Corporate Bonus and Pension Plans: A Legitimate Business Purpose Test

Minn. L. Rev. Editorial Board

Follow this and additional works at: https://scholarship.law.umn.edu/mlr

Part of the Law Commons

Recommended Citation
https://scholarship.law.umn.edu/mlr/2805

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.
Corporate Bonus and Pension Plans: A "Legitimate Business Purpose" Test

In determining the validity of corporate bonus and pension plans, American courts have generally imposed a contract-type consideration requirement, which voids bonuses and pensions based solely on past services. In contrast, English courts have merely looked to see if the compensation agreement benefits the corporation. The author of this Note suggests that application of a "legitimate business purpose" test, patterned after the English test, would give corporations valuable flexibility in the formulation of their compensation plans. He concludes that although the result will differ in but few cases, such an approach will allow courts to direct their attention exclusively to the crucial issue—whether the transaction is intended to benefit the corporation.

The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.1

I. INTRODUCTION

Payment of bonuses and pensions to corporate employees is under most circumstances an unquestioned practice.2 When such payments are not supported by legally adequate consideration, however, they have been held to constitute "gifts" of corporate assets, which are prohibited under corporation law to protect the interest of minority shareholders and creditors.3 Past services to the corporation are generally considered to be inadequate consideration to support compensation by the corporation,4 so that payments made on that basis can be recovered by the corporation or, if not, the directors can be held liable.5 Courts, sympathetic to the corporate practice, have frequently sought to avoid this result by finding collateral, and often remote, consideration.6

2. See 1 Washington & Rothchild, Compensating the Corporate Executive 52 (3d ed. 1962); Cohen, Corporate Bonuses and Stockholders' Rights, 14 Tenn. L. Rev. 87 (1936).
5. See 5 Fletcher, op. cit. supra note 3, § 2143 n.20.
The problem of justifying corporate distributions basically arises where a corporation, without any prior obligation, pays a bonus to an active employee or a bonus or pension to a retiring employee or to the family of a deceased employee. Notwithstanding that the directors might have intended in good faith to further the best interests of the corporation and that the expenditure constituted an ordinary and necessary business expense for tax purposes, it has been held that a payment based only on past services is ultra vires for lack of adequate consideration. This result can seriously impede corporate efforts to maintain good employee relations, procure new employees, and retain key executives. The question ultimately facing the courts is whether, in light of the corporate policies underlying the practice of payment of bonuses and pensions, traditional contract-type consideration ought to be required. The purpose of this Note is to show that the consideration requirement invoked by American courts as a test of the validity of corporate compensation arrangements is unsatisfactory; that a “legitimate business purpose” test similar to that utilized by English courts can better serve the interests of the corporation without detriment to the interests of minority shareholders and creditors.

II. TWO TESTS: CONSIDERATION V. LEGITIMATE BUSINESS PURPOSE

A. The American Rule — A Search for Consideration

Compensation agreements based on past services are generally held to be ultra vires in this country because corporate directors, as trustees of corporate assets, are empowered to expend assets only in discharge of valid and enforceable corporate obligations. Recognizing that unrealistic results can follow from strict application of such a rule, courts have been willing to sustain compensation plans supported by theoretical rather than actual consideration.

Some American courts, in searching for consideration to support corporate bonuses, have implied an agreement between the corporation and the employee for the payment of extra compensation. One such implied agreement is based on past practices of a corporation in granting extra compensation in prosperous


years. That reasoning, however, would not sustain an identical plan adopted for the first time by a competing company because of a lack of "past practices" upon which to base consideration. Yet, substantially different consequences should not follow from distinctions based on fiction. Similarly, courts have sustained bonuses paid for "unusual" services, "above and beyond" one's ordinary duties, on the theory of an implied promise by the employer to pay for extra services. But factually, "ordinary" duties are difficult to delineate in determining whether "extra" or "unusual" services have been performed; furthermore, the ordinary employment contract often contemplates that occasional extraordinary services are to be performed as a term of employment.

Another source of consideration to support bonuses has been found in the legal detriment incurred by an employee in refraining from the exercise of his ever-present right to terminate his employment. In the absence of clear proof of arm's length bargaining, however, such a basis for finding consideration must fail, since that "detriment" is theoretically incurred in every bonus transaction but is a substantial factor in few. A similar legal detriment, sufficient to support the payment of a bonus, could be found where an employee foregoes his demand for a higher salary in reliance on the payment of a bonus if the excellence of his services or the company's prosperity justifies an increase. Although the sound business purpose of minimizing fixed salary expense might justify corporate reliance on this form of consideration, an actual bonus agreement executed in the first instance would seem to be a more logical way of maximizing the corporation's benefit from such an incentive plan; the absence of strong supporting evidence should render that type of "agreement" vulnerable to attack.

The search for consideration has also taken place in the context of payments made upon the decease or retirement of employees. One American court has found the existence of supporting consideration on a third-party beneficiary theory in the benefit

10. See, e.g., Church v. Harrill, 35 F.2d 499 (6th Cir. 1929); Neff v. Gas & Elec. Shop, 232 Ky. 66, 22 S.W.2d 265 (1929); Wineburgh v. Seeman Bros., 21 N.Y.S.2d 180 (Sup. Ct. 1940).
11. See, e.g., Hurt v. Cotton States Fertilizer Co., 159 F.2d 52, 58-59 (5th Cir. 1947); Vaught v. Charleston Nat'l Bank, 62 F.2d 817 (10th Cir. 1933); cf. Church v. Harrill, 35 F.2d 499 (6th Cir. 1929) (quantum meruit); 1 WILLIAMS, CONTRACTS § 36 (3d ed. 1957); 5 CORNELL L.Q. 450 (1920).
conferred to the corporation from the higher morale of its remaining employees and the enhanced reputation of the corporation in the community resulting from such bonuses or pensions.\textsuperscript{13} A difficult evidentiary problem is presented in those cases, however, as to whether benefit from improved morale and reputation was actually received. Payments to departed employees might be more easily justified as a legitimate attempt to benefit the corporation in a manner similar to advertising, and the courts then would not be burdened with evaluation of the actual results. Bonus and pension agreements have also been sustained in cases where the retiring recipient reputedly promised to render counsel when requested or promised to refrain from competing with the corporation.\textsuperscript{14} Since such “contracts” are technically valid if the promisor remains “available” to advise or could in fact compete,\textsuperscript{15} the door is opened to payments, unjustifiable as pensions, under the guise of consultant or noncompetition contracts. In order to avoid this abuse, possible under the usual contract approach, the courts should apply an objective test to such transactions, sustaining only those where it appears that it is the good faith intent of the directors that the corporation shall benefit.

Although bonuses and pensions, ostensibly paid for past services, in many instances can be justified according to contract principles, such a common business practice should not be dependent on the finding of certain facts which are often collateral to the main business considerations motivating the bonus. The main business purposes for payment of bonuses to active employees would seem to be to create an incentive for the employees to raise their productivity and to maintain as low a fixed salary

\textsuperscript{13} Acker v. MacDonald, Sup. Ct., N.Y. Co., N.Y., April 26, 1940. (Not reported.)

The payment of retirement allowances measured by past services to those employees at or above retirement age or too near retirement age to achieve an adequate allowance otherwise, is not an additional payment for services, previously rendered, or a gratuity, but is a justified expenditure from the point of view of the corporation in that it removes super-annuated employees, reduces payroll, improves the morale and efficiency of the younger employees remaining in the employ, attracts better employees, and benefits the relations between the corporation and the public.


commitment as possible in order to ease the burden in unprofitable years. Similarly, payments on the decease or retirement of employees not only improve the morale and incentive of remaining employees to stay with the corporation but also give the corporation a good "public image." Since stockholders have presumptively approved of the business acumen of corporate directors, courts are not justified in impeding the good faith efforts of directors in furthering legitimate corporate interests through reasonable "gratuitous" compensation arrangements. On the other hand, whatever standard is used in testing corporate bonuses and pensions, it is the stockholder's interest that is of prime concern.

16. Presumably, if stockholders did not approve of their directors' judgment, they would not have purchased stock in that particular corporation, or would sell that stock which they hold.

17. Compare BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 164-88 (1954) and Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932), with Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv. L. Rev. 1365 (1932). In 1932 Professor Dodd took the position that corporate managers are trustees for the joint benefit of shareholders, employees, consumers and the general public. Professor Berle immediately rejected that position, asserting that

you can not abandon emphasis on "the view that business corporations exist for the sole purpose of making profits for their stockholders" until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else . . . . Either you have a system based on individual ownership of property or you do not . . . . Otherwise the economic power now mobilized and massed under the corporate form . . . is simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all.

Berle, supra at 1367-68.

It is interesting to note that 22 years later Professor Berle altered his position 180 degrees, stating that Professor Dodd took the better view in their earlier controversy. Berle, op. cit. supra at 169.

In envisioning the fiduciary duty owed to society by corporate management, it appears that perhaps Professors Dodd and Berle differ from the traditional view in form only. For example, in determining whether giant corporations should assure the availability of a first-rate college education or should avoid turning a thriving city into a ghost-town because of greater profit-making opportunities elsewhere, the society-beneficiary and the stockholder-beneficiary viewpoints would likely coincide. One would call it a duty to society and the other, in its enlightened self-interest, would realize its long range personnel needs required the availability of good colleges and that the importance of its public image prohibited creating a ghost-town. Professor Berle probably best sums up his and Professor Dodd's position—"we are nibbling at the edges of a vast, dangerous, and fascinating piece of thinking." Berle, op. cit. supra at 174; cf. Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 688 (1919) (the court disapproved of Mr. Ford's altruistic inclinations and compelled the declaration of dividends).
Therefore, when retroactive bonuses appear to be a management attempt to “share the profits” at the operational level, stockholders have good cause to object.

B. The English Rule — A Look at Benefit

The English courts rejected the consideration approach to corporate bonus agreements. In determining whether corporate directors had the power to grant compensation for past services, the English courts merely inquired whether the transaction was intended to benefit the company. Ultimately a three-part standard was established: Gratuitous company payments had to be (1) reasonably incidental to the carrying on of the company’s business; (2) bona fide; and (3) made for the benefit and to promote the prosperity of the company.

By freeing itself from the tenets of contract law, the English judiciary has been able to maintain remarkable flexibility in passing on gratuitous distributions of company assets. In an early case, Evans v. Brunner, Mond & Co., a grant of £100,000 by a chemical manufacturing company to universities or other scientific institutions in the United Kingdom was held to be intra vires when the benefit to the corporation from establishing “a reservoir of trained experts” from which the company would be able to

18. See Cyclists’ Touring Club v. Hopkinson, [1910] 1 Ch. 179 (1909); Henderson v. Bank of Australasia, 40 Ch. D. 170 (1888); Hutton v. West Cork Ry., 23 Ch. D. 654 (1888); 76 SOL. J. 505 (1932). The bonus in Hutton was held to be invalid on the ground that it was paid incidentally to the “winding up” of the company and not for the purpose of carrying on the railway business.

19. Good faith on the part of directors without intent to benefit the company was deemed to be insufficient justification for past service compensation. One court envisioned “a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational.” Hutton v. West Cork Ry., 23 Ch. D. 654, 671 (1888).

20. In re Lee, Behrens & Co., [1931] 2 Ch. 46, 51 (1931). In Lee an annuity was voted to the widow of the deceased managing director. When the company went into liquidation the court refused the widow’s claim since no evidence was introduced of the board’s intent to benefit the company by payment of the annuity. The court did admit, however, that a company generally does have the power to provide for the welfare of former employees. The fact that this case arose out of a liquidation proceeding rather than from the objection of a shareholder of a going concern may have affected the result.

21. [1921] 1 Ch. 359, 367 (1920). In answer to the objecting shareholder’s argument that much of the benefit from the grant would inure to competing companies, the court made the assumption that the directors will consider that and other factors in determining whether such application of funds is to the company’s advantage. (There was no hint in this case that the company was not financially sound.)
select men was found to be not too remote. The *Evans* case could be interpreted as the beginning of a “benefit to society” test; but the recent decision in *Parke v. The Daily News* 22 ended any such notion. *Parke* involved the sale of two large newspapers for about £2,000,000 with a resulting loss of employment to many. The selling company distributed certain amounts to its former employees as it was obligated to do under the employment contract; in addition, it authorized distribution of £1,125,000 to the affected employees as compensation for loss of pension rights representing one week’s pay for each year of service. An objecting shareholder sought to enjoin this gratuitous payment on the ground that it was ultra vires. The court determined that the directors did not intend primarily to benefit the company by authorization of the severance pay; notwithstanding that the director’s motives were “laudable” and “enlightened from the point of view of industrial relations,” the payments were held ultra vires since the director’s main purpose was to benefit the former employees.23

Reduced to the narrowest possible view, *Parke* holds that payment of one week’s wages to a discharged employee is ultra vires even where there are no competing creditors. Viewed more broadly, it reaffirms the proposition that a company must be run for the benefit of the shareholders. Although reasonable severance pay ordinarily provides a benefit to the shareholders through better industrial relations, such a payment is not beneficial when it requires distribution of an amount out of proportion to the possible advantages to be derived. There may be some question of whether the proper result was reached in *Parke*,24 but the court’s approach did deal directly with the crucial factor. The fact that the proposed compensation was for past services and was not supported by consideration was deemed, as it should have been, irrelevant.25 The approach of the English courts has had no appeal, however, in most American jurisdictions.

III. “LEGITIMATE BUSINESS PURPOSE” AS AN ALTERNATIVE TO THE CONSIDERATION REQUIREMENT

Adoption of a “legitimate business purpose” test, patterned on the English cases, would settle much of the uncertainty that has

---

24. The company contended that severance pay was required to avoid incurring the hostility of trade unions and therefore was in the best interest of the company. Id. at 947; see 25 MODERN L. REV. 715, 715–16 (1962).
been created by the diverse treatment afforded past service compensation arrangements by American courts. The unpredictability of the result in most cases has not been nearly as great as the unpredictability of the approach taken by the court. "The "legitimate business purpose" test, if substituted for the consideration requirement, would change the result in few cases but it would permit courts to deal directly with the crucial issue — whether the transaction in question is intended to benefit the corporation — thereby giving greater assurance that a desirable result will be reached by applying a single standard.

A. BONUSES TO ACTIVE EMPLOYEES

The application of the legitimate business purpose test to representative American cases clearly illustrates its efficacy in focusing on what must be the underlying rationale for the court's result. In Holmes v. Republic Steel Corp.,26 an objecting shareholder contended that payment of a $51,000 bonus in addition to a $175,000 salary to the president of Republic was ultra vires. The court, after finding that the president's salary was "fixed" in accordance with an applicable statute27 by a director's resolution providing for $175,000 "plus any additional amount, if any, as the board of directors may determine prior to Dec. 31, 1940,"28 determined that the consideration requirement was satisfied by an implied promise to pay additional compensation in good years.29 The court obviously felt constrained to reach this result because of evidence that the president had earned $359,000 in his last year with his previous employer. An opposite result in Holmes would have been an unjustifiable judicial interference with a legitimate business transaction. It was clearly in the shareholders' interest for the company not to "fix" the president's salary at the much higher level that would have been required had the bonus system failed,30 for under the bonus plan, the

27. N.J. Stat. Ann. § 14:3-1 (1939). Every corporation shall have power to:
   e. Appoint such officers and agents as the business of the corporation may require, and fix their compensation.
28. 84 Ohio App. at 450, 84 N.E.2d at 512. The board's resolution could in no way be construed to be an offer for a unilateral contract, since the promise of additional compensation was patently illusory.
29. Church v. Harmit, 38 F.2d 499 (6th Cir. 1929), which involved similar facts, provided adequate authority for upholding the bonus in Holmes once the existence of an implied contract had been established.
30. See McGuire, Chiu & Elbing, Executive Incomes, Sales and Profits, 52 Amer. Econ. Rev. 753 (1962). This Article suggests that a greater correlation
president received additional compensation only when justified by earnings generated by his management of the company. The bonus in *Holmes*, or any bonus paid in good faith, with a long-run intent to benefit the corporation, is not the proper subject of judicial review. That is not to say, however, that courts should not stand ready to intervene where gratuitous distributions do not appear to have a legitimate business purpose. In evaluating directors' intent, an objective test should be applied which measures the circumstances surrounding any distribution in question against the standards and requirements of that industry.

Stock options were granted in *Frankel v. Donovan* by a corporation as additional compensation to provide an incentive for key executives and retain the services of executives that might otherwise leave. Although the court took notice of the company's salary ceiling "which was fixed at an unrealistic level by an obsolete federal law," it nevertheless held that increased loyalty and job satisfaction among employees is not adequate consideration to support an option plan. The court found that unless provision be made to prevent an employee from taking his options and leaving prior to rendering the services expected in return for the options, the stock-option plan lacked adequate consideration.

A court applying the legitimate business purpose test would likely have reached a contrary result on the basis that the low ceiling imposed on salaries made a supplemental compensation plan necessary in order to retain competent employees.

Where a corporation grants stock options to its employees exercisable within five years whether or not the employee remains in the employ of the granting corporation, objectively, the primary purpose of the plan does not appear to be to benefit the corporation. Although the option plan might have been intended

exists between volume of sales and executive compensation than between profits and executive compensation. The conclusion that seems to follow from that study is that lower executive salaries supplemented by a bonus plan based on profits would be desirable from the shareholder's viewpoint.

31. 35 Del. Ch. 433, 120 A.2d 311 (New Castle 1956).
32. Id. at 438, 120 A.2d at 314. The company was a federally subsidized shipping line, subject to salary limitations imposed by the Merchant Marine Act of 1936. 49 Stat. 1985. The Act was repealed in 1952.
33. Provision was made for the option to terminate three months after an employee left his employment, but apparently this was not adequate precaution. Id. at 436, 120 A.2d at 313.
34. See Holthusen v. Edward G. Budd Mfg. Co., 52 F. Supp. 125 (E.D. Pa. 1944). The corporation in *Budd* provided that stock options were not exercisable after the holder's employment was discontinued "unless otherwise specified by the Board of Directors." That plan failed because the bonus had no relation to the services rendered since the optionees undertook no obliga-
to reward past service, it is more likely that it was intended to provide an incentive for employees to strive for greater corporate profits in the future. Where an employee quits immediately after receipt of such an option, retaining the right to exercise that option five years later, the purpose of the plan might be frustrated. Yet the granting of options, whenever exercisable, acts to deter an employee from quitting, since as an option holder he has an incentive to stay with the corporation and direct his efforts toward higher corporate profits and the enhancement of the value of his option. Where an option is granted expressly in exchange for an employee’s promise to continue his services, obviously, a much stronger case is presented to support the directors’ legitimate business purpose.86

Even though there is no precisely defined relationship between a reasonable bonus for purposes of benefit to the corporation and a reasonable bonus for purposes of an income tax business deduction, advertizing to the latter standard might be helpful in resolving the former question; however, the consideration rule would disclaim any relationship, while the legitimate business purpose test might recognize one. For example, in Fry v. National Rejectors, Inc.,86 the executors of a deceased corporate officer’s estate sought to recover the full amount of an outstanding bonus. The Internal Revenue Service had previously disallowed as a business deduction the difference between a bonus of 12 1/2 percent and 20 percent of the profits in excess of $300,000 as excessive compensation.87 The Missouri court could well have held as a matter of law that such a bonus was an attempt to benefit an individual employee at the expense of the shareholders and that no intent to benefit the corporation can be found when it is known that such payments will incur tax deficiencies.86 The Treasury Regulations clearly state that a bonus paid in good faith as additional com-

36. 306 S.W.2d 465 (Mo. 1957).
37. The bonus agreement provided for modification or discontinuance of payments in case of “unusual or extraordinary contingencies.” The court held that the assessment for tax deficiencies due to the “excessive” compensation plan was such an “unusual or extraordinary contingency” so as to justify reducing the bonus to 12 1/2 percent.
38. In that sense, Internal Revenue Service findings should raise a pre-
Compensation for services actually rendered is deductible if, when added to the salary already paid, it does not exceed reasonable compensation for the services rendered. This indicates that reasonable bonuses based merely on past services are deductible as ordinary and necessary business expenses, and a finding of deductibility might well serve as evidence of the reasonableness of the corporate expenditure.

An early Missouri case, Putnam v. Juvenile Shoe Corp., indicates the utility of the legitimate business purpose test. The board of directors appropriated $50,000 for the purpose of paying bonuses to the employees, the amounts of the bonuses “to be determined by the president in view of the services rendered by each.” The bonuses, ranging from $50 to $18,800, were paid only two months after the inception of the plan, the latter amount being paid to the president himself. Relying mainly on the English “benefit” rule, the court had no difficulty upholding the legality of the bonuses.

An expected bonus, based upon results, tends to discourage and expose employees who are inclined to be lazy, thoughtless, inefficient, and...

...to the validity of bonuses, since loss of a deduction for a bonus would seem to be prima facie evidence that the bonus was not beneficial to the corporation. I.R.S. findings should be given prospective effect only; bonuses paid prior to notice of disallowance should be tested on the basis of the good faith intent of the directors to benefit the company. It is not the wisdom of the findings that necessarily makes them important; but the adverse effect a disallowance has on profits available to stockholders should cause grave doubt as to the intent of the directors to benefit the company. In evaluating bonuses, the Treasury Department seems most concerned with attempts to distribute earnings to owners of businesses and attempts to purchase property through the guise of deductible bonuses. See Int. Rev. Code of 1954, § 162(a)(1); Treas. Reg. § 1.162-7 to -9 (1963).


Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though...it may prove to be greater than the amount which would ordinarily be paid.

(Emphasis added.)

41. 307 Mo. 74, 269 S.W. 593 (1925).
42. Id. at 83, 269 S.W. at 594.
43. Apparently the president did a great deal of traveling and was a successful salesman of shoes—not his primary duty as president. Net profits for the year in question were $150,000 before payment of the bonuses. Id. at 88, 89, 269 S.W. at 594, 595.
wasteful. Experience has demonstrated that the payment of a bonus  
... is advantageous to stockholders of corporations employing labor.44

The propriety of the result in Putnam is not relevant for present purposes, but the approach taken by the court, standard in other areas of business and corporate law,45 is worth noting: The court first determined that no fraud had occurred, then that the plan was intended to benefit the company, and last, that the court would not substitute its judgment for that of the directors.

B. RETIREMENT COMPENSATION

American courts have had a more difficult time finding the existence of consideration for an agreement to pay a bonus or pension when the recipient of such compensation is no longer employed by the granting corporation. Lost, at that point, is the argument that payment of the bonus will provide to the employee "an incentive to retain his services, sharpen his interest, intensify his zeal, spur him on to more ardent effort in the interest and for the benefit of the company, and to enable him thereby to share in the resulting success of the enterprise."46 As a result, corporations have resorted to the "noncompetition" contract, an agreement by the retired employee not to compete with the granting corporation, in order to meet the consideration requirement.47 The problem of finding consideration for pension contracts, however, has diminished in recent years with the advent of formal pension plans.48

In Fogelson v. American Woolen Co.,49 a corporation proposed to pay $4,000,000 into a pension trust fund, computing the pen-

44. Id. at 91, 269 S.W. at 596.
45. Absent fraud, courts generally will not review the expediency of contracts or other business transactions authorized by the directors. See BALLANTINE, CORPORATIONS § 63a (Rev. ed. 1946).
47. See cases cited note 14 supra and accompanying text.
48. See O'Neal, Stockholder Attacks on Corporate Pension Systems, 2 Vand. L. Rev. 351 (1949). The consideration problem still exists in formal pension plans where the pension agreement is entered with an employee substantially after the inception of his employment. Since retirement income is usually based on years of service, where an old employee contracts for a pension based on his total term of employment, those pension rights which vest in him immediately are based on past services rendered. Such a retirement plan was upheld in Meyers v. Cowdin, 47 N.Y.S.2d 471 (Sup. Ct. 1944), aff'd without opinion, 270 App. Div. 827, 60 N.Y.S.2d 129 (2d Dep't 1946), aff'd without opinion, 296 N.Y. 765, 70 N.E.2d 555 (1946).
49. 170 F.2d 660 (2d Cir. 1948).
sions on a percentage formula according to the employee’s salary and length of service; on the basis of the plan the president of the corporation was eligible for a $54,000 annual pension beginning the following year, and the next highest pension was to be only $7,285. Because there was no evidence establishing that the large pension was necessary to retain the president’s services, the Second Circuit concluded that the $54,000 pension might have been intended primarily to benefit him personally. The court reversed the summary judgment entered below against the objecting shareholders and held that a triable issue of fact existed on whether the president’s pension would amount to an illegal gift. Fogelson seemed to turn on the reasonableness of the amount payable to the president in relation to the possible benefit to be derived by the corporation rather than on the failure of the plan to meet the consideration requirement, for the validity of the remainder of the pension plan was implicitly upheld by the court despite its past-service benefits. Although the court may have been applying the English “benefit” rule, the unnecessarily broad language employed severely limits the value of the decision as authority for any rule.

Probably the greatest obstacle to pension payments based on past services is the decision of the Pennsylvania court in Moore v. Keystone Macaroni Mfg. Co.51 Upon the death of the president-founder, the corporation voted to pay $2,083 per month to his widow “in recognition of . . . valued services rendered . . . by her deceased husband.”52 In an action contesting the plan brought by a minority shareholder, the court went so far as to assume that the payments to the widow were intended by the directors

50. Cf. Blish v. Thompson Automatic Arms Corp., 30 Del. Ch. 538, 64 A.2d 581 (Sup. Ct. 1948), 25 IND. L.J. 212 (1950). A past-service bonus was upheld by the court on the apparent “theory” that because the amount was reasonable, the consideration requirement was satisfied. Blish seems to represent merely a liberal application of an old rule rather than any type of new approach.


52. 370 Pa. at 175, 87 A.2d at 297. A Pennsylvania statute allowed pensions to retired employees, but the court, in not mentioning the statute, must have concluded that it didn’t apply to widows of employees. Pa. Laws 1933, act 364, art. III, § 316. In 1957, act 711, § 1 was enacted which directly overruled Moore. Pa. Sess. tit. 15, § 2852-316 (1958). It specifically provided for, inter alia, pensions to widows of employees. In Osborne v. United Gas Improvement Co., 334 Pa. 57, 46 A.2d 208 (1946) the Pennsylvania court upheld a pension plan based, in part, on past services. The only legally significant distinction between Osborne and Moore is the fact that Moore involved a pension to the widow of a deceased employee; whereas, in Osborne the pension was payable to retired employees only, thereby falling precisely within the 1933 statute
to be for the best interests of the corporation, and the court also took judicial notice of the Treasury Regulation which specifically allowed deduction as an ordinary and necessary expense that amount of a deceased officer's salary which is paid to his widow. Nevertheless, since the corporation was not legally obligated to make such payments, the court held that the corporate action amounted to an illegal "giving away" of corporate assets and ordered the widow to repay the $24,000 she had already received and held the directors accountable for any balance left unpaid by the widow.

On the facts as assumed by the court in Moore, an untenable result was reached. The case should have been remanded for trial of the question of whether or not the directors' action was intended in good faith to benefit the corporation and whether the amount of the pension was reasonable under the circumstances. By basing its decision solely on lack of consideration, the court reached an unsound result. On the basis of the Moore decision, a $50 per week pension to the widow of a deceased worker is ultra vires, even though the corporation may suffer damage to employee morale and to its reputation in the community by not paying the pension. "Good will" represents a substantial portion of the value of a going concern, and corporate directors should be given as much freedom as possible in their efforts to protect that asset. The fiduciary capacity in which directors hold corporate assets cited above. From the standpoint of the public policy considerations which must have motivated the enactment of the 1933 statute, the distinction between allowing pensions to retired employees and allowing pensions to the families of deceased employees is tenuous.

53. 370 Pa. at 176, 87 A.2d at 297.
54. Id. at 178, 87 A.2d at 298. The regulation in point was Treas. Reg. 111, § 29.2923(a)-9 (1943). The court found it to be irrelevant that the payments in question were deductible for federal tax purposes. 370 Pa. at 178, 87 A.2d at 298.
57. "Good will" has been defined as "the fixed and favorable consideration of customers arising from an established and well-conducted business." Colson v. Duvall, 254 Mich. 346, 349, 387 N.W. 48, 49 (1931). "The good will of a business is property which the law protects and for injuries to it damages may be recovered." Sessinghaus Milling Co. v. Hanebrink, 247 Mo. 212, 222, 162 S.W. 354, 357 (1913).
imposes a negative duty on them to refrain from wasting corporate assets. An affirmative duty, however, is also imposed, requiring fiduciaries to conserve and enhance the value of the assets they hold. The line where “good will” protection ends and “giving away” of assets begins lies somewhere in the broad area of past-service compensation. When the existence of this division is recognized by American courts, the location of the line will follow on a case-by-case basis.

CONCLUSION

“Legitimate business purpose” as a substitute for consideration in testing the validity of corporate compensation agreements is not a concept which will necessarily make the court’s task easier. The evidentiary problems in establishing the absence of fraud, determining a standard of “reasonableness,” and analyzing the objective intent of directors will raise difficulties. By using a business oriented approach in resolving what is necessarily a business problem, however, courts will not lose sight of their real purpose—that of protecting shareholders and creditors from abuses of discretion by corporate directors. Application of traditional contract law doctrine in this area requires excessive formality and imposes an undue burden on the imagination of corporate attorneys by requiring them to invent “benefits conferred” or “detriments incurred” by employees in order to establish the existence of consideration. Corporate compensation should be governed by a body of law that can, independently, grow and change with business needs.