried v. Gottfried, 112 N.Y.S.2d 431, 461 (1952) the court said that there is no simple test available to determine when an incentive compensation contract keyed to employer's profits is wasteful and that the courts are loath to overturn a contract particularly when "the only defect claimed is that as things worked out the contingent compensation proved to be excessive."
of the directors is unreasonable per se is a trespass by the court upon the
domain of the corporation directors.

In addition to the main objection of "unreasonableness," the court
stated that the company was aware of the fact that the market value of
the stock bore no reasonable relation to services rendered and this was
why the company provided a two year extension for determining the
value of the stock. The defendant stated in its supplemental brief
that the purpose of the two year provision was to give the employees a
chance to capitalize on the fruits of their labor which might not be trans-
formed into market appreciation at the time of retirement. It would
seem clear that the reflection of valuable services in the rise of the corpo-
rate stock would not be an instantaneous operation.

Since two top executives did not participate in the plan the court
reasoned that their services contributed to the increase in the value of the
capital stock, and yet others reaped the benefits from their labor. This
objection could be brought against the plan even if these two men had
joined, since through their positions and abilities they effectively con-
trolled the policy of the company. But more important, this criticism by
the court recognizes that the valuable leadership and services of these
two men did result in a rise in the market value of the stock.

The court vigorously objected to the plan because of the influence
on the stock of non-recurring capital gains derived from the sale of
assets in transactions where only one or two executives participate but in
the fruits of which all of the unit holders would share. Such a criticism
does not take into consideration the fact that one of the assumptions
underlying profit sharing plans is that the efforts of all key personnel
helped to provide the company with the asset now being sold. Since unit
holders would suffer from non-recurring losses, it seems only fair to
permit them to share in non-recurring gains.

One of the main reasons for instituting such a plan was to furnish
an incentive for the employees to remain with the company and put forth
their best efforts. The training of a top executive involves an expense
which the corporation would like to amortize over a long period. In
speaking of profit sharing plans, the court in the Gruber case said:

The company is compensated by increased profits, ultimately
distributed to the shareholders through dividends, and elicited
to a great extent by that continuity of service on the part of
its executives which would otherwise be frustrated. A $51,000 bonus paid to the chairman of the board of directors of

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11 The plan as originally instituted provided a five year period extending
from date of retirement during which the retired employee could select a market
value date which would serve as the basis for computing his bonus. The plan
was amended to provide for a two year period and any date chosen during this
period had to be designated ten days in advance.

12 Gruber v. Chesapeake & O. Ry., supra note 3, at 597.
Republic Steel was held valid as incentive for his continued valuable services.\textsuperscript{13}

A retirement plan such as that of Pitt-Consol serves as one method of hedging against inflation. In an inflationary economy, a retirement bonus determined by prior income gives to the employee a dollar valuation which does not represent the purchasing power that it did at the time the right to the bonus was earned.\textsuperscript{14} Many pension plans which are automatically adjusted to the cost of living continue to do so even after the employee has been retired.\textsuperscript{15} Since studies show that there is a correlation, though not exact, between stock prices and cost of living,\textsuperscript{16} it would seem that the Pitt-Consol plan has this valuable built-in feature.

Conceding that the benefits paid out under any compensation plan must bear a reasonable relation to the services rendered, this does not require a finding of more than that the total compensation paid out is related to the total benefits received. Thus it has been suggested that the existence of this relationship should not be tested by whether the corporation will receive from any individual employee services in the future commensurate with the pension to be paid him, but rather by whether the overall cost of the pension plan will be offset by the total benefits arising from the existence of the plan.\textsuperscript{17}

The decision in this case reduces the sphere of operations in which corporate directors can move without fear of judicial intercession. It also tends to neutralize the effectiveness of the business judgment rule.

Since many other companies have adopted the Management Unit Plan or a similar system for compensating their executives, the importance of this decision is clear. Because this is a case of first impression, it sets a trend which may be followed by other courts. The validity of these other plans will depend upon their factual similarity to the Management Unit Plan and whether the court will withhold its judgment until it can be ascertained whether or not the amounts actually paid out were excessive.

\textit{Rick E. Marsh}

\textsuperscript{13} Holmes v. Republic Steel Corp., 84 Ohio App. 442, 84 N.E.2d 508 (1948).
\textsuperscript{14} Calvert, \textit{Taking the Gamble Out of Pensions}, 51 PUB. UTIL. FORT. 415 (1953); 1 P-H CORP. SERV. ¶ 25048 (1957).
\textsuperscript{15} 1 P-H CORP. SERV., supra note 14. E.g., an employee accrues a pension unit of $100 in 1956 and the cost of living in that year is 116. If at retirement, the cost-of-living index stands at 140, that particular pension would be adjusted by multiplying 140 x 100. The result is an adjusted pension unit of $121. Many plans continue this adjustment even though the employee has been retired for many years.
\textsuperscript{16} Ibid.
\textsuperscript{17} Note, 70 HARV. L. REV. 490 (1957).