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Consideration in Corporate Stock Option Plans

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court agreed with the views expressed by the North Dakota Supreme Court in the *WDAY* case. The court stated in its opinion:

> . . . that Congress under the Federal Communications Act of 1934, as amended, completely occupied and preempted the field of interstate communications in radio and television, and that from the censorship provision in Section 315 and other regulatory provisions of the Act, there results by necessary implication an immunity of a broadcaster from liability for defamatory material broadcast by a legally qualified candidate.[27]

It would appear that the Supreme Court should now meet the foregoing issues head on. It should determine the congressional intent in passing this legislation, but, above all, it should determine the power of Congress to deprive an innocent third party of compensation for a tortious wrong.

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Consideration in Corporate Stock Option Plans — *Gruber v. Chesapeake and Ohio Railway Company*[1] was a shareholder's derivative suit brought by two joint shareholders on behalf of the Chesapeake and Ohio Railway Company against the directors of that corporaiton, who were alleged to have committed waste of corporate assets through the implementation of an executive stock option plan. In an effort to retain its key executives the railroad adopted a plan which, in general, provided that options to buy company stock might be exercised from year to year, but not completely exercised until four years after the plan had been adopted. The options were issued subject to defeasance by the disapproval of a majority of shareholders, and could not be exercised unless the company's earnings equalled a stipulated amount per year. Essential to participation in the plan was the company's retention of the optionee's services for a certain period after the adoption of the plan. In considering these facts, the United States District Court for the Northern District of Ohio, Eastern Division, found that adequate consideration was received by the company for the options granted under the instant plan, and that therefore they did not constitute a gift or waste of corporate assets for which the directors would be liable.

In the ten year period prior to 1950, stock option plans were relatively rare.[2] However, partly as a result of changes in the Internal Revenue Code, stock option plans since 1950 have become a frequently utilized means of inducing executives to remain

[27] *Id.* at 934.
[1] 158 F. Supp. 593 (N.D. Ohio 1958).
[2] FETTER & JOHNSON, COMPENSATION AND INCENTIVES FOR INDUSTRIAL EXECUTIVES 95 (1952). Only two of 50 companies studied had stock options between 1945 and 1949.

with a company and of giving them an incentive for more efficient management.[3] The company is thereby compensated by increased profits, ultimately distributed to the shareholders through dividends, developed to an extent by continuity of service on the part of its executives. The executive is stimulated to greater efficiency by the possible benefits that may accrue to him if the company's operation improves sufficiently to make its stock, which the executive has an option to buy at a figure fixed on the day of issuance of the option, appreciate in value. If the option plan complies with certain requirements of the Internal Revenue Code, the optionee also benefits by the favorable tax treatment afforded his stock purchase and the gain realized on subsequent sale.[4]

However, the directors of a corporation cannot bestow such benefits on executives or employees without the corporation receiving some benefit or consideration in return. In general, directors and majority stockholders cannot make gifts of corporate assets for other than charitable purposes.[5]

Therefore, in all stock option plans, the presence and adequacy of consideration is of crucial importance. Sufficient consideration to validate a plan may be the retention of key personnel, the acquisition of a new employee, or the signing of a favorable employment contract, provided there is a reasonable relationship between the value of the services to be rendered by the employee and the value of the option.[6] Within the plan itself there must be provision made to insure that the corporation will actually realize the anticipated consideration.[7]

In the absence of such express provision within the plan, the court may find consideration inherent in the plan itself. For example, the plan may provide that the employee will be unable to exercise his option unless he first renders substantial service to the corporation.[8] It is important to realize that the time for ascertaining whether option plans are supported by sufficient consideration is not when the options are exercised, but when they are granted.[9]

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[3] Note, 62 YALE L. J. 84 (1952). Over 300 corporations adopted stock options for executives in years 1950 to 1952.

[4] INT. REV. CODE OF 1954, §421.

[5] Rogers v. Hill, 289 U. S. 582 (1933); 6A FLETCHER, CYC. CORP. §2939 (1950).

[6] Wyles v. Campbell, 77 F. Supp. 343 (D. Del. 1948); McQuillan v. National Cash Register Co.; 27 F. Supp. 639 (D. Md. 1939); Sandler v. Schenley Industries, Inc., 32 Del. Ch. 46, 79 A.2d 606 (1951); Holthusen v. Edward G. Budd Mfg. Co., 53 F. Supp. 488 (E.D. Penn. 1943); Clamitz v. Thatcher Mfg. Co., 158 F.2d 687 (2d Cir. 1947); 5 FLETCHER, *supra* note 5, §2143.

[7] Kerbs v. California Eastern Airways, 33 Del. Ch. 69, 90 A.2d 652 (1952); Frankel v. Donovan, 120 A.2d 311 (Del. Ch. 1956).

[8] Gottlieb v. Heyden Chemical Corp., 90 A.2d 660, 664 (Del. 1952).

[9] Elster v. American Airlines, 100 A.2d 219 (Del. Ch. 1953); RESTATEMENT, CONTRACTS §75, comment c (1932).

The purpose of the stock option incentive plan of the Chesapeake and Ohio Railway Company was "to secure to the . . . Company the advantages of the incentive inherent in stock ownership on the part of key officers responsible for the continued success of the company and to create in such key officers a proprietary interest in, and a greater concern for, the welfare of the Company."

The options were granted "For the services and duties to be rendered and performed by the offiicers . . . at the purchase price herein specified and subject to all of the terms and conditions set forth herein."

The plan was adopted by a majority of the fifteen man Board of Directors on January 9, 1951. The meeting was attended by fourteen of the members, three of whom were to be participants in the proposed stock option plan. In adopting the plan, the three members of the Board who were to be optionees abstained from voting. The Board set May 1, 1951 as the first option date. The plan was approved by a majority of the stockholders on April 17, 1951.

The conditions set forth in the plan were as follows:[10] The options were to have been exercised before December 31, 1957; an optionee was allowed, on or after May 1, 1951, to exercise his option as to not more than 20% of the shares made available to him. Subject to the provisions of a subsequent paragraph, an optionee was permitted to exercise his option to the remaining shares made available to him as follows: 20% on or after the option date in 1952, 20% on or after the option date in 1953, 20% on or after the option date in 1954, and the remaining 20% on or after the option date in 1955.

If in any of the years 1951 through 1954 the net income of the company, computed by a provided formula, dropped below an amount equal to $3.50 per share on the company's common stock outstanding at the end of each such year, respectively, the option was to be revoked as to the number of additional shares otherwise becoming available for purchase by each optionee in the succeeding year.

The purchase price was set at the fair market value based on the closing price of the Company's common stock on the date of the Board of Directors' approval of the plan.

Paragraph Eight of the plan provided that the options were not to be transferable otherwise than by will or the laws of descent and distribution, and could only be exercised by the optionee during his lifetime. In the event that the optionee left the company (through retirement or otherwise) or died, during 1951, 1952, 1953, or 1954, he or his personal representative could, subject to the provisions set forth in the plan, exercise his option as follows: For each full month of employment by the company in the year of leaving the company's

[10] See note 1 *supra*, at 598 and 599.

employ or death, he would be entitled to exercise the options with respect to 1/12 of the entire number of shares that would have become available to him during the following calendar year. The optionee or his personal representative (in the case of death) could exercise the entitled option within three months after leaving the company's employ or death.

The plan further provided that any participant could, on or after May 1, 1951, exercise his option as to not more than 20% of the shares available to him.

The plan expressly provided that it was "subject to defeasance" by the disapproval of the stockholders.

To ascertain whether sufficient consideration was expressed by the above provisions the court reviewed determinations in several previous cases where consideration was in issue.

In *Rogers v. Hill,*[11] a leading case, the Supreme Court of the United States in 1933, speaking of extra compensation given to officers of a corporation, stated: "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of a minority."

In *McQuillen v. National Cash Register Co.* (1939),[12] an option was upheld which provided for exercise in installments over a period of five years, and which became null and void upon the termination of the optionee's employment.

In *Holthusen v. Edward G. Budd Mfg. Co.* (1942),[13] the court enjoined a plan in which the optionee employee was not obligated to remain in the company's employ, nor was his right to exercise the option dependent upon continued employment. However, an amended plan was upheld, requiring the optionee to remain in the employ of the company for one year, and also prohibiting exercise of the option before one year had elapsed from the date of issuance of the option.[14]

In *Clamitz v. Thatcher Mfg. Co.* (1947),[15] options were sustained which were exercisable at any time after being granted, though only while the optionee remained in the corporation's employ.

In *Wyles v. Campbell* (1948),[16] an option plan was upheld in which the optionee was required to be under an employment contract, and where the compensation to be received by the optionee, via this plan, bore a reasonable relation to the services expected to be rendered by him to the company.

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[11] Rogers v. Hill, *supra* note 5, at 591.
[12] McQuillen v. National Cash Register Co., 27 F. Supp. 639 (D. Md. 1939).
[13] Holthusen v. Edward G. Budd Mfg. Co., 52 F. Supp. 125 (E.D. Penn. 1943).
[14] *Id.*
[15] Clamitz v. Thatcher Mfg. Co., 158 F.2d 687 (2d Cir. 1947).
[16] Wyles v. Campbell, 77 F. Supp. 343 (D. Del. 1948).

In *Rosenthal v. Burry Biscuit Corp.* (1948),[17] an option granted to the President, who dominated the Board of Directors, was declared invalid because he could have exercised his option immediately. The court found no showing that the option was granted either to induce the optionee to enter the company's employ or to remain in it.

In *Wise v. Universal Corp.* (1950),[18] it was held that under Delaware law inducement to enter into employment contracts was sufficient consideration for the corporate agreement to issue warrants to buy stock. The court here made an express finding that, but for the grant of options by the company, the employees in question would have terminated their services.

In *Sandler v. Schenley Industries, Inc.* (1951),[19] a contract to purchase shares in installments was upheld where a valued employee would have terminated his employment with the company if he had not been given this contract.

In *Kerbs v. California Eastern Airways* (1952),[20] the Delaware court relied on many of the above cited cases to invalidate a stock option plan in which options could have been exercised immediately upon their issuance and at anytime within six months after termination of employment. The court stated that the plan did not insure that the benefits contemplated by the plan (retention of employee's services) would in fact be realized by the corporation.

In *Gottlieb v. Heyden Chemical Corporation*,[21] decided on the same day as the *Kerbs* case, the Delaware Court stated that valid consideration for a stock option plan may be found in a covenant to do something for the corporation, or may be inherent in the plan itself (option exercisable only by employes who had remained in the company's employment for one year following the option issuance). The court also stated that if the only purpose of a stock option plan giving officers the right to purchase stock at less than market value was to enable such officers to buy stock, there was no legal consideration for the agreement.

The Delaware Court, in *Frankel v. Donovan* (1956),[22] declared a plan invalid where the only consideration contemplated by the plan was increased job satisfaction. The court stated ". . . legal consideration sufficient to support an option plan is not found in increased employee effort and loyalty attributable to job satisfaction or in the incentive which an option plan furnishes to stay with one's old job. There must be in addition some assurance in an option plan, or in

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[17] Rosenthal v. Burry Biscuit Corp., 30 Del. Ch. 299, 60 A.2d 106 (1948).
[18] Wise v. Universal Corp., 93 F. Supp. 393 (D. Del. 1950).
[19] Sandler v. Schenley Industries, Inc., 32 Del. Ch. 46, 79 A.2d 606 (1951).
[20] Kerbs v. California Eastern Airways, 33 Del. Ch. 69, 90 A.2d 652 (1952).
[21] Gottlieb v. Heyden Chemical Corp., 90 A.2d 660 (Del. 1952).
[22] Frankel v. Donovan, 120 A.2d 311 (Del. Ch. 1956).

the circumstances surrounding it, that an ungrateful employee won't take his options and leave prior to rendering services reasonably expected by the corporation in return for the grant."[23]

Finally and most recently, the Massachusetts Court in *McPhail v. L. S. Starrett Company*,[24] decided in July, 1958, upheld an option plan which required that options were to be exercisable only by employees and that they be exercised within 30 days after their issuance.

The question confronting the court in the instant case was: In the light of precedent, did the provisions of the Chesapeake Plan, and the circumstances surrounding its implementation, manifest or imply sufficient consideration?

The court found that consideration is "inherent in the plan itself because the optionee is unable to exercise his option until he first renders service to the company."[25]

To further insure that contemplated benefit woud actually accrue to the company,[26] a condition precedent was incorporated into the plan to the effect that options could be exercised only if the company's net income for the preceding year was above a certain level.

Under this plan the participant could have taken one-quarter of his option for working one-third of a year but then had to work four more years to get the remaining three-quarters. In no case prior to this one was the court able to find participants required to work as long as four years before being able to exercise their option completely. Thus, the above cited precedents were more than amply satisfied by this plan.

In each of the cases where the court upheld a stock option plan, in the words of Justice Wolcott in the *Kerbs* case,[27] "there was some element, either in the plan itself or in the surrounding circumstances, reasonably calculated to keep the optionee in the corporation's employ. We do not think it is indispensable to bind the optionee by an employment contract but there must besome circumstance which may reasonably be regarded as sufficient to insure that the corporation will receive that which it desires to obtain by granting the options."

Although it is readily apparent that consideration is an indispensable element of a stock option plan, no inflexible formula can be given to the attorney for use in insuring the adequacy of consideration in a contemplated or already existing plan. The above cited cases are precedents which a court will consider in deciding future cases of this nature. They are, therefore, guideposts to which the attorney must

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[23] *Id.* at 314.
[24] McPhail v. L. S. Starrett Company, 257 F.2d 388 (1st Cir. 1958).
[25] Gruber v. Chestapeake and Ohio Railway Company, 158 F. Supp. 593, 599 (N.D. Ohio 1958).
[26] *Cf.* Frankel v. Donovan, *supra* note 22.
[27] Kerbs v. California Eastern Airways, *supra* note 20, at 657.

look in drafting an option plan. This case is important, not as a departure from the general trend of decisions, but as a further delineation and clarification — another waymark for the attorney to follow in spelling out adequate consideration.

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