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STOCK OPTIONS AND OTHER EXECUTIVE INCENTIVE ARRANGEMENTS

CHARLES W. STEADMAN*

The immense economic expansion and changes of the post-war period have generated numerous problems. In American business a major product of this is to be found in the difficulty of developing and maintaining the reservoir of executive talent at levels sufficiently high that managerial functions can continue to be performed with an advanced degree of efficiency. The shortage of qualified executives has been widely reported. The competition for those available is intense and increasing.

Unfortunately, it would seem that at the very time the need is greatest the normal incentives for an individual to assume major executive status have been most severely reduced. The promise of greater income has little efficacy to induce an executive to work harder or to assume a more demanding position. The current, unprecedented scale of the graduated income tax causes the greater part of any increase in pay to be absorbed in taxes. An executive with a present taxable income of $60,000 could pay $7,800 out of a $10,000 raise to the U. S. Treasury.[1] Such results will hardly produce substantial incentive.

At the same time the constant inflation of the past twenty years has eroded the value of the dollars that remain to such an extent that it has become exceedingly difficult to build an estate and to provide properly for one's own retirement. Thus, the $2,200 that remain from the executive's $10,000 raise in the previous example would have the purchasing power of only eleven hundred 1940 dollars and we may expect that its purchasing power will be reduced even further.

The need to develop and encourage executive talent in the face of the incentive-destroying factors which have arisen has forced a drastic reassessment of traditional corporate incentive devices. Because simple increases in present income of the executive have proved ineffective, the corporation, its executives and its attorneys have been constrained to develop new means of compensation. These are frequently described as "deferred incentive compensation plans."

It is our intention to discuss in this article what these plans are, by whom they may be used, and the advantages which may flow

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1. Under INT. REV. CODE OF 1954, § 1, taxable income over $60,000 but less than $70,000 is taxed at a rate of 78%. Hence, of the $10,000 increase in salary, $7,800 would be paid in income taxes.

from their proper application. While there are many combinations of such plans possible, this article is concerned primarily with those which may be designed for the executives in higher income levels. It is here that the aberrations caused by exceedingly high income tax rates have created the greatest need for incentive arrangements. Human nature being what it is such incentives are necessary and beneficial to the nation in deriving the utmost from executive talent.

Generally speaking, the executive's aim is to develop a program which will give his family security, which will result in a lower total tax burden, and which will possibly give him a chance for considerable growth of his capital. He may very well desire to defer income presently earned until the time of his retirement when his income will presumably be lower and consequently so will his income taxes. By this means he may have an adequate income upon retirement. It may be vital to his security that he have a hedge against inflation and this can be achieved by a stock bonus plan. Whatever may be his needs these deferred incentive compensation plans constitute one of the few means by which they may be fulfilled.

A properly designed deferred incentive compensation plan creates joint benefits. It benefits the executive and his family, and by so doing may also bring a considerable return to his corporate employer. These plans do encourage an ever-higher standard of performance by the beneficiary-executive. The corporate employer can further benefit inasmuch as such plans can instill in their beneficiary-executives a loyalty and strengthen the will and desire of these individuals to remain with the organization. Moreover, if benefits are made contingent upon retirement and provision is made for the executive's family in the event of his prior death, he will have an ease of mind which will permit him to devote full attention to his work. Deferred vesting of incentive compensation and forfeiture of benefits in the event an executive voluntarily leaves his position prior to retirement is an invaluable inducement to the executive to remain with the corporation and may even be used to retain his advisory services following retirement.

From the point of view of both the executive and the corporation it is clear that an incentive compensation plan must be carefully tailored to meet each individual situation. Whether the plan is intended for an individual or for a group of executives, each situation will have its peculiar problems and the plan must be carefully designed to meet them.

I. TYPES OF INCENTIVE COMPENSATION

PLANS AVAILABLE AND THEIR FUNCTIONS

Among the most widely used of present-day incentive compensation devices is the "restricted" stock option.[2] With such an option, certain tax advantages are granted, notably capital gains on the sale of the stock by the optionee if the rules established by law are followed. A restricted stock option is in a unique position as an incentive plan, however, and it is appropriate that its functions, advantages and disadvantages be discussed below in considerable detail.

Where for some reason a restricted stock option is not an appropriate vehicle for executive incentive compensation, there are several other devices which may be successfully and imaginatively employed. These include pension, profit-sharing, stock bonus and annuity plans or a combination of these. Some plans may be funded, while others, such as the retirement programs of certain corporations, may remain unfunded and still be adequately secure.

Among these arrangements it is natural that the profit-sharing plan should be highly regarded as a means of providing incentive. The executive may see clearly under such a plan the fruits of his efforts. The plan is often ideal for a growing company with an irregular profit record and excellent potential because no definite financial commitment is involved. But it has broad possibilities for application and is widely used by organizations of all sizes, among them many of the nation's largest and strongest industrial concerns. The profit-sharing plan is not used primarily to provide retirement income. It is rather designed to reward a key executive for especial performance. Income so derived can be spread over a period of years. This has the combined effect of preventing peaks and valleys in his income[3] and alleviating the impact of income taxes in many circumstances. Spreading payments will have retirement income features if the plan is so drawn that amounts earned remain unpaid at the point of retirement and are to be paid for a period of years after retirement in the same manner as before, for example.

The function of the stock bonus plan is somewhat different from that of the profit-sharing plan although it, too, may be successfully employed as an incentive device. Where the plan is directed primarily to a group of key executives, as opposed to a whole range of employees, those executives can see the fruits of their efforts in the increased value of the stock. In this sense it is related to profits and has substantial incentive elements. If the plan is not directly keyed

2. INT. REV. CODE OF 1954, § 421.
3. Such peaks and valleys will produce a higher total income tax than the same amount of income spread out evenly over a period of years due to the effect of the graduated income tax.

to profits, however, the incentive value of the plan may not be as great as that of a profit-sharing plan. The stock bonus plan is nonetheless coming into increasing favor as a means of rewarding the individual efforts of key executives. One reason is that a stock bonus from a successful company is one of the soundest possible hedges against inflation. The stock bonus plan is often used in lieu of or as a supplement to a pension or annuity plan. The fact that it need not be dependent upon profits makes it attractive as a means for rewarding executive personnel for past excellence—for profits already created.

It should be pointed out that a stock bonus plan may be difficult to implement in a closely-held corporation where valuation of the stock is difficult and where the equity of the shareholders may be easily diluted. The other side of the coin, of course, is that since a stock bonus plan will not dissipate liquid assets this may at times outweigh the disadvantages which have been mentioned.

A pension or annuity plan[4] ordinarily has no place in the field of incentive compensation as a means of inducing superior performance by the corporate executive. When pension rights are properly restricted as to vesting, of course, a pension plan has the same value as other types of plans in encouraging a key executive to remain with the corporation and to render advisory services following retirement. It may well be a useful supplement to a stock bonus or profit-sharing plan but it is not a successful performance incentive when used alone except to the extent that it may indirectly create a desire by the recipient to exert greater effort for the success of his benefactor.

It should be pointed out here that the structure of the plan chosen can have vast effect upon its tax consequences. The Internal Revenue Code of 1954 accords special favorable tax treatment to profit-sharing, stock bonus and annuity plans that fall within its provisions. Such plans are called "qualified."[5] As we shall see, however, these plans are largely unsuited for the purpose of executive incentive compensation because the code provisions require that too great a percentage of a corporation's employees be included. As a result, a "nonqualified" plan, which can be fashioned to satisfy the particular needs of a corporation and its executives is normally best employed where incentive considerations, before or after the fact so to speak, are present. Nonetheless, the tax treatment of qualified plans is so favorable that they will be examined with a view toward determining

4. U.S. Treasury Regulations define a pension plan as ". . . . a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)-(1)(i) (1958). An annuity plan comprehends a contract under which amounts will be paid out in the future for a period of years certain or for life.

5. INT. REV. CODE OF 1954, §§ 401-04.

whether or not they can be successfully used as executive incentive devices.

II. Restricted Stock Options

In this era of high prosperity and greatly expanded production, it has not been unusual to see common stocks of successful corporations triple or even quadruple over a rather short period of time. In many instances this may have resulted only from the general expansion of the economy. In others, however, it may be ascribed directly to the brilliant efforts of one or a few key executives who have taken advantage of the opportunity offered by the state of the economy. If these executives had ample capital, they could profit from the results of their efforts by buying the corporation's stock in the open market, in cases where the stock is traded. With the difficulty of creating capital out of ordinary income however, it is often true that they are not in such a position, or if they have capital it may be otherwise employed. In such a situation, what is needed is a means by which the executive can have an opportunity to participate in the growth of the corporation through ownership of its stock without being required to make an immediate outlay of capital by present purchase of such stock.

This function is in fact performed by the "restricted" stock option. This is a device by which the executive is granted an option to purchase stock of the corporation at a certain price at some time in the future. If the statutory criteria are met, upon disposition of the stock the optionee will be taxed at capital gains rates.[6] The corporation itself will receive no deduction at any time, but no income will result to the executive at the time of the actual purchase of the stock and the corporation is treated as receiving no consideration other than the price paid under the option for the optioned stock.[7] An opportunity for capital gains income in this manner may be far more beneficial to an executive than a mere increase in salary taxed at extraordinarily high rates.

The restricted stock option is an especially important incentive device. Options will normally be given to executives who are so placed that they can directly affect the value of the options given to them. The rules are sufficiently flexible that option may be given to selected individuals and different exercise terms may be given to different individuals.[8] Furthermore, the option may be so restricted that it is cancellable on the termination of the optionee's employment.[9] The corporation can thereby maintain some control over the optionee's services.

6. Int. Rev. Code of 1954, § 421.
7. Int. Rev. Code of 1954, § 421(a).
8. Rev. Rul. 59-198, 1959-1 Cum. Bull. 91.
9. Treas. Reg., § 1.421-1(a) (1) (1957).

Like stock bonus plans, a restricted stock option plan may be a more appropriate incentive compensation vehicle for the publicly-held enterprise than for the closely held corporation. The danger of dilution of shareholders' equity in a close corporation is considerable. Furthermore, since the shares of these corporations usually have no ready market, the incentive value of the option may be somewhat diminished.

The requirements for qualification of a restricted stock option are rigid and they must be precisely followed to secure favorable tax treatment. The option must be granted to the executive by reason of his employment and must be exercised during such employment or within three months of the termination of the employment relationship.[10] The employee will not receive capital gains treatment if the option stock is disposed of by him within two years of the time the option is granted or within six months of its exercise.[11] The option rights must be nontransferrable during the life of the optionee[12] and the option must be exercisable over a period of not more than ten years.[13] Finally the option price must be not less than eighty-five percent of the fair market value of the stock at the time of the grant.[14] An exception to the eighty-five percent requirement was incorporated into the 1954 Code to allow relatively closely-held corporations to employ restricted stock options. Prior to 1954, no option could qualify if the optionee held more than ten percent of the voting stock of the corporation.[15] To enable the corporate entrepreneur to obtain outside financing without incurring risk of loss of control, the Internal Revenue Code now permits the grant of options to an individual regardless of the percentage of stock in the corporation owned by him. In the case of a person owning more than ten percent of the shares in a corporation, however, the option price must be at least one hundred and ten percent of the fair market value of the stock.[16]

It is now becoming apparent that within this rigid statutory framework a corporation may exercise broad discretion as to the conditions which it imposes on the enjoyment of the stock option plan by its executives. It is recognized, for example, that the right to exercise

10. INT. REV. CODE OF 1954, § 421(a).

11. *Ibid.*

12. INT. REV. CODE OF 1954, § 421(d)(1)(B). However, during his lifetime, the optionee may appoint the individual who is to have the power to exercise the option on his death. Treas. Reg., § 1.421-2(a)(4) (1957).

13. INT. REV. CODE OF 1954, § 421(d)(1)(D). In the case of an individual owning ten per cent or more of the voting stock of the corporation, the option must be exercised within five years of the time of the grant. INT. REV. CODE OF 1954, § 421(d)(1)(c).

14. INT. REV. CODE OF 1954, § 421(d)(1)(A).

15. INT. REV. CODE OF 1939, § 130(A), added by 64 Stat. 942 (1950).

16. INT. REV. CODE OF 1954, § 421(d)(1)(c). S. REP. No. 1622, 83rd Cong., 2d Sess. 60 (1954).

the option may be postponed for any length of time within the scope of the ten year rule.[17]

Although the Internal Revenue Code itself establishes employment criteria,[18] its provisions limit only the right of the employee to exercise the option. The corporation's interest may call for a restriction on the right of the employee to dispose of the stock after it is transferred to him. A balancing of interest should be considered, but if there are too many restrictions upon the employee's enjoyment of the option's benefits its purposes for incentive will be defeated. It would appear that the employee may exercise the option in toto at any time that he is an employee or within three months after the termination of the employee relationship and still be treated as having exercised a restricted stock option.

Under the code, it is likewise possible to grant options for a block of shares to be exercised in series over a period of time. For example, an option may be granted for 3,000 shares, 1,000 exercisable after the expiration of one year, an additional 1,000 after two years, and the final segment after three years. The Internal Revenue Service treats this arrangement as three separate options all granted on the same date.[19]

The previously mentioned restrictions impinge only on the right to exercise the option, but leave the employee absolute freedom of activity after he acquires the stock. It is now apparent that the Internal Revenue Service will not disqualify plans which impose restrictions on the disposition of the stock by the employee for a limited period of time after the exercise of the option.[20] Thus, it is possible to require the employee to endorse the stock in blank and place it with the corporation for a limited period.

In summary, it can be readily seen that a restricted stock option is an invaluable incentive device. It does not have any large tangible value at the moment of granting, however, and where such tangible value is required, some other plan must be used. It is to these that we now turn.

III. Qualified Plans

As has been pointed out, the "qualified" deferred compensation plan is often disregarded as a device for executive incentive compensation. The income tax advantages of a qualified plan are so substantial however, that it should be considered with a view to determining whether these outweigh the inherent disadvantages of such a plan and whether a qualified plan can be adapted as an incentive device for a relatively small number of executives.

17. Int. Rev. Code of 1954, § 421(d)(1)(D).
18. Int. Rev. Code of 1954, § 421(a).
19. Treas. Reg., § 1.421-1(a)(3) (1957).
20. Rev. Rul. 467, 1954-2 Cum. Bull. 207.

What are these advantages? A trust forming part of a qualified deferred compensation plan is not taxable on its income unless it is a "feeder organization," engages in a "prohibited transaction" or has "unrelated business taxable income."[21] The employer secures an immediate deduction for its contributions to the trust or for amounts paid under a qualified annuity plan.[22] The beneficiary will not actually be taxed until he receives amounts under the plan.[23] Long-term capital gains treatment will be accorded to a payee or distributee under a qualified trust or annuity plan if the total amount payable is paid within one year following certain specified events.[24] If a total distribution is made under a qualified trust or annuity plan within one year of the death of an employee by reason of the employee's death, up to $5,000 will be excludable from the gross income of the distributee.[25] The value of an annuity or other payment receivable by a beneficiary (other than the executor) of a decedent under an employee's trust or a retirement annuity contract may be excluded from the decedent's gross estate.[26]

The difficulty with qualified plans is that the same statute which grants certain benefits also imposes severe limitations on the percentage of income which may be committed to the plan[27] and considerable restrictions as to the plan's coverage.

While the Internal Revenue Code does not define qualified deferred compensation plans, it does set forth in subchapter D the criteria which will cause a trust or annuity contract forming part of a plan to be qualified.

A trust forming part of a qualified plan must:

(1) be formed for the purpose of distributing the corpus and income of the fund accumulated to the employees or their beneficiaries;

(2) be for the exclusive benefit of the employees or their beneficiaries;

(3) cover employees in such a manner as not to discriminate in

21. INT. REV. CODE OF 1954, § 401(a). "Feeder organization" is defined in § 402, "prohibited transaction" in § 503 and "unrelated business taxable income" in § 512.

22. INT. REV. CODE OF 1954, § 404.

23. INT. REV. CODE OF 1954, § 402 relates to beneficiaries of employee trusts. Taxation of beneficiaries of qualified annuities is covered in INT. REV. CODE OF 1954, § 403.

24. INT. REV. CODE OF 1954, §§ 402(b) and 403(a)(2).

25. INT. REV. CODE OF 1954, § 101(b).

26. INT. REV. CODE OF 1954, § 2039(c).

27. The limitations are contained in INT. REV. CODE OF 1954, § 402(a). Generally not more than 5% of the compensation paid or accrued during the taxable year to all employees under the trust may be deducted. The limitation for stock bonus and profit-sharing plans is 15% of such compensation. There are numerous exceptions not discussed here.

favor of employees who are officers, shareholders, or other employees whose primary job is the supervision of other employees; and

(4) not discriminate in contributions or benefits provided in favor of those employees mentioned in (3) above.

In addition, the program must be "permanent" and communicated in writing to the employees.[28]

Despite the restrictive nature of these provisions, the qualified plan should not be ignored in the development of an adequate incentive plan for executives. Over a number of years, the amounts in a given individual's account may grow to many thousands of dollars. The area of inquiry here should be the means by which the key executive or group of executives may receive as large a share of deferred compensation as possible and yet permit the plan to remain within the established rules.[29]

There must of course be compliance with all statutory criteria. The greatest obstacles in this regard are those designed to prevent discrimination in favor of certain specified groups.

Such discrimination may occur in a number of ways:

(1) by establishing compulsory employee contributions which are so large a percentage of the employee's salary that only the best paid groups can participate;[30]

(2) by weighing the benefits and distributions formulae so that highly-paid or supervisory employees or shareholders are favored; and[31]

(3) by establishing longevity or age limitations for participation which initially or in practice favor highly-paid or supervisory employees or shareholders.[32]

The plan must eliminate these or it will fail of qualification.

A. Integration With Social Security Benefits

Of the forms of qualified plans, the one that probably provides the corporation with the best opportunity to meet its key executives'

28. INT. REV. CODE OF 1954, § 401(a). The above requirements are detailed in Treas. Reg. § 1.401-1(a)(2) (1958).

29. Some risks may have to be taken in establishing a plan, particularly when speed is required. A clause may be inserted in a plan about which there is doubt as to qualification which will permit recovery of company contributions in the event that the plan is later found not qualified. Rev. Rul. 59-309, 1959; INT. REV. BULL. No. 13 at 10.

30. Rev. Rul. 57-163, Part 4(g), 1957-1 CUM. BULL. 128.

31. Treas. Reg. § 1.401-1(b)(3) (1956); Rev. Rul. 57-163, Part 5.

32. Treas. Reg. § 1.401-1(b)(3); Rev. Rul. 57-163, Part 4 (a-h) 1957-1 CUM. BULL. 128.

needs is one which is "integrated" with social security (OASI)[33] or a similar retirement program such as the Railroad Retirement Act.[34] This integrating is permitted by the Internal Revenue Code.[35]

A properly integrated plan will permit a corporation to establish a pension, profit-sharing or stock bonus plan in which only salaried employees earning more than $4,200 may participate.[36] As a matter of practice, in many small corporations this may well restrict the list of those eligible to the executive level and a few others. Such a plan is called a "$4,200 excess" plan and provides benefits related only to that part of an individual's compensation which is in excess of $4,200.

The basic requirement of such a plan is that benefits paid to beneficiaries be no greater, proportionally to their income, than the benefits received by lower-paid employees. If such proportionality is achieved, a plan which would not otherwise qualify will be considered qualified under the code.[37]

The Internal Revenue Service for purposes of determining whether such benefits are more than proportional, has decreed that: "Normal annual retirement benefits for any employee cannot exceed 37½ percent of his average annual compensation in excess of $4200 . . . ."[38] This percentage is based upon a series of assumptions as to the total value of OASI payments and the percentage contributed by the employee.[39]

The Internal Revenue Service has further determined that a profit-sharing plan which excludes lower-paid employees as described above will be considered integrated, assuming it was created after May 3, 1951,[40] only if:

> (1) the employer has no other plan involving integration with OASI benefits;
>
> (2) the plan provides benefits only upon retirement or separation from

33. 50 Stat. 439 (1937), as amended, 72 Stat. 1659 (1958), 26 U.S.C. § 3121 (1954).
34. 66 Stat. 777 (1952), 45 U.S.C. § 228(a) (1952).
35. INT. REV. CODE OF 1954, § 401(a)(5). See also Treas. Reg. § 1.401-3(3) (1956); Rev. Rul. 57-163, Part 4 (i), 1957-1 CUM. BULL. 128.
36. Rev. Rul. 57-163, Part 4 (i)(1) 1957-1 CUM. BULL. On other occasions on which Congress has raised the level of remuneration subject to OASI taxation, the Internal Revenue Service has made a commensurate change in the income level at which "excess" plans may begin. In 1958 the maximum amount of income subject to OASI taxation was raised to $4800, effective January 1, 1959. 72 Stat. 1659 (1958), 26 U.S.C. § 3121 (a) (1958). No further change has yet been made, however, by the Internal Revenue Service. Notwithstanding, it would seem that the language of INT. REV. CODE OF 1954 § 401(a)(5) would permit employers contemplating an integrated plan to use the new $4,800 level.
37. Treas. Reg. § 1.401-3(3)(1) (1956).
38. Treas. Reg. § 1.401-3 (2) (i) (1956).
39. See CCH 1959 STAND. FED. TAX REP., ¶ 2609.46, where a complete explanation is given.
40. The date on which these restrictions were promulgated.

service and all contributions are allocated upon a non-discriminatory basis when made; and

(3) the amount of employer contributions allocated to any particular participant in any year does not exceed one-fourth of the benefit rate described above, or nine and three-eighths percent of eligible employees' compensation. (37½% x 25%).[41]

It is clear that such a plan may have considerable potential for the small corporation and perhaps even the large one. It permits substantial amounts to be set aside. It is conceivable that an executive with an annual income of $60,000 could have over $5,200 set apart in a profit-sharing plan each year to be taxed at lower rates in future years when his total income is greatly reduced.[42] On the other hand, if this were given to him directly in the form of increased income, assuming a taxable income of $50,000 the executive could immediately pay out more than $3,500 in additional taxes.[43] The executive would also have the additional advantage of the tax-exempt status of the trust with respect to income on all amounts set aside for him.[44]

Likewise, an executive with an annual income of $50,000 could well have provided for him upon retirement a pension of $17,000.[45] It would seem, then, that the benefits of an integrated plan are so substantial that they should not be disregarded. They may at the very least provide a base for satisfactory incentive compensation of the executive and at the same time save the corporation substantial amounts.

It can be seen, as I have said, that the restrictions imposed even on integrated plans are substantial. Benefits are tied directly to individual compensation. If a profit-sharing plan is employed, as would be normal where the purpose is to provide a performance incentive to the executive, a contribution which is less than the maximum permitted in a given year cannot be made up in the next.[46]

An integrated plan would doubtless be of little use to a large corporation. It would encompass so many individuals that it would not be possible to restrict it largely to persons for whom the corporation desired to create an incentive. In the small corporation however, a general integrated profit-sharing plan might in fact cover largely the persons who were responsible for the company's success.[47] The tax

41. Mim. 6641, 1951-1 CUM. BULL. 41, 56; see also Rev. Rul. 56-692, 1956-2 CUM. BULL. 287. A minimum contribution of $60 in any one year is permitted as a matter of administrative convenience.

42. This amount is derived by subtracting $4,200 from $60,000, leaving $55,800. The latter figure is then multiplied by 9-3/8%.

43. An executive with a taxable income of $50,000 is in the 75% income tax bracket. INT. REV. CODE OF 1954, § 1.

44. INT. REV. CODE OF 1954, § 501(a).

45. This amount is derived by subtracting $4200 from $50,000, leaving $45,800. The latter figure is then multiplied by 37½%.

46. Mim. 6641, 1951-1 CUM. BULL. 41.

47. Thus, the Internal Revenue Service has ruled favorably for the employer

advantages might then become so great that they would overcome the disadvantage of including persons who might not otherwise be covered in an incentive compensation scheme.

B. Savings Additions

There has recently been developed a little known but very important furtherance of deferred compensation. This is the voluntary savings plan which can be added to qualified profit-sharing, retirement or pension, or stock bonus plans, approved by the Treasury and established under the Internal Revenue Code of 1954, Section 401. This voluntary savings plan, which is in addition to other features of the qualified plans that have been discussed, may provide that each individual employee covered by the plan may contribute to a fund each year an amount not to exceed ten percent of his annual compensation.[48] The trust fund established under the plan would accept the employee's contributions and these become a part of his share in the total fund. He acquires in this way all of the tax advantages which have been outlined before and are otherwise applicable to contributions by employer or employee to these approved plans. Under these circumstances the tax advantages become rather apparent:

1) Investment income from these voluntary contributions will be tax free and can be reinvested tax free until the time of payment by the fund.
2) The investment and all income therefrom will be subject to capital gains treatment at the time of payment rather than being taxed as ordinary income.

This voluntary savings arrangement can be of particular advantage to the shareholder-officer, especially if he is in the higher tax brackets. He may participate in the same manner and to the same extent as any other employee.

In addition to the tax savings, several other points should be noted. The voluntary savings plan can be made quite flexible. It may permit the segregation and investment and reinvestment of the voluntary contributions in higher yield investments if that is considered to be

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in two situations where integrated pension plans were employed. In one, a company had 2000 employees, of whom 300 were covered, with five of the covered employees owning stock. This stock represented 20% of the outstanding stock of the company. Thirty of the employees were officers or supervisory personnel. I.T. 3613, 1943 CUM. BULL. 475. On another, the company had 1000 employees of whom only 100 were covered. No employees owned more than five per cent of the company's stock, but ninety owned some stock. Fifteen employees were officers or had primarily supervisory duties. I.T. 3614, 1943 CUM. BULL. 476. In a smaller company, an even lesser proportion of employees might be beneficiaries.

48. Rev. Rul. 59-185, 1959 INT. REV. BULL. No. 21-11.

desirable, as it well might be in the instance of executive personnel whose incomes are substantial. It may provide that the employee may borrow his voluntary savings for emergencies. Furthermore, the voluntary contributions and the income thereon must be non-forfeitable, guaranteeing the employee the right to receive them upon his severance from the corporation.

Because of these advantages many corporations which now have plans may find it worthwhile to consider amending to include a savings provision.[49] Many others who have been reluctant to previously initiate qualified plans might well reconsider in view of this development. Especially is this true of those employers who have not been willing to make the maximum contribution to all employees and thus have restricted their own tax benefits. It is now possible to establish a plan with a lower percentage of employer contributions and yet enable the stockholder-officer to take full advantage of the tax savings provisions through voluntary contributions. Admittedly, the voluntary tax contribution is in after tax dollars but nonetheless the savings are very substantial.[50]

A caveat should be added. In approving these plans providing for voluntary contributions not in excess of ten percent, the treasury has indicated that the purpose of the plan must be to encourage savings on the part of the employees.[51] Consistent with this view, cer-

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49. An example of a provision which might be used in amending or adopting such a plan is as follows:
"*Contributions by Employees.* Employees may also make voluntary contributions to the Fund in any amount not to exceed ten per cent (10%) of their Annual Compensation from the COMPANY. Voluntary contributions by the employee as provided herein shall be allocated, immediately upon receipt, to the account of the employee making the contribution and shall thereafter be administered in exactly the same manner as contributions made by the COMPANY except that, under no circumstances shall these employer contributions or any increment therein or income therefrom be forfeited, and the entire amount of principal and income shall be payable to the employee upon termination of his services with COMPANY regardless of the cause of such termination or the length of his employment. The voluntary savings provision contained in this paragraph is designed to encourage savings among the employees of COMPANY in accordance with the provisions of Revenue Ruling 59-185, 1959 INT. REV. BULL. No. 21 at 11. It is the intent of this paragraph that this provision permit the maximum savings allowable under said Revenue Ruling but that it remain in effect only to the extent that it does not disqualify the balance of the plan and, to the extent that the aforesaid Revenue Ruling is hereafter qualified, amended, amplified or overruled, this paragraph shall be amended accordingly."

50. For example, a shareholder-officer in the 50% tax bracket has the choice of putting $2000 in a trust fund of a qualified plan earning 6% or personally investing it elsewhere at the same 6% rate. At the end of ten years the earnings personally invested would amount to $687 after taxes. The earnings of the trust fund would amount to $1,583 before taxes. However, he is entitled to apply capital gains rates, or a maximum of 25%, to these earnings if he withdraws them in a lump sum. Thus the maximum tax would be $395, leaving earnings after taxes of $1,187 as opposed to the $687 personally invested.

51. See note 48 *supra*.

tain other conditions must be met in obtaining approval of such a provision. The basic plan must be a qualified employee benefit plan under section 401 of the Internal Revenue Code of 1954. The employer contribution under the basic plan should in no way be dependent upon the voluntary contributions of the employee. All employees eligible in the basic plan must be able to participate in the voluntary savings plan. All voluntary contributions must be used solely to provide benefits for the individual contributors.

IV. NONQUALIFIED EXECUTIVE INCENTIVE COMPENSATION PLANS

In many situations, the restrictions imposed even on qualified integrated plans are so great that another method must be used to grant key executives adequate incentive compensation. Normally, where the restricted stock option is not employed, this is done by means of a "nonqualified" stock bonus or profit-sharing plan.

These plans have a great advantage found in none of the other methods discussed. They have almost limitless flexibility. They can be tailored to the peculiar needs of one executive or a small group of executives. The vesting of benefits can be so conditioned that the corporation can assure itself of the executives' services for years to come and they can likewise prevent the key executive from working for a competitor. Furthermore, a given plan can be so arranged that individual effort and skill can be rewarded even in the face of a poor general company earnings record. The plan need not be cast in general terms so as to reward an entire group proportionally to its members' income as in a qualified plan. The very fact that individual initiative can be rewarded should serve as an incentive to the entire group. Thus it is that a key executive incentive plan is almost invariably, and necessarily a nonqualified one.

The incentive program, if it comprehends a profit-sharing, should aim at a level which represents truly superior effort. The net profit motive is quite satisfactory, so long as it is limited to that proportion of profits which is above a reasonable standard for the company or the industry of which it is a member.

While it may be desirable to establish a method by which profits or shares from a stock bonus plan may be systematically allocated, there is much to be said for leaving such allocation to a group of directors or top-echelon managers so that the rewards can be distributed where they are most deserved. Such an approach, indeed, simply takes advantage of the unique flexibility of nonqualified plans.

A. Tax Consequences of Nonqualified Plans—Restrictive Clauses

As has been pointed out above, the nonqualified incentive com-

pensation program loses the desirable tax advantages of a qualified plan. The employer may not take a deduction when amounts are paid out under a plan unless these amounts are "nonforfeitable" by the employee.[52] If nonforfeitable, however, they will probably be taxable income to the employee.[53] The employee will not be accorded capital gains treatment for distributions made within one year[54] and the provisions of section 2039(c) of the Internal Revenue Code of 1954 will not apply.[55]

Actually these tax consequences may not be as undersirable as might appear on the surface. Let us assume, for example, that a corporation is being taxed at 52% on its large, current profits. One of its executives has a taxable income of $60,000 per year. The corporation wishes to reward him for his efforts. If it increases his salary by $20,000, the corporation's income tax will be reduced by $10,400 ($20,000 x 52%),[56] making the net cost to the corporation $9,600. At the same time the executive could pay current income taxes of $16,900, leaving him a net increased salary of only $3,100.

If the corporation takes the net cost of $9,600 and sets it aside for the executive by means of a properly-conceived nonqualified incentive compensation scheme, however, both the corporation and the executive may be in a significantly better position. The net cost to the corporation is no greater than if it had given the executive a $20,000 increase in salary.[57] The corporation may also be able to take a later deduction of this $9,600 when it is actually paid to the executive. From the executive's point of view, the $9,600 may well be more real income when paid in later years. It may be invested in stock of the corporation and the stock may appreciate considerably. Other income producing investments may be made. Furthermore, it will

52. INT. REV. CODE OF 1954, § 404(a)(5); Treas. Reg. § 1.404(a)-12 (1956). "Nonforfeitable," a term of art in the tax law, will be discussed immediately below.

53. Pension Fund Service Ruling, No. 9, Aug. 4, 1944. P-H 1959 FED. TAX SERV. ¶ 15,465.1.

54. The treatment accorded to qualified trusts and annuities under INT. REV. CODE OF 1954, §§ 402(a)(2) and 403(a)(2) is not accorded to nonqualified plans. See note 24 *supra*.

55. INT. REV. CODE OF 1954, § 2039(c) does not apply to nonqualified annuities.

56. The rate of taxation on all amounts of corporate net income greater than $25,000 is 52%. INT. REV. CODE OF 1954, § 11.

57. In fact, the corporation will even have a slightly greater net income. If it has $100,000 net taxable income, but reduces its net taxable income to $80,000 by payment of a $20,000 increase in salary to one of its executives, it will pay income taxes on $80,000. The income tax on the first $25,000 will be $7,500. The tax on the remaining $55,000 will be $28,600, leaving a net income after taxes of $43,900. On the other hand, if it sets apart $9,600 in a nonqualified plan, it will still have net taxable income of $100,000. At the same time, subtracting the taxes paid on $100,000 net taxable income ($46,500) from actual net income ($91,400), the corporation still has net income after taxes of $44,900 or $1,000 more than if the executive were given a deductible increase in salary of $20,000.

probably be paid out to the executive at a time when his other income is reduced by retirement to such an extent that he is in a far lower income tax bracket.

Again, it should be pointed out that such results may be achieved because the nonqualified incentive compensation plan is such a flexible instrument.

The factors which have been discussed above lead to the conclusion that these are the most desirable tax consequences that can flow from a nonqualified plan:

(1) amounts paid out by the corporation to the beneficiary of a plan should be deductible as they are paid out; and

(2) these amounts should not be taxable to the beneficiary until they are actually received by him.

It follows from the above that certain points should be borne in mind in developing a nonqualified pension, profit-sharing or stock bonus plan.

B. The Plan Should Not Provide for Immediate Vesting of Benefits

No plan which provides for immediate vesting of benefits will preserve for the beneficiary the most desirable tax consequences. This is true whether the plan comprehends a trust or not.

If the plan does include a nonexempt (nonqualified) trust, the key to the problem is whether or not the benefits set aside for the account of beneficiaries are "forfeitable." As stated in U. S. Treasury Regulations, contributions to a trust are nonforfeitable "if there is no contingency under the plan which may cause the employee to lose his rights in the contribution."[58] It would thus appear that if there are any substantial conditions attached to the credits to beneficiaries under which a beneficiary may lose his rights, those credits will be deemed "forfeitable." It would seem, however, that to be safe these conditions should be substantial. This is evident from *Oreste Casale*[59] where Casale was virtually sole owner of a corporation. He could lose certain pension rights only by voluntarily leaving the corporation's employ prior to retirement without the corporation's consent or accepted employment from a competitor without its consent. The Tax Court concluded that these conditions were illusory and said: "To sustain petitioner's argument of forfeitability in the light of the record would be a gross distortion of fact."[60] The decision of the Tax Court in the case was reversed on appeal, but the Tax Court's view as to the validity of the forfeiture conditions would appear to be

58. Treas. Reg. § 1.402(b)(1)(a)(2)(i) (1956); see also Schaefer v. Bowers, 50 F.2d 689 (2d Cir. 1931); Julian Robertson, 6 T.C. 1060 (1946).

59. 26 T.C. 1020 (1956), *rev'd*, 247 F.2d 440 (2d Cir. 1957).

60. 26 T.C. at 1026.

undisturbed since the issue was scarcely touched upon and the reversal was grounded upon the fact that the corporation was the true owner of the life insurance policy which was being used to fund retirement benefits.

If the contributions to a trust are deemed forfeitable at the time they are granted, and they are contributed to a non-exempt trust they will not be taxable income to the beneficiaries even if they later become nonforfeitable. This is directly provided for by treasury regulations,[61] and while it does appear to extend the applicable code provision[62] somewhat, it is a benefit which should not be disregarded.

The more typical nonqualified plan does not comprehend a trust, for reasons which will appear below. The Internal Revenue Code makes no provision for taxation of beneficiaries on amounts contributed under such a plan and we are therefore thrown back to more general principles of income tax accounting. Here, the primary concepts to be guarded against in order to avoid premature taxation of beneficiaries are the "constructive receipt" and "economic benefit" doctrines.

The "constructive receipt" doctrine "treats as taxable any income which is unqualifiedly subject to the demand of a taxpayer on the cash receipts and disbursements method of accounting, whether or not such income has actually been received . . . ."[63]

The treasury has treated the subject in the Regulations:

> "Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt."[64]

It would seem that many of the restrictions which satisfy the "forfeitability" tests likewise satisfy the "constructive receipt" doctrine, but these restrictions should be drafted so that they continue up to the point that the money or other benefits are actually made available to the beneficiary.

For example, the right to benefits contained in a nonqualified plan can be made forfeitable:

(1) if the employee voluntarily leaves the corporation prior to retirement without the consent of the corporation; or

(2) if upon leaving the corporation, whether before or after retirement, the beneficiary works for a competing concern; or

61. Treas. Reg. § 1.402(b)-1(a) (1956).
62. INT. REV. CODE OF 1954, § 402(b).
63. Weil v. Commissioner, 173 F.2d 805, 806 (2d Cir. 1949).
64. Treas. Reg. § 1.451-2(a) (1957).

(3) if the employee is required to hold himself available for consultation and fails to do so.

In other words, the aim is to subject the right to the benefits to such adequate restrictions that the beneficiary could at no time prior to their being placed in his hands control their receipt. Naturally, such restrictions have an invaluable nontax purpose for the corporation. If the executive has a large amount at stake in a stock bonus or profit-sharing plan, he will certainly be less willing to leave the corporation prior to the time provided under the plan. The restriction on receipt thus gives a strong incentive to remain with the corporation and for that reason alone should be included in any incentive compensation plan.

A slightly different problem is involved in the concept of "economic benefit." This involves the power of the recipient or beneficiary to dispose of the right to income or stock which he may not yet even have.[65] Thus, for example, it may well be that the right to receive income which may be forfeited only upon the beneficiary's voluntary departure from his employer has some economic value. To avoid any problem of this nature, it is considered wise to put in a deferred compensation agreement a broad nonalienability clause which will void any efforts to sell, anticipate, alienate, assign, pledge or otherwise convey any interest which the employee might have in future benefits.

If the above rules are followed, it would seem that they would prevent any premature taxation of the beneficiary on amounts set aside for him under a deferred incentive compensation plan.

C. The Plan Should Ordinarily Not Employ a Trust

That section of Section 404(a) dealing with taxation of employers having nonqualified plans[66] is a good deal broader than that relating to taxation of beneficiaries of nonexempt trusts.[67] It comprehends payments made under any kind of plan, whether a trust or other funded or non-funded plan. It is the only section of the Internal

65. The basic principles are enunciated in Helvering v. Horst, 311 U.S. 112 (1940).

66. INT. REV. CODE OF 1954, § 404 reads in part:
"Sec. 404(a) *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation . . . they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

. . .

"(5) Other Plans—In the taxable year when paid, if the plan is not one included in paragraphs (1), (2), or (3) [relating to qualified plans,] if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid."

67. INT. REV. CODE OF 1954, § 402 (b).

Revenue Code by which payments to beneficiaries may be deducted.[68]

Here, again, the key to deductibility by the employers is forfeitability. If the amounts contributed or paid out under a nonqualified plan are forfeitable, they cannot be deducted in the year paid out and, in fact, under treasury regulations, they can never be deducted.

The pertinent U. S. Treasury Regulation reads: "If an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amounts are forfeitable at the time the amount is paid, no deduction is allowable for any taxable year."[69]

The Internal Revenue Service has taken the position that amounts paid to a trust are payments for the purpose of the regulation and that if amounts contributed to the trust are forfeitable when paid, no deduction may ever be taken by the employer. Indeed, this position until recently has been generally accepted.

In two cases decided recently, under the Internal Revenue Code of 1939,[70] however, the courts have come to opposite conclusions on similar sets of facts. In both, the trusts to which profit-sharing contributions were made were styled "irrevocable." Benefits could be forfeited by leaving the employers voluntarily, with all money forfeited being distributed to other beneficiaries of the trusts.

In *Wesley Heat Treating Company*,[71] the U. S. Tax Court concluded that amounts paid to the trusts were not deductible because the employees' rights were forfeitable. The Tax Court accepted the applicable treasury regulation, quoted above,[72] in the most perfunctory manner and did not question its validity under the statute.

The U. S. Court of Appeals for the Seventh Circuit upheld the Commissioner. It denied the taxpayer the right to deduct amounts actually paid out because the taxpayer was on the accrual basis and therefore the amounts could be deducted only when the trusts were created. Apparently the court was prepared to concede that the company's obligation to pay was determined as of the moment funds were transferred irrevocably.

The court then went on, however, and said that if amounts paid in were forfeitable, the employer could claim no deduction for any taxable year. The court concluded that no deduction would be permitted unless amounts funnelled through a non-qualified trust were nonforfeitable and taxable to the beneficiary.

68. Bailey v. Commissioner, 15 T.C. 468, *aff'd per curiam*, 192 F.2d 574 (3d Cir. 1951).
69. Treas. Reg. § 1.404(a)-12 (1956).
70. INT. REV. CODE OF 1939, §§ 23 (p) and 165. The regulation under which these cases were decided, Treas. Reg. 111, § 39, 23(p)-11 reads: "If an amount is paid during the taxable year but the rights of the employee therein are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year."
71. 30 T.C. 10 (1958).
72. See note 65 *supra*.

On the other hand, the U. S. Court of Claims, in *Russell Manufacturing Company v. United States*[73] distinguished *Wesley* on its facts (although the basis for this distinction is obscure) and ruled that amounts paid out of certain profit-sharing trusts to officers of the corporation could be deducted by the company even though the contribution to the trusts was forfeitable when paid in.

The court invalidated the regulations[74] as applied to compensation paid in the year in question. The court's reasoning was based upon section 23(p) of the Internal Revenue Code of 1939 in which provision is made for compensation paid on account of an employee under a nonqualified plan as well as contributions made to a pension, profit-sharing or annuity plan.[75] The court found in this statutory distinction congressional recognition of the fact that contributions to nonqualified trusts might later be paid out by the trusts and indicated that this was the "compensation" referred to in the statute. It said:

> In fact, the wording of Sec. 23(p)(1) strongly indicated a congressional anticipation that "compensation" would be paid by a trustee, and a congressional intention that compensation paid by a trustee should be deductible. In the first paragraph of Sec. 23(p)(1) Congress refers to "contributions" "paid by an employer," whereas "compensation" is mentioned, significantly we think, without any reference to the person who hands the compensation over to the employee.[76]

In view of the present uncertain state of this area, it would seem wise to avoid the use of a trust in nonqualified plan where the employer desires to take a deduction on payments made to beneficiaries. Use of a trust can only be an invitation to litigation. Furthermore, even if the *Russell* reasoning is ultimately adopted, if the trust has income, that income will be taxed to it.[77]

On the contrary, if the company is successful in preventing a trust from arising under its nonqualified plan, there may be considerable income tax savings. Thus, if a corporation has established a stock bonus plan and keeps stock accrued to the credit of its executive in its general accounts, dividends paid thereon and credited to the executives' accounts will be only a bookkeeping transaction and no tax consequences will arise. There will be no trust to tax and if restrictive clauses have been carefully planned, there will be no constructive receipt on the part of the beneficiary. As a result, when

73. CCH 1959 STAND. FED. TAX REP. (59-2 U.S. Tax Cas.) ¶ 9582 (Ct. Cl. July 15, 1959). The Internal Revenue Service announced on October 23, 1959 that it would not follow this decision 28 U.S.L. WEEK. 2187 (Oct. 27, 1959).

74. Quoted in note 70 *supra*.

75. INT. REV. CODE OF 1939, § 23 (p), 52 Stat. 464. (now INT. REV. CODE OF 1954, § 404).

76. Russell Mfg. Co. v. United States, CCH 1959 STAND. FED. TAX REP. (59-2 U.S. Tax Cas.).

77. See INT. REV. CODE OF 1954, beginning at § 641.

stock or cash from the sale of stock is paid out, it can be argued that that is the only payment made for purposes of the Internal Revenue Code and U. S. Treasury Regulations. Hence, if amounts paid out to executives are nonforfeitable when paid out, they are deductible by the corporation.[78]

Similarly, if cash credits to the account of a given executive under a plan are simply kept as a general liability of the corporation, no payment is made for the purposes of the Internal Revenue Code and U. S. Treasury Regulations until money is actually paid out to beneficiaries. There is some danger, of course, in that these credits are not segregated in a trust but instead remain available to general creditors of the corporation. If the corporation is reasonably stable, however, this should not be too great a disadvantage to the executive.

D. Some Suggested Nonqualified Plans

It may be helpful, in analyzing the desirability of a nonqualified plan, to compare one which is contemplated with some which have been placed in operation. It cannot be assumed that the broad general outlines of the plans set forth below satisfy all conceivable needs nor that the outlines themselves are sufficient to solve all problems which may arise. The plans outlined do demonstrate the great variety of forms which nonqualified plans may take.

1. An Unfunded Individual Deferred Compensation Contract.—Under this kind of plan the corporation, before services are actually rendered, promises to pay the key executive a certain sum per year following his retirement. Deductions are taken as the amounts are paid, and the amounts paid are taxable to the executive only when paid. Such an agreement, of course, has value to the executive only if the company is stable and with a reasonably certain future.

Such a plan can have, in addition to fixed retirement benefits, provisions to pay certain amount to the beneficiaries of the executive's estate. The only limitation on the above payment, insofar as deductibility is concerned, is that they must not be so large as to be beyond the bounds of ordinary and reasonable expenditures.[79]

2. The Key Executive Stock Bonus Plan.—Under a typical plan, a committee of members of the board of directors selects employees who are to receive credits for their services to the company. The fund out of which these credits are to be made may be a specified percentage of net profits after deducting a certain percentage on invested capital, or may be based on some other formula designed to spur the efforts of the executive. The dollar credits are converted

78. Treas. Reg. § 1.404(a)-12.
79. INT. REV. CODE OF 1954, § 162.

into stock of the company which is held, bought and sold as a general asset of the company. The credits vest over a period of five to ten years. Dividends are credited to each beneficiary in accordance with the number of shares credited to his account and vest in a manner similar to stock credits. Payments are made to beneficiaries in cash or in stock of the company over a period of years following retirement and, sometimes, death benefits are provided for.

Care must be taken to assure that the actual stock purchased by the company may be sold or interchanged and that no specific shares are set aside for a given executive. The danger is that the Internal Revenue Service may conclude that a trust exists and will therefore deny deductibility when amounts are paid out by the company.

3. Deferred Compensation Unit Plan.—In such a plan the company authorizes the distribution of a certain number of deferred compensation units which are equivalent to the market value of the company stock on the day on which they are granted. A selection committee has broad power to determine who shall participate and the extent to which such participation shall be allowed and awards are made on the basis of individual performance. Payments are made upon retirement over a given period of years. This plan requires that reserves be set up. Care must likewise be taken to assure that such reserves represent general obligations of the company so that they will not be considered a trust res.

4. Incentive Compensation Plan.—Under this plan, a percentage of earnings after return on invested capital is set aside. A profit-sharing committee has wide authority to select personnel from the upper managerial levels and to determine the award each shall receive. Compensation is paid out over the succeeding three to five year period.

The effort here is not so much to create security as to reward each employee soon after the income is earned. At the same time payments, which are of course subject to forfeiture, are spread out over a sufficient period that an employee has a vested interest in staying with the company.

5. Dividend Unit Profit-Sharing Plan.—A variation of the deferred compensation unit plan is the "dividend unit" plan which has been used by Du Pont de Nemours and Company. In such a plan each unit is equivalent to the dividends paid on one share of company common stock. Dividend units are given to key employees of the company in accordance with broad powers of the board of directors. Credits are forfeitable for a period of ten years following the anniversary of the credit if the employee is dismissed or leaves the company for any reason other than death or retirement. They then become non-

forfeitable. Cash benefits are paid annually up to the beneficiary's eighty-fifth birthday, unless he dies prior to that time, in accordance with the number of dividend credits built up to his account. The plan is unfunded.

Certain points should be noted. Dividend unit credits are even more uncertain than direct profit-sharing. The result is that such a plan could be undertaken only with a company whose earnings were stable and which had a consistent dividends policy. Valuable rights can be wiped out by the unilateral action of the company. It is conceivable that there will be unfavorable tax consequences with respect to rights which vest in the beneficiary. On the other hand, the plan does permit deferral of large amounts of income; it does serve as an incentive to further the best efforts of the executive-beneficiaries and the length of time before payments become nonforfeitable render an executive less willing to leave the company.

V. Requirements of State Law

The important tax questions which surround deferred executive incentive compensation have tended to obscure many of the legal problems which have confronted corporate attorneys. In this regard, it must be remembered that no solution of these tax problems is worth much if the entire plan can be attacked and destroyed by the operation of state corporate law.

The management of the day to day affairs of the corporation is a responsibility which has been conferred by state law upon its board of directors.[80] The determination as to compensation of executives is considered to be within the category of conduct of ordinary business and the judgment of the board as to its reasonableness normally may not be questioned.

There can be no doubt, however, that the board of directors does not have license to compensate executives in unlimited amounts, whether the board of directors is itself interested or not. If the board of directors grants deferred compensation which the court considers too high, it may well step in to investigate the reasonableness of such compensation itself. Thus, in *Fogelson v. American Woolen Company*,[81] a pension of $54,000 was voted to the president of the company. He had earned $100,000 for many years and more than $150,000 in the year preceding the year in which the pension plan was adopted. The court of appeals did not determine the validity of the pension on the merits. It did reverse summary judgment for the defendant and held that the size of the pension and the great disparity between it and pensions accorded other employees demanded a trial on the factual

80. *E.g.*, Del. Code Ann., tit. 8, § 141(a) (1953).
81. 170 F.2d 660 (2d Cir. 1948).

issue of whether or not the board had exercised its honest business judgment. The court was clearly concerned in that there seemed to be no reasonable relationship between the size of the pension and the worth of the services performed by the president, and more precisely by the value of the pension and its worth as a means of securing a president of equal ability.

If members of the board of directors are participants in an incentive compensation plan it is even more likely that the terms of the plan will be subjected to judicial review. It is essential to the validity of such a plan that the corporation receive a benefit in return for the grant of option rights. Such a corporate benefit may be in the form of a requirement that the optionees remain in the service of the corporation for a specified period of time as a condition precedent to the enjoyment of rights under the option.

It is important to recognize that a gift of corporate assets is generally invalid absent unanimous shareholder ratification, irrespective of whether or not approved by a totally disinterested board of directors. When this theory was initially employed by minority shareholders to attack stock option plans, the gravamen of the complaint was that stock option plans accorded the corporation no greater benefit than it would have received without offering the options and that a gift of corporate assets therefore resulted.[82]

It eventually developed that establishment of the existence of consideration was relatively uncomplicated. A showing that the executive was attracted to serve the corporation by the offer of option rights[83] or that he refrained from resigning because the corporation offered option rights was held sufficient.[84]

Complaining shareholders therefore shifted their attack to the adequacy of the benefit to be received by the enterprise from stock option plans devised by interested directors for their own compensation. In *Kerbs v. California Eastern Airways* the Delaware Supreme Court indicated that the fairness to the corporation of a plan involving interested directors was subject to judicial scrutiny. The willingness of this court to substitute its judgment for that of the board of directors was a severe blow to the framers of this plan, and others interested in similar plans.[85] Although the court founded its decision in that case on the fact that no consideration was forthcoming to the corporation and invalidated the option plan as tantamount to a gift of the corporate assets,[86] it indicated by way of dictum that even

82. Rogers v. Hill, 289 U.S. 582 (1933); Rosenthal v. Burry Biscuit Corp., 30 Del. Ch. 299, 60 A.2d 106 (1948).
83. Wise v. Universal Corp., 93 F. Supp. 393 (D. Del. 1950).
84. Sandler v. Schenley Industries, 32 Del. Ch. 46, 79 A.2d 606 (1951).
85. 33 Del. Ch. 69, 90 A.2d 652 (1952).
86. 33 Del. Ch. 69, 74, 90 A.2d 652, 656 (1952). Increased employee "incentive" was the stated aim of the plan. The court held that since no guarantee

where consideration was present it would investigate reasonable relationship between the value of the option and the value of the services to be afforded the corporation.[87] This judgment was surprising to many because the plan had been ratified by a majority of the shareholders.

In *Gottleib v. Heyden Chemical Corporation,* decided the same day as *Kerbs,* the Delaware Supreme Court indicated even more clearly a propensity to exercise its business judgment as to the adequacy of consideration.[88] In reversing a summary judgment for the defendants, the court maintained that interested directors must demonstrate to the satisfaction of the court that the option was as favorable a bargain to the corporation as if the interested directors had been dealing with outsiders. In granting rehearing, however, the court provided interested directors with a vehicle which eases their burden of establishing the validity of option plans.[89] The court contended that the burden of proving fairness was only incumbent on the directors absent majority shareholder approval. If shareholder ratification was obtained, the complainant would be obliged to shoulder the burden of showing that no person of sound business judgment would approve the plan.[90]

The importance of placing the burden of proof on the plaintiff cannot be overemphasized. Considerable difficulty is involved in assigning an exact dollar value to the right to purchase stock. Even more uncertain is the precise value to the corporation of the retained services of an executive. In view of these factors, it would seem that *Gottleib* has established the validity for practical purposes of any plan which is not actually consummate to a gift of the corporate assets provided majority shareholder approval has been achieved.

Nevertheless, the Delaware legislature amended the corporation law in 1953 to render director decisions "as to consideration" received by the corporation for stock option plans conclusive unless actual fraud is apparent.[91] This statute at first blush seems to afford little additional solace to the corporate executive who is concerned with the

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of increased incentive existed, there was no consideration to support the option grant.

87. 33 Del. Ch. 69, 75, 90 A.2d 652, 656 (1952).

88. The *Gottleib* case was before the Delaware Supreme Court on three occasions. 33 Del. Ch. 82, 90 A.2d 660 (1952), *rehearing granted,* 33 Del. Ch. 177, 91 A.2d 57 (1952), *decision on rehearing,* 33 Del. Ch. 283, 92 A.2d 594 (1952).

89. 33 Del. Ch. 177, 91 A.2d 57 (1952).

90. In Kaufman v. Schoenberg, the court of chancery elaborated on the *Gottleib* rule: "Where there has been independent stockholder ratification of interested director action, the objecting stockholder has the burden of showing that no person of ordinary sound business judgment would say that the consideration received for the options was a fair exchange for the options granted." 33 Del. Ch. 211 at 221, 91 A.2d 786, at 791 (1952).

91. DEL. CODE ANN., tit. 8, § 157 (1953).

validity of stock option plans for interested director beneficiaries. It is by no means apparent that a "decision of the board" under this law includes the decision of an interested board. However, since this enactment followed so closely the *Kerbs* and *Gottleib* decisions, it would appear to be that the determinations of an interested board are entitled to the same deference as those of directors who do not stand to benefit from the plan.

It is clear that this statute will not rescue plans under which no consideration flows to the corporation. In *Frankel v. Donovan*, decided under the amended law, it was ruled that employee "incentive" was no consideration since there was no assurance that an ungrateful employee would not exercise his option and terminate his services immediately.[92] It seems that the court came precariously near an investigation of the adequacy of consideration. How closely a search for the existence of consideration may approach an inquiry into matters properly relating to the adequacy thereof is obscure, but it seems certain that so unfavórable an arrangement as to resemble a gift of the corporate assets will not be tolerated.

Finally, the court in *Frankel* contended that the amended statute accorded the same finality to director decisions "as to consideration" for stock options as had been previously accorded their determinations as to consideration for the issuance of stock.[93] In cases involving interpretations of the statutory conclusivity provisions relating to the terms of issuance of shares, the courts have indicated a willingness to investigate the sufficiency of the benefit to the corporation as a circumstance bearing on possible fraud.[94]

It can be seen that there are a number of aspects of state corporate law which may prove fatal to a deferred incentive compensation scheme. Certainly in Delaware there is a need for a clear benefit to the corporation in the form of retained services of the key executives who are given certain forms of deferred compensation. These needs must be measured, however, against the disadvantages such restrictions present. If they are too onerous, an incentive compensation plan may very well fail to fulfill the need required of it.

The purpose here has been to present major concepts in the field of incentive compensation. Certain arrangements effective principally

92. 120 A.2d 311 (Del. Ch. 1956).

93. 120 A.2d 311 (Del. Ch. 1956). See Del. Code Ann., tit. 8, § 152 (1953). Support for this view may be found in the Delaware Supreme Court decision after rehearing in the *Gottleib* case. 33 Del. Ch. 283, 92 A.2d 594 (1952). The court found that the conclusivity provision in § 152 of the code relating to the consideration for the issuance of shares was inapplicable to director determinations as to the consideration for option rights. The legislature may have intended to amend the effect of this holding.

94. West v. Sirian Lamp Co., 28 Del. Ch. 398, 44 A.2d 658 (1945); Diamond State Brewery v. De La Rigaudiere, 25 Del. Ch. 257, 17 A.2d 313 (1941).

in limited situations have been left to other dissertation. This study is a recognition of the immense importance of this subject and is an effort to awaken and sharpen interest in application of these measures to satisfy the continuing and expanding need for their use. Incentive compensation is not new but the present devices available for the full realization of its benefits are developments of recent years and more may be expected. This area has grown and evolved from necessity and it is not likely that this necessity will be diminished in the foreseeable term. This realizes an especial emphasis by the intense international competition into which we have been precipitated, presenting a challenge which we dare not fail but to meet successfully. Unless we are to ignore the lessons of history and human behavior we must surely avail ourselves of incentives which will draw and maintain a constant flow of skilled talent into managerial roles. In this manner we shall stimulate that talent to that superior performance and leadership which is vital to the successful direction of our national enterprise.