

# THE CORPORATION EXECUTIVE AND HIS PROFIT-SHARING CONTRACT

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THE importance of good management to corporate enterprise has never been more apparent than during the last few years of depression and uncertainty. Executives of known ability are in a position to insist on tenure and reward. At the same time, a board of directors which is negotiating with a prospective manager is likely today to drive a harder bargain than it might have in 1929. The directors want results for their money; the executive wants a substantial reward for producing the desired results. Accordingly, we find a very large number of corporations employing their executives under arrangements in which compensation is largely contingent upon success.<sup>1</sup> We find also that these arrangements are being prepared with increasing care. The executive head of a large corporation might formerly have been content to serve from year to year on a salary fixed at the beginning of each year by simple resolution of the directors. Today, he is likely to ask for a carefully prepared contract giving him several years' tenure and a share of the company's profits. The purpose of this Article is to examine the problems of drafting which arise in this situation, and to discuss in some detail the provisions of a number of contracts in actual use. While particular emphasis will be placed upon profit-sharing clauses, consideration will be given to all of the usual provisions of executives' employment contracts.

## PRELIMINARY CONSIDERATIONS

First, as to the substance of the arrangement. A fixed salary will normally be required—a sum which the executive can count on in any event.<sup>2</sup> In addition, the parties will wish an “incentive” compensation.

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1. BAKER, EXECUTIVE SALARIES AND BONUS PLANS (1938) 16 *et seq.*, states that executive bonus plans were seldom used prior to 1914; that in 1928 some 64% of a group of companies studied had adopted such plans; that the depression curtailed the use of bonus systems; and that the number functioning had fallen off substantially by 1932, the latest date for which figures are given. Although the present writer cannot offer precise statistics, his experience leads him to believe that the past three years have witnessed a very widespread revival of the bonus system. Mr. Baker's book discusses compensation arrangements from the economic rather than the legal point of view. However, like many other books intended for the economist and business man, it has considerable value to the lawyer, and will frequently be mentioned in the following pages. It is cited herein as BAKER.

2. The Woolworth contracts, described *infra* note 17, are exceptional in providing for no fixed salary. See BAKER, 190. The background of the Woolworth compensation plan is sketched in WINKLER, FIVE AND TEN (1940) 61, 106, 125-126, 137, 142.

This "incentive" can take any one of a large number of forms: a cash bonus, a stock bonus, an interest in an investment fund, or any combination of these. The measuring rod of the added compensation is usually corporate earnings, dividends,<sup>3</sup> sales,<sup>4</sup> or some other significant figure. The cash bonus based on a percentage of the company's earnings is one of the most common forms of incentive compensation, and it is that form which is the principal subject of this Article. In granting additional compensation, the corporation may set up a "bonus fund," in which two or more executives will share in designated proportions,<sup>5</sup> or it may enter into a separate contract with each executive who is to receive a percentage of earnings.<sup>6</sup> Our discussion here will center about the latter alternative, though the problems involved in drafting "bonus fund" contracts are very similar, and will be referred to occasionally.<sup>7</sup>

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3. See Eastman Kodak Co. plan, referred to in BAKER, 200, and revised Bethlehem Steel Corp. plan, discussed in BAKER, 210.

4. Executives in charge of distribution are often granted additional compensation based on increases in volume of sales. Compare the provisions of the Woolworth contracts, *infra* note 41.

5. Such funds are in common use. See BAKER, 209, 210, 214; *Rogers v. Hill*, 289 U. S. 582 (1933); *Berendt v. Bethlehem Steel Corp.*, 108 N. J. Eq. 148, 154 Atl. 321 (1931); *Gallin v. National City Bank*, 152 Misc. 679, 273 N. Y. Supp. 87 (Sup. Ct. 1934), *s. c.*, 155 Misc. 880, 281 N. Y. Supp. 795 (Sup. Ct. 1935) (report of Referee). See also bonus fund plan of Container Corp. of America, attached to proxy statement for stockholders' meeting of April 25, 1940. On the question of the application of INT. REV. CODE § 165 to executives' bonus funds, see Reg. 101, Art. 165-1. For an investment fund plan, see *Coats v. General Motors Corp.*, 11 Cal. (2d) 601, 81 P. (2d) 906 (1938).

6. Bonus plans can, of course, be adopted in various ways. Baker, writing in 1938, studied 30 large industrial companies with definite bonus plans (200, 201). These were established in the following ways: sixteen by directors' resolution, six by contract with executives, four by resolution and contract, three by by-law, one not reporting. Establishment by contract seems on the whole the most desirable method, as adoption through by-law seems to impart too much rigidity, at least if the by-laws can be amended only by stockholder action. Bonus plans should be flexible and subject to frequent review by the directors. In any event, the executive's attorney will doubtless deem it advisable to have his client's percentage arrangement embodied in a contract rather than in a by-law.

7. See note 45 *infra*, and note 5 *supra*. Occasionally, a corporation will contract with a partnership or another corporation for the furnishing to it of executive management. Thus, in 1928, Warner Bros. Pictures, Inc., and Renraw, Inc., entered into a contract whereby the former would pay to Renraw, Inc., certain sums for the services of Harry M. Warner, Albert Warner and Jack L. Warner. For the text of this contract, see *Koplar v. Warner Bros. Pictures, Inc.*, 19 F. Supp. 173, 179-182n. (D. Del. 1937); *cf. Sherman & Ellis, Inc. v. Indiana Mutual Casualty Co.*, 41 F. (2d) 588 (C. C. A. 7th, 1930); STEVENS, CORPORATIONS (1936) 558-559.

The possibilities of forms of incentive compensation other than those here discussed should not, of course, be overlooked. Success of a particular plan depends upon the requirements of the corporation's business. Compare BAKER, 245: "Plans doubtless should be adapted to meet company and industrial needs . . . Satisfactory solutions in any area will not be 'ready made' ones; rather they will be 'made to order.'" For example, the stock option plan, among other advantages, offers the desirable feature of not requiring

A cash bonus based on a percentage of earnings—the “percentage participation” plan—is said by its proponents to offer a powerful inducement to the management to increase the company’s earnings. It is argued that the corporation can cut its fixed expenses by offering to the executives salaries of only moderate size, holding out as bait the prospect of substantial bonuses dependent on the future success of the business.<sup>8</sup> Stockholders, it is claimed, should be willing to pay a higher rate of compensation if and when the corporation makes increased earnings. Considerations such as these have led the courts to sustain the validity of profit-sharing contracts, if properly adopted.<sup>9</sup> Further, in corporations where ownership and active management are in different hands, it might even be contended that the stockholders should receive only that portion of the profits which is “sufficient to insure the continued supplying of capital and taking of risk,”<sup>10</sup> granting to management the remaining profits as a reward for efficiency, on the premise that the general good is best served by encouraging profitable and efficient business enterprise.<sup>11</sup>

That, at least, is one side of the picture. On the other side, there is the fact that executives sometimes ask and obtain a “minimum” salary that is unconscionably high, with the acquiescence of an indifferent or controlled board of directors, and secure in addition an unduly large percentage of the profits.<sup>12</sup> It is also true that business leaders often

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the expenditure of corporate funds—in fact, it brings new funds to the business. An incentive is provided by giving an option at higher prices than those presently prevailing, so that if the market price of the company’s stock rises (presumably through the management’s good work for the corporation), the executive will find it advantageous to exercise the option. See *McQuillen v. National Cash Reg. Co.*, 27 F. Supp. 639 (D. Md. 1939); Baker, *Stock Options For Executives* (1940) 19 HARV. BUS. REV. 106.

8. Baker offers data to refute this argument, concluding: “There is no evidence that the use of bonus plans lowered the regular cash salaries paid executives. Instead there is definite evidence that companies paying bonuses paid larger total compensation to their officers than did non-bonus-paying companies.” (222, 236). He also points out that bonus-paying companies had a somewhat smaller decline in earnings in 1928-1932 than did non-bonus-paying companies, but it seems doubtful that any significant trend is shown. (40-41, 44, 69, 107).

9. See *Putnam v. Juvenile Shoe Corp.*, 307 Mo. 74, 90, 269 S. W. 593, 596 (1925); *Gray & Co. v. United States*, 35 F. (2d) 968, 974 (Ct. Cl. 1929). As to the formalities of adopting the contract, see Comment (1934) 32 MICH. L. REV. 672. Corporations having securities listed on a national securities exchange must observe Rule X-14A-1 of the Securities and Exchange Commission, and particularly Schedule 14A, Section D, Item 7 of that Rule. See also Washington, *The Corporation Executive: His Living Wage*, shortly to be published in the Harvard Law Review.

10. See BERLE & MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) 342-343.

11. Compare O’LEARY, *CORPORATE ENTERPRISE IN MODERN ECONOMIC LIFE* (1933) 37; BERLE & MEANS, *op. cit. supra* note 10, at 343, 350.

12. See WORMSER, *FRANKENSTEIN, INCORPORATED* (1931) 115-123; REIS, *FALSE SECURITY* (1937) 22-23.

credit themselves with having produced the huge earnings of 1926-1929, without accepting any responsibility for the falling off of earnings during the depression. Be that as it may, prevailing business opinion awards to management credit for earnings, however produced, and management generally will not be satisfied unless it receives a share.<sup>13</sup> It must be admitted, of course, that a change of executives can make all the difference between a surplus and a deficit for an individual enterprise. Real managerial ability is something worth paying for, even though the executive may in fact be receiving a portion of an earnings increase due rather to general business conditions (or, of late, to government contracts awarded under the defense program) than to his own efforts.<sup>14</sup> If an attempt is made to limit the executive to a share of those profits which he himself has helped to produce, experience shows that certain contractual limitations may well be imposed.<sup>15</sup>

Assuming, then, that the parties have finally decided upon the percentage participation plan, and have reached an agreement upon the precise amount of the fixed salary to be paid as well as the precise percentage of the profits which the executive is to receive,<sup>16</sup> let us turn to the problems of draftsmanship presented.

#### DRAFTING THE CONTRACT

As has been indicated above, there is no "ideal" form of bonus contract; the needs of the individual business must control the substance and form of the final arrangement. As a compensation contract which has worked out well in one business may be unsatisfactory in another, it is inadvisable to rely too completely on any form of model contract. With this caveat, it may be explained that the form which follows is a composite, derived from several similar contracts in whose drafting the present writer assisted. These contracts, which have proved satisfactory in operation, were drawn for industrial corporations of medium size. To provide a basis of comparison, the writer has obtained copies of the

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13. It has been suggested that even where compensation to management is confined to payment of large flat salaries, these rewards "should probably be looked upon as a form of commuted profits . . ." O'LEARY, *op. cit. supra* note 11, at 29. See also Taussig & Barker, *American Corporations and Their Executives* (Nov. 1925) 40 Q. J. ECON. 1, 40.

14. BAKER, 227, lists numerous causes for increases in earnings, beyond the control of management. See also O'LEARY, *op. cit. supra* note 11, at 36; KENNEDY, *DIVIDENDS TO PAY* (1939) 114-135.

15. See pp. 52-54 *infra*.

16. On the subject of judicial review of the "reasonableness" of the compensation paid to corporation executives, see Washington, *The Corporation Executive: His Living Wage*, shortly to be published in the Harvard Law Review. This subject is noted in (1931) 41 YALE L. J. 109, (1933) 42 YALE L. J. 419, (1933) 46 HARV. L. REV. 828, (1934) 32 MICH. L. REV. 672.

compensation contracts of the principal executives of certain large corporations,<sup>17</sup> to which reference will frequently be made.

17. The contracts referred to were obtained from the files of the Securities and Exchange Commission. The starting point was a list of 105 companies, given in the *New Republic* for December 27, 1939, which were among the corporations reporting to the SEC the payment of compensation of \$25,000 or more to an officer or director in 1938. All of these companies appear to have securities listed on national securities exchanges, and are hence required to file registration statements with the SEC under the Securities Exchange Act of 1934. At the writer's request, the Commission examined its files to discover whether each of these companies had deposited a copy of the employment contract of its principal executive, and reported that in eleven instances copies of such contracts had been deposited. In the case of a twelfth company—F. W. Woolworth & Co.—the desired contract was not available, but there had been deposited copies of form contracts entered into by that company with certain of its officers. The Commission's search was made on or about March 23, 1940; a further search was made on or about July 23, 1940, bringing up to that date the information previously obtained. The Commission's requirements as to disclosing the terms of employment contracts, under the 1934 Act, are to be found in Form 10 for Corporations (Application for Registration), Items 29 and 30, and Exhibit "F"; Form 10-K for Corporations (Annual Report), Items 5 and 6; Form 8-K for Current Reports, Items 1 and 2, and 5. In the agreements at hand, most of the provisions follow a normal pattern, though in view of the smallness of the sample the writer's conclusions as to general practices have not been based solely on this group of contracts. These agreements are described in the following table:

<i>Company</i>	<i>Executive</i>	<i>Date of Contract</i>	<i>Type ***</i>	<i>Description Hrcin</i>
Allied Stores Corporation	B. E. Puckett	Feb. 1, 1940	S. & P. P.	Allied
Bloomingdale Bros., Inc.	M. Schaap	Feb. 2, 1935	S. & P. P.	Bloomingdale A
		Jan. 19, 1937	Am.	" B
		Jan. 7, 1938	Am.	" C
Burlington Mills Corporation	J. S. Love	Dec. 29, 1939	S. & P. P.	Burlington
Columbia Broadcasting System, Inc.	W. S. Paley	June 18, 1934	S. & P. P.	Columbia A
		April 26, 1935	Am.	" B
		Nov. 9, 1937	Am.	" C
		Feb. 14, 1940	Am.	" D
Eastern Air Lines, Inc.	E. V. Rickenbacker	April 14, 1938	S. & Stk.	Eastern
Esquire-Coronet, Inc.	D. A. Smart	April 1, 1937	S.	Esquire
Fairbanks, Morse & Co.	R. H. Morse	July 8, 1936	S.	Fairbanks A
		Dec. 13, 1938	S. & P. P.	" B
*Federated Department Stores, Inc.	F. Lazarus, Jr.	March 2, 1932	S.	Federated
Wm. Filene's Sons Company	A. L. Filene	Sept. 1, 1928	S.	Filene A
		Jan. 23, 1940	Am.	" B
		July 5, 1934	S.	Lorillard
P. Lorillard Company	D. H. Ball	July 5, 1934	S.	Lorillard
National Container Corporation	S. Kipnis	March 8, 1937	S.	National
F. W. Woolworth Company	_____**	No date	P. P.	Woolworth A
		(Exhibit F)		
	_____**	No date	P. P.	" B
		(Exhibit F 1)		

\* Contract entered into between F. Lazarus, Jr., and F. & R. Lazarus & Co., reported to be a subsidiary of Federated Department Stores, Inc.

\*\* Form contract; executives' names omitted in filed form.

\*\*\* Types of contract: S.—Salary; P. P.—percentage participation; Stk.—stock option; Am.—amendatory contract.

It is worth noting that even though the negotiations leading up to the final contract may be characterized by considerable firmness on both sides, they are hardly likely to be carried on in a "pound of flesh" atmosphere. The company's representative does not want to take unfair advantage of one of the present or future executives; in fact, he may not be sufficiently hard-boiled in his attitude, particularly where one of the present managers is concerned. The executive, for his part, seldom insists on a provision which would be obviously detrimental to the corporation. Both sides recognize, without much being said about it, that the contract will not be quite so hard-and-fast as it looks on paper. If conditions change so that the compensation becomes inadequate, the executive will probably be able to persuade the board of directors to amend the contract to provide for a higher rate. An executive who is held to his contract against his will is not likely to be of much value to the business. If, on the other hand, the company falls on hard times, a request by the board that the executive accept less than the contracted amount will very often be honored. The discussion which follows should, therefore, be read with the realization that any hardships resulting from the operation of the agreement will probably be corrected as they arise by amendatory contracts.<sup>18</sup>

Let us now examine, clause by clause, a typical profit-sharing contract.

#### *The Hiring Clause.*

"1. The Corporation agrees to and hereby does employ the Executive, and the Executive agrees to and hereby does enter the employ of the Corporation, as manager [chief executive] of the Corporation in charge of the operation of its business and affairs, subject to the supervision and direction of its Board of Directors, for a period beginning ....., 1940, and ending ....., 19....., unless sooner terminated pursuant to the provisions of paragraph 7 below."

This clause presents primarily the question of the duration of the term and the nature of the office to be occupied. Many attorneys feel that it is not desirable to hire an executive to serve for a fixed number of years as "president" or "vice-president," or to fill any other by-law office, since as a technical matter the officers must in most jurisdictions be elected yearly by the board of directors.<sup>19</sup> In fact, the most desirable

18. Note that six of the agreements, *supra* note 17, are amendatory contracts.

19. In the following contracts the executive is named to a definite post:

ALLIED, ¶ 1: "General Manager."

BLOOMINGDALE A, ¶ 1: "General Manager of the business."

COLUMBIA A, ¶ 1: "President and General Manager."

EASTERN, ¶ 1: "General Manager . . . and, so long as he shall be elected to such office, as President of the Corporation."

ESQUIRE, ¶ 3: "President of the Company, and in the event that at any time the Board of Directors of the Company shall fail

form of hiring clause from an employer's point of view is one which simply "employs" the executive without describing his position, or one which engages him "to perform such duties as the Board of Directors shall from time to time assign to him."<sup>20</sup> Ordinarily, however, the executive will insist that the dignity of his position be safeguarded as carefully as the circumstances will permit. This is sometimes accomplished by using a general clause of the type just mentioned, accompanied by a statement that the duties initially to be performed by the employee shall be those of "general manager," "chief executive," "manager of sales in the New England territory," or the like, with the further provision that any change in the duties or rank of the executive shall be only to a post of equal or greater dignity and importance. The executive also may wish to have it provided that any such change shall only be made after obtaining his prior consent in writing, or that he shall not, without his consent, be assigned to duties outside a given state or group of states.

The powers of the executive are seldom affirmatively enumerated, though special circumstances may occasionally make this desirable.<sup>21</sup> If the executive is named to a definite post, the title given may indicate his powers and responsibilities. Further, the executive's duties are generally stated in the clause which is about to be discussed, and from this statement of duties there can no doubt be derived a grant of power.

#### *The Performance Clause.*

"2. The Executive agrees to devote all of his time and effort to the performance of his duties as manager [chief executive] of the Corporation, and to the performance of all of the duties of office of

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to elect him as President of the Company, or shall remove him as President, he shall be free, if he so elects, to cancel this Agreement."

In the following contracts, the executive's position is described more generally:

FEDERATED, ¶ 2: "a manager of the business."

FILENE A, ¶ 1: "a manager of the business."

In BURLINGTON, ¶ 1, the corporation merely agrees to "employ" the executive. In WOOLWORTH A and WOOLWORTH B, which are form contracts, there is apparently no express covenant of employment by the corporation.

20. See clause quoted *infra* note 22.

21. ALLIED, ¶ 1: "During the term of the employment hereunder, Puckett shall be the General Manager of Allied and its subsidiary, Allied Purchasing Corporation, and shall have the full control and management of the business and affairs of Allied and Allied Purchasing Corporation subject to the powers by law vested in the Board of Directors, the Executive Committee, and the officers of Allied and Allied Purchasing Corporation."

FAIRBANKS A: "[The Company employs the executive as General Manager] with authority to manage and control all of its operations and to hire and discharge and fix the compensation of all of its employees, excepting the officers thereof elected from time to time by its Board of Directors."

President of the Corporation or of any subsidiary or subsidiaries of the Corporation, if elected, all under the supervision and direction of their respective Boards of Directors."

This clause is generally somewhat broader in scope than the hiring paragraph, since it is a covenant by the executive rather than by the employer. The executive often agrees to perform any tasks demanded by the directors,<sup>22</sup> and sometimes to perform certain specified duties.<sup>23</sup> He almost always states that he will perform "faithfully and to the best of his ability,"<sup>24</sup> and will give "his entire time" to the business.<sup>25</sup> This last point is also dealt with in Paragraph 6 of the contract.<sup>26</sup>

*The Primary Compensation Clause.*

"3. For the services to be rendered by him hereunder, the Corporation agrees to pay the Executive, so long as he shall be employed hereunder,

(a) a fixed salary at the rate of \$..... per annum, payable in equal monthly instalments at the end of each month; and

(b) an additional sum (hereinafter sometimes referred to as

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22. The following clause appears particularly desirable from the employer's point of view:

BURLINGTON, ¶ 3: "Love agrees to serve the Corporation, and such of the Corporation's subsidiary companies as may be designated by the Corporation, faithfully, and to the best of his ability, under the direction of the Board of Directors of the Corporation and of such subsidiary companies, devoting his entire time, energy and skill during the regular business hours of such employment, and to be of good personal behavior and perform from time to time such services as said Board of Directors shall request, and to act as Director, President and any other officer of the Corporation and of any of its subsidiary companies, without further compensation."

23. See clauses quoted *supra* note 21.

24. "Faithfully and to the best of his ability": BURLINGTON, ¶ 3; FILENE A, ¶ 2.

"Faithfully and efficiently": BLOOMINGDALE A, ¶ 2.

"Faithfully and diligently": WOOLWORTH A, ¶ 1; WOOLWORTH B, ¶ 1.

"Faithfully and conscientiously": FEDERATED, ¶ 2.

"Diligently and to the best of his ability": EASTERN, ¶ 2.

"To use his best endeavor, judgment and energy to promote, improve and advance the business and interests of the Company": FAIRBANKS A.

25. "Substantially his entire time and attention": ALLIED, ¶ 1.

"Entire time, energy and skill during the regular business hours of such employment": BURLINGTON, ¶ 3.

"Entire time, skill and attention": COLUMBIA A, ¶ 2.

"Entire time and energy": EASTERN, ¶ 2.

"Such time and attention to the business of the Employer as may be fairly and reasonably necessary": FEDERATED, ¶ 2.

"Give his time and attention to the business without unreasonably absenting himself except by consent of the party of the first part": WOOLWORTH A, ¶ 1; WOOLWORTH B, ¶ 1.

26. See p. 59 *infra*.



'the Executive's percentage compensation') equal to \_\_\_\_\_ per cent of the adjusted consolidated net earnings of the Corporation and its subsidiaries<sup>27</sup> for each calendar year of his employment hereunder beginning January 1, 1940,<sup>28</sup> such sum to be computed and payable as provided in paragraph 4 below; provided always that the total percentage compensation payable to the executive under this contract during or for any calendar year shall not exceed the sum of \$\_\_\_\_\_”

The fixed salary provisions require no comment. As to the percentage compensation,<sup>29</sup> our first reference must be to the fact that the basic figure used is “the adjusted consolidated net earnings of the Corporation and its subsidiaries.” This is used rather than “the adjusted net earnings of the Corporation,” for the reason that a company which pays percentage compensation is likely to be a holding company, using consolidated financial statements in reporting to its stockholders.<sup>30</sup> It would, perhaps, be misleading and unfair to report to the stockholders on the consolidated basis and pay compensation on the parent company basis. It is arguable, at least, that the parent company as a separate entity might be able to show a profit at a time when its subsidiaries were losing money. At any rate, companies which report to stockholders on the consolidated

27. Or, in the case of a company without subsidiaries, “the adjusted net earnings of the Corporation.”

28. If the executive's employment does not begin at the start of the corporation's accounting period, it will be advisable to add a clause providing for ratable adjustment of the percentage compensation. This might be either a ratable portion of the earnings of the entire fiscal year, or a percentage of the earnings actually accruing during the months when the executive is on the job. This question assumes considerable importance if the executive is not hired until after the most profitable season of the year has passed.

29. The word “bonus” is very much in disfavor. The usual expression is “additional compensation” (COLUMBIA A, ¶ 3). BLOOMINGDALE A, ¶ 3, speaks of “a sum based on the net earnings of the Employer”; BURLINGTON, ¶ 4, of a “share of the profits”; WOOLWORTH A, ¶ 4, and WOOLWORTH B, ¶ 4, speak of “compensation equal to ... per cent of the net profits.”

FAIRBANKS B, ¶ (e) provides: “Nothing contained in this agreement shall be construed to give the party of the second part any interest in or to the surplus or net profits of the Company, it being agreed that the annual profits thereof are being adopted herein as a standard by which to measure the amount of the additional compensation payable under this agreement.”

That properly authorized percentage compensation is a true business expense rather than a division of shareholder's profits, see 1 WILLISTON, CONTRACTS (rev. ed. 1936) § 130 B and cases cited. Non-executive employees, such as salesmen, are frequently hired on a profit-sharing basis. See cases collected in GORDON, EMPLOYMENT AND AGENCY AGREEMENTS (1940) 153, 154, 157.

30. COLUMBIA A, ¶ 4, speaks of “annual consolidated net profits”; BURLINGTON, ¶ 5 (1), of “consolidated net profits of the Corporation and of its subsidiary companies”; ALLIED, ¶ 2, of “net profits”; BLOOMINGDALE A, ¶ 3 (A), of “net earnings”; WOOLWORTH A, ¶ 4, and WOOLWORTH B, ¶ 4, of “net profits.” If the employing corporation is a holding company, the expressions “net profits” or “net earnings” are ambiguous, and should not be used.

basis seem uniformly to use that basis in computing participations for executives.

Regardless of the position which we may take as to the suitability of consolidated balance sheets and consolidated income statements as a basis for declaring dividends or for other business purposes,<sup>31</sup> there seems to be no insuperable legal objection to the use of consolidated earnings figures as a base for percentage compensation. We are, after all, merely seeking a fair measuring rod of the success of the enterprise, and, in the case of a holding company, a consolidated statement prepared in conformity with good accounting practice doubtless provides such a measure.<sup>32</sup>

A further accounting question relates to the *period* during which the earnings are to be measured. The usual period is, of course, one year; corporations keep their accounts on a yearly basis, and the writer knows of no instance in which bonus compensation has been computed otherwise. However, it must be recognized that for many businesses the year is not a natural cycle; some companies would be justified in keeping their accounts on a two-year, three-year, or even five-year basis. Occasionally, we find wide fluctuations between the earnings of one calendar year and the next; the executive may receive a large bonus in the first year and none in the second, whereas if the company had been on a two-year accounting basis, he would have received a bonus of perhaps one-fourth of the amount actually paid. Ideally, perhaps, corporations should endeavor to determine what accounting system would properly reflect the conditions prevailing in their particular line of business, and then regulate their bonus payments accordingly.<sup>33</sup> This need not disturb the usual

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31. For a short treatment of the subject, see Berle and Fisher, *The Law of Business Accounting* (1932) 32 COL. L. REV. 573, 597-599.

32. A question may arise as to whether companies which are less than wholly owned should be included in the consolidation, though accepted accounting practice usually provides an adequate answer. COLUMBIA A, ¶ 5, states: ". . . there shall be included [in consolidated net profits], in the case of subsidiaries of which Columbia shall own less than the entire capital stock, only such part of their net profits as shall be applicable to dividends on stock of such subsidiaries held by Columbia." The same contract provides, at ¶ 8: "The term 'subsidiaries', as used herein, shall include future, as well as present subsidiaries, and shall mean any corporation more than fifty per cent. (50%) of whose stock entitled to vote for the election of directors is at the time owned by Columbia and/or any other subsidiary of Columbia."

One caveat is perhaps necessary. If the executive does not render services which benefit the entire group of companies, there is no justification for compensating him on the basis of consolidated earnings. In a chain-store organization, for example, the vice-president in charge of the midwest territory might deserve a bonus based on the earnings of the stores in his territory, but hardly one based on the consolidated earnings of the whole enterprise.

33. A parallel suggestion is that payments to stockholders should be based on some period other than one year. O'LEARY, *supra* note 11, at 38.

yearly audit and yearly report to stockholders. If a two-year cycle were decided upon, it would merely mean that the executive would receive a bonus every two years, based on the total earnings for that period. It is doubtful, however, whether any such plan would ever be widely adopted, inasmuch as the executive's own standard of living is generally based on yearly commitments for rent, taxes, and the like.<sup>34</sup> A desirable step in this direction can be readily accomplished, however, by providing for a carry-over of losses; that is, it can be agreed that the net loss of one year is to be carried over and offset against the profit of the following year, allowing the executive a percentage of the net amount remaining. If such a clause is used, it should probably be accompanied by a proviso that in no event shall the executive be required to refund to the company any compensation paid to him in a previous year.

It will be noted that the compensation clause includes a proviso which places a definite limitation on the amount payable. Sometimes, of course, the executive is given a fixed percentage of the company's net profits, regardless of the extent of the company's future earnings. In the event of unexpected success, the company may find itself paying to the executive a much larger dollar amount than was contemplated at the time the contract was signed.<sup>35</sup> In numerous instances, an executive in such a situation has consented to a reduction in the percentage rate. Even if no such reduction is made, many stockholders — perhaps most — would not object too strenuously to payment at the old rate, inasmuch as their own profits are being increased beyond their expectations. However, there may be stockholders who will raise objection, and it seems evident that the courts will give them support, at least in an extreme case. Thus, in the *American Tobacco* case,<sup>36</sup> the court had before it a by-law passed in 1912, giving the executives a total of ten percent of the net profits of the company above \$8,222,248.42. In 1921 this produced a bonus of less than \$360,000 for the managing group; in 1929 the operation of the by-law produced a bonus of \$2,670,000 for the group, paid in addition to salaries and other rewards. The United States Supreme Court, sustaining a minority stockholder's complaint, held that "the payments under the by-law have by reason of increase of profits become so large as to warrant investigation in equity in the interest of the company."<sup>37</sup> While the Court's

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34. It might also be difficult to work out a two-year plan which would not increase the executive's tax burden. Under some plans, the executive's bonus for a given year is payable in instalments over as much as four years. See BALDERSTON, *MANAGERIAL PROFIT SHARING* (1928) 83-84. This may aid in preventing management turnover but it hardly meets the problem of fluctuations in the company's earnings.

35. On the tax aspect of this situation, see MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* (Cum. Supp. 1939) § 23.81.

36. *Rogers v. Hill*, 289 U. S. 582 (1933).

37. *Per Butler, J.*, 289 U. S. 582, 591 (1933). The amounts produced by the by-law in the years prior to 1921 are not revealed in the opinions or the record on appeal, as the

decision might possibly have been different had the facts presented a recent contract, rather than an outmoded by-law, the teachings of the case are fairly plain.

Apart from the attitude of the courts, it is well to consider the public relations aspect of the matter. A large part of the public condemnation of bonus contracts, and of the litigation which they have all too frequently caused, has been based on the payment of fantastically large amounts arising from unforeseen increases in corporate earnings. Simply from the standpoint of keeping on good terms with stockholders and the public, executives should agree in advance to some definite limitation upon the total monetary amount payable to them. Limiting clauses of this nature are being used with increasing frequency,<sup>38</sup> often taking one of the following forms:

1. A ceiling may be imposed, by inserting a proviso such as that given in the text, limiting the gross amount payable.

2. A decreasing scale of percentages may be fixed in the contract. For example, the 1937 contract between William S. Paley and the Columbia Broadcasting System, Inc. ("Columbia C"), provides:

*"Additional Compensation.* As additional compensation, Columbia agrees to pay, and/or cause its subsidiaries to pay, to Paley five percent (5%) of the amount of the annual consolidated net profits of Columbia and its subsidiaries (hereinafter referred to as 'such net profits') up to \$1,000,000., plus four percent (4%) of the next \$1,000,000. of such net profits, plus three percent (3%) of the next \$1,000,000. of such net profits, plus two percent (2%) of the sum by which such net profits shall exceed \$3,000,000."<sup>39</sup>

Clauses such as the one just quoted are frequently used.<sup>40</sup> The drafts-

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plaintiff made no complaint concerning them. Another instance of compensation in excess of amounts originally contemplated is that of the American Woolen Co., discussed in BAKER at 227, 228, where stockholders' dissatisfaction led to the termination of the plan. Compare the language of Dibell, J., in *Seitz v. Union Brass & Metal Mfg. Co.*, 152 Minn. 460, 468-469, 189 N. W. 586, 589 (1922). See also KENNEDY, *op. cit. supra* note 14, at 117-118.

38. See BAKER, 208. A resolution proposed by a stockholder of the American Tobacco Co., designed to place a definite limitation on the amounts received by the company's executives, was defeated at a stockholders' meeting held on April 3, 1940. See N. Y. Times, April 4, 1940, p. 33, col. 1.

39. This represents an amendment of COLUMBIA A, ¶ 4, which provided for a bonus of 2½% of the consolidated net profits up to \$600,000, and 5% of such profits above \$600,000.

40. See, for example, the plan of the Corn Products Refining Co. as summarized in BAKER, 212. The opposite arrangement—an increasing scale—is, of course, also possible. BLOOMINGDALE B, ¶ 3, provides for a bonus of 1% on net profits (above preferred dividend requirements), 1½% additional on that part of such profits which is in excess of \$500,000, and 2½% additional on the part in excess of \$1,000,000. See also the plan of the Continental Oil Co. as summarized in BAKER, 212.

man may work out other means of limiting the amount receivable in an attempt to meet the needs of a particular business.<sup>41</sup>

A similar problem is raised by the stockholder's desire to obtain dividends, and the probability that he will be somewhat annoyed if the company, failing to pay a dividend, nevertheless pays substantial bonus compensation to its executives. Accordingly, many corporations include in their employment contracts clauses to the effect that no bonus compensation shall be payable for any year in which the stockholders have not received a dividend.<sup>42</sup> This is open to some objection. If the directors are unfriendly to the executives, they will simply fail to declare any dividend. If, on the other hand, they are over-friendly to the executives, they will declare dividends in some small amount for the sole purpose of justifying bonus payments. A clause which at least partly meets these objections is the following:

"No percentage compensation shall be payable to the Executive for or during any year in which dividends are not declared and paid in respect of shares of the common stock of the Corporation in an amount equal to or in excess of \$..... per share."

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41. FAIRBANKS B, ¶¶ (a) and (b), presents an interesting plan:

"(a) Upon the accounts of the Company covering its operations for each calendar year of the term hereof having been approved by its Board of Directors and audited and certified by a Certified Public Accountant there shall be deducted from the net profits for such year shown thereby a sum equalling six percent (6%) of the sum of its average outstanding Common Capital Stock during such year and its surplus and undivided profits at the beginning of such year as shown by its books of account, which deductions are hereinafter referred to as 'Capital Earnings.' The remainder after the deduction of such 'Capital Earnings' from the said net profits is hereinafter referred to as the 'Balance of Profits.'

"(b) Such additional compensation shall be that proportion of the annual salary paid to said party of the second part during such year as said 'Balance of Profits' shall bear to said 'Capital Earnings' above described, provided, however, such additional compensation in any year shall not exceed the amount of one hundred percent (100%) of said salary paid to said party of the second part for such year."

WOOLWORTH A and B grant a percentage of net profits derived from the sale of merchandise; WOOLWORTH A, ¶¶ 4 and 5, bases this on sales in stores owned or controlled by the Corporation; WOOLWORTH B, ¶¶ 4 and 5, bases this on sales in stores owned or controlled by the Corporation in the territory controlled by the district office managed by the executive.

42. None of the contracts here studied contains a clause of this precise nature. The Container Corp. bonus fund plan, *supra* note 5, provides: ". . . no such additional compensation shall be paid and no liability for such additional compensation shall be created or recorded as to any fiscal year in which no dividend has been paid on the capital stock of the Company." See also discussion of the Bethlehem and Westinghouse plans in BAKER, 210, 211, 214, and note 46 *infra*.

As a matter of recent history, however, it must be reported that corporations which have omitted a dividend simply have not paid executive bonuses for that year.<sup>43</sup> In some instances, this may be due to a generous renunciation on the part of the executive; in others, it may be caused by a feeling that if he does not voluntarily waive his bonus, his position in the corporation will be in jeopardy. It seems desirable, however, to put the matter beyond doubt by an express clause in the contract.<sup>44</sup>

This development can be carried one step further, by basing the executive's bonus not on earnings but on the amount disbursed to stockholders in the form of dividends. A plan of this nature was adopted several years ago by the Bethlehem Steel Corporation, after previous bonus plans had been subjected to attack in the courts.<sup>45</sup>

Plans of the type just mentioned, as well as plans which forbid bonuses in years in which dividends are not paid, are open to the possible objection that the directors may be tempted to favor the executives by declaring a dividend under circumstances in which the financial condition of the corporation really does not justify it. Although opinions may differ as to whether or not this is a serious risk, but little protection against it can be obtained, in any event, through contractual provisions. The stockholders must rely for their protection on the good faith and informed judgment of the directors; if the directors are dishonest or negligent, relief will have to come (if at all) through an action for violation of fiduciary duty.

Still another approach to the same problem is to give the executive a percentage of net earnings in excess of a stated amount (as in the *Tobacco* case), or in excess of a stated return on invested capital, or remaining after the payment of a dividend of specified amount.<sup>46</sup> Such

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43. See BAKER, 208.

44. At a stockholders' meeting of the Curtiss-Wright Corp., held on July 2, 1940, a resolution was defeated which proposed that no incentive compensation be paid officers and directors in any year in which a dividend of at least 10 cents a share was not declared on common stock. *N. Y. Times*, July 3, 1940, p. 31, col. 3. At a stockholders' meeting of the Pan American Airways Corp. on May 16, 1940, a resolution was defeated which proposed that no bonus compensation be paid to officers and employees "unless a dividend of at least like amount is distributed pro-rata among the stockholders." The management resisted this proposal as an unwise restriction on the judgment of the directors. See proxy statement, dated April 26, 1940.

45. See excerpts from the Bethlehem Steel Corp.'s plan given in BAKER, 210, 211. For a digest of the Westinghouse Elec. & Mfg. Co.'s bonus plan see BAKER, 214.

46. ALLIED, ¶ 2, and BLOOMINGDALE B, ¶ 3, provide that the executive shall receive a percentage of the net profits remaining after provision for the annual preferred stock dividend requirements, but no mention is made of common stock. See also FAIRBANKS B, *supra* note 41; BALDERSTON, *op. cit. supra* note 34, at 71-75; Preinrich, *Profit-Sharing Problems and Their Solution* (1929) 48 J. ACCOUNTANCY 341, 350-353 (discussing basis of fixing fair return on stockholders' investment).

Baker, studying the bonus plans of 30 large industrial companies (pp. 200-201), found that 15 made a deduction in favor of stockholders in calculating the bonus fund, 1

a plan has much to recommend it, as it avoids many of the difficulties which have just been discussed, and is, in effect, a method of informing the management that the stockholders must be given a fair return on their investment before the executive receives a share in the profits.

*The Computation Clause.*

"4. The adjusted consolidated net earnings of the Corporation and its subsidiaries, for the purpose of computing the Executive's percentage compensation under the provisions of paragraph 3 above, shall be determined in accordance with accepted accounting practice by the independent accounting firm employed by the Corporation as its auditors, within 90 days after the end of each calendar [fiscal] year. The computation by such firm of the net earnings and of the Executive's percentage compensation, made in the manner herein provided, shall be final and binding upon the Corporation and upon the Executive, and the Corporation shall pay such compensation to the Executive within 120 days after the end of the calendar [fiscal] year in question. For the purpose of computing the Executive's percentage compensation, the adjusted consolidated net earnings of the Corporation and its subsidiaries for any of the periods referred to in paragraph 3 above shall be determined before deducting

(a) profit participations, if any, which may be payable by the corporation under any plan, agreement or contract with its other officers, or any of them;

but shall be after full allowance for, and deduction of,

- (a) all expenses and other charges applicable to the operations for such period, including all expenditures by the Corporation for engineering or development work, or any similar expenditures, except to the extent that, in the discretion of the Board of Directors, such expenditures may be properly capitalized;
- (b) all federal, state and municipal taxes;
- (c) depreciation for such period based on the amount of depreciation set forth in the annual report of the Corporation to its stockholders for the calendar year which includes such period, and approved by said independent accounting firm, whether the

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made such a deduction for preferred stock only, 13 made no deduction, 1 gave no information. The plan formerly in use by The National City Bank was thus described by the court in *Gallin v. Nat. City Bank*, 152 Misc. 679, 699, 273 N. Y. Supp. 87, 109 (Sup. Ct. 1934), cited *supra* note 5: "After eight per cent had been set aside for the stockholders on invested and employed capital, one-fifth of the total remaining net profits in any one year was apportioned by periodical action of the boards among the executives responsible for the management, and the remaining four-fifths distributed to the stockholders."

The Container Corp. plan (*supra* notes 5 and 42) provides that from net profits there shall be first deducted "an amount equivalent to 6% of the aggregate of the Capital Stock and Surplus accounts as at the beginning of the year for which the additional compensation is to be calculated"; the bonus fund is to be 15% of the balance remaining after such deduction.

depreciation so reported shall be more or less than the depreciation allowed by the federal income tax authorities for the purpose of computing federal income taxes for such year;

- (d) such write-offs and reserves as the auditors may recommend and/or the Board of Directors deem advisable, so that the directors shall be permitted and enabled to exercise the fullest degree of conservative, prudent business judgment in making write-offs and in setting up reserves against contingencies and for all other purposes;
- (e) all items of capital and non-recurring gains and profits, not arising from the ordinary operation of the business of the Corporation; except that if the Board of Directors in its uncontrolled discretion finds that the Executive has been instrumental in producing for the Corporation any such item of capital or non-recurring gains and profits, the Board shall have power expressly to direct that any such item of non-recurring gains and profits shall be included in whole or in part in determining adjusted consolidated net earnings of the Corporation and its subsidiaries for the purpose of computing the Executive's percentage compensation."

In the computation clause, our effort is to define and limit the earnings fund so as to confine it to sources of income which the executive has aided in producing, and at the same time to attain reasonable ease of administration and calculation. We start, then, with the accountants' determination of "net earnings"—imperfect though that determination may be<sup>47</sup>—and next state expressly various deductions from income.<sup>48</sup> Operating expenses, of course, must be deducted, and it is possible to

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47. See p. 55 *infra*.

48. See ALLIED, ¶ 4; BLOOMINGDALE A, ¶ 3D; BURLINGTON, ¶ 5(2); FAIRBANKS B; WOOLWORTH A and B, ¶ 5. COLUMBIA A, ¶ 5 provides: "*Determination of Net Profits*. Columbia agrees to cause its accounts and books and those of its subsidiaries to be audited, and their consolidated net profits to be determined, at the end of each fiscal year, by Messrs. Price, Waterhouse & Co. or such other reputable firm of certified public accountants as shall be selected by the Board of Directors of Columbia. Such net profits shall be determined according to standard accounting methods, and in such determination all federal, state, and municipal taxes other than income and excess profits taxes, and a reasonable amount for depreciation and all other appropriate reserves, shall be deducted; and there shall be included, in the case of subsidiaries of which Columbia shall own less than the entire capital stock, only such part of their net profits as shall be applicable to dividends on stock of such subsidiaries held by Columbia. The certified audits of such accountants, including their determination of such consolidated net profits, shall be conclusive and binding upon the parties hereto." The second sentence (beginning "Such net profits") was later amended by COLUMBIA B to read as follows: "Such net profits shall be determined according to standard accounting methods, and in such determination all federal, state and municipal taxes *including* income and excess profits taxes, and a reasonable amount for depreciation and all other appropriate reserves, shall be deducted."



go into considerable detail in specifying them.<sup>49</sup> Frequently, federal and state income taxes will expressly be made deductible, and the executive will be given a percentage of the net earnings remaining after provision for their payment.<sup>50</sup> Inasmuch as the federal income tax and similar taxes can be computed only after the executive's total compensation (provided it is reasonable) is deducted as a corporate expense, it is evident that the accountants will have to employ a little algebra. A similar problem, but one of much more difficulty, arises when the corporation employs more than one executive on a percentage compensation basis. The question here is whether the compensation of any one executive should be computed as a percentage of the net earnings remaining after the compensation payable to the other executives has been deducted as an expense. If the contract with any single executive fails to provide that the percentage compensation payable to the other executives shall not be deducted as an expense, it is doubtless necessary that this deduction be made, despite difficulties in making the computation. Usage varies as to deducting all or any part of the executive's own compensation.<sup>51</sup> It would seem that only his fixed salary should be deducted.

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49. *Operating Expenses*: "all ordinary and necessary expenses," BURLINGTON, ¶5(2); "all legitimate expense," WOOLWORTH A, ¶5, WOOLWORTH B, ¶5.

Particular items of expense are often specified: "reserve for contingencies," FAIRBANKS B, ¶(c); "interest," ALLIED, ¶2; BURLINGTON, ¶5(2); "losses," BURLINGTON, ¶5(2); "obsolescence," BURLINGTON, ¶5(2); "cost of all ordinary alterations and repairs," WOOLWORTH A, ¶5; WOOLWORTH B, ¶5; "depreciation," BURLINGTON, ¶5(2); COLUMBIA A, ¶5; FAIRBANKS B, ¶(c); "depreciation on fixtures at the rate of 5½ per annum," WOOLWORTH A, ¶5; WOOLWORTH B, ¶5; "bad debts," BURLINGTON, ¶5(2); FAIRBANKS B, ¶(c); "unearned factory profit on branch house goods," FAIRBANKS B, ¶(c).

Depreciation, repairs, loss of finished product, and insurance are all proper deductions under an agreement to share the "net profits" of an enterprise. *Stone v. Wright Wire Co.*, 199 Mass. 306, 85 N. E. 471 (1908); see *Stein v. Strathmore Worsted Mills*, 221 Mass. 86, 89, 108 N. E. 1029, 1030 (1915).

50. ALLIED, ¶4, BURLINGTON, ¶5(2), and FAIRBANKS B, ¶(c) provide that all taxes shall be deducted as an expense. As to the COLUMBIA contract, see note 48 *supra*. For illustrative computations of typical income tax and accounting problems arising from profit-sharing contracts, see Preinrich, *supra* note 46, at 346-349.

WOOLWORTH A, ¶5, deducts "Governmental Income Taxes and other taxes"; WOOLWORTH B, ¶5, deducts "Federal Income Taxes and other taxes."

Where a bonus was given under a directors' resolution which spoke of "net earnings . . . after . . . all expenses . . . [and] depreciation," it was held that state and federal taxes must be deducted before computing the employee's percentage compensation. *Fleischer v. Pelton Steel Co.*, 183 Wis. 451, 198 N. W. 444 (1924). See also *Ransome Concrete Mach. Co. v. Moody*, 282 Fed. 29, 35, 36 (C. C. A. 2d, 1922).

51. ALLIED, ¶4, provides that all compensation payable to the executive himself under the contract shall be deducted as an expense. WOOLWORTH A, ¶5, provides for the deduction of "store managers' compensation."

BLOOMINGDALE A, ¶3D, provides: ". . . there shall not be deducted in determining 'net earnings' or 'basic net earnings' for the purpose of this agreement the amount payable under said clause 3 B to the employee hereunder or the amount payable to Harry

A more serious question is whether or not the executive shall be permitted to share in capital and non-recurring gains. It will be noted that the form given in the text contains a clause attempting to prevent him from sharing in such gains. This device has not been tested by the writer's experience, as the contracts on which the form was based did not contain such a clause. However, it has been included here because it represents a recent and apparently sound trend. The Burlington contract expresses the underlying idea more simply, and probably as effectively, by providing that the executive is to share in income "from ordinary operations (exclusive of capital and non-recurring gains and losses)."<sup>52</sup> Likewise, the plan adopted by the Continental Oil Co. in January, 1937, provides that "Net nonrecurring gains and profits will not be included in the computation of earnings except to the extent authorized by the Board of Directors."<sup>53</sup> Similarly, the Merit Bonus Plan of the DuPont Co. is based on "surplus net receipts . . . on the capital employed by the company and its substantially wholly owned subsidiaries, which capital is primarily of an operative as distinguished from an investment character." Other portions of the DuPont plan indicate that it is not intended to distribute under the plan earnings derived from investments, such as the company's investment in the stock of General Motors Corporation.<sup>54</sup> These are good precedents, but they are probably not followed as frequently as they should be. The average bonus contract no doubt still provides that the executive is to share in "net earnings."

Quite apart from any express clause on the subject, however, a strong argument can be made for interpreting the ordinary reference to "net earnings" in bonus contracts as applying only to operating earnings. The purpose of the contract is to give the executive a share in earnings produced by his own efforts, and it may well be urged that any intention to give him a share in capital gains or other income not derived from the normal operation of the business must be stated in the most explicit terms. Suppose, for example, that the corporation receives an attractive offer for the purchase of its interest in an important subsidiary. If the

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A. Hatry under a similar clause designated as 3 B in an agreement of even date between this corporation and said Harry A. Hatry."

BURLINGTON, ¶ 5(2), provides: ". . . there shall be deducted . . . salaries, including the amount of the salary paid to Love pursuant to Article 'FOURTH' hereof (and including, but without limitation, salaries and/or other compensation payable to officers, directors, and any other employees, but excluding all additional compensation payments, based upon a percentage of the profits, payable to officers and employees in accordance with the policies heretofore pursued by the Corporation and its predecessor corporations)."

52. BURLINGTON A, ¶ 5(2).

53. Excerpt from report of the Continental Oil Co. to the SEC, Form 10K, Item 5, as quoted in BAKER, 212.

54. See BAKER, 213.

executive knows that he is to share in whatever capital gain is realized by the corporation upon the sale, he will be strongly tempted to approve the proposition, even though the corporation would then be faced with the problem of finding an equally advantageous investment for its funds. As the corporation is not in the business of buying and selling its investments in subsidiaries, there appears no reason for allowing the executive to share in any profit so derived.<sup>55</sup>

On the other hand, if the executive is to be deprived of any share in non-recurring profits, he will argue that he should not have to take the burden of non-recurring losses. There is some merit in this contention, and provisions are occasionally inserted in contracts that the executive will neither benefit from non-recurring profits nor share the burden of non-recurring losses.<sup>56</sup> It is evident, however, that if the corporation sells an asset — for example, its investment in a subsidiary — at a very considerable loss, the stockholders will be disgruntled if the executive receives a substantial bonus for the very year in which the loss was incurred. From a practical standpoint, therefore, it may not be good judgment for the executive to seek to have his bonus computed on a basis more favorable than the income reported to the stockholders. Yet such special methods of computation are frequently provided for. The parties often agree, for example, that losses due to events occurring before the executive became connected with the company, but actually charged off on the books after his employment began, should not be deducted from income in determining his bonus.<sup>57</sup> Little is to be found in the cases

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55. No direct authority on the point has been found. It would seem, however, that bonus contracts should be strictly construed in favor of the corporation. But see *Flannery Bolt Co. v. Flannery*, 16 F. Supp. 803 (W. D. Pa. 1935), *rev'd*, 86 F. (2d) 43 (C. C. A. 3d, 1936).

56. See *BURLINGTON A.*, ¶ 5(2). If it is desired to insert such a provision in the principal form, the following language may be used (to follow the first clause "(a)" in Paragraph 4):

"(b) losses of a non-recurring nature, not connected with the ordinary operation of the business of the Corporation; except that the Board of Directors shall have power expressly to direct that any such loss or losses shall be deducted in whole or in part in determining adjusted consolidated net earnings of the Corporation and its subsidiaries for the purpose of computing the Executive's percentage compensation."

57. A clause of this nature, which may be inserted in the principal form (to follow the first clause "(a)" in Paragraph 4), is the following:

"(b) losses actually incurred prior to . . ., 1940, or reserves, charged against profits, actually relating to the period prior to . . ., 1940, although such losses or reserves may be realized, or approved and recorded on the books of the Corporation, subsequent to said date; provided, however, that if, after charging any such losses or reserves, there should be any re-

bearing upon the validity of such an arrangement.<sup>58</sup> An extreme case is conceivable, in which a company reports a loss to its stockholders, but, nevertheless, pays a bonus based on a special formula which shows earnings available for executive compensation. It seems that stockholders in such an event are not entitled to complain. The distribution to the executive is not in the nature of a dividend, but rather in the nature of the discharge of a debt — assuming always that the bonus contract was properly adopted and was “reasonable” in its terms. The mere use of a special formula should not render it unreasonable. As we have noticed, sales managers very often receive bonus compensation based on a percentage of sales;<sup>59</sup> it is arguable that if sales increase, the sales manager is entitled to increased compensation even though the earnings of the corporation as a whole were materially reduced by poor management in other departments.<sup>60</sup> It seems, however, that the use of gross receipts as a compensation base should not be permitted in the case of a general executive, who might be able to cause an increase in gross receipts by means which would reduce net profits. Can creditors complain of these special formulae for determining earnings? Probably not, if no actual injury to them has been shown — and it would be a rare case in which injury could be proven.

The date of payment of the bonus is ordinarily in the spring, after the completion of the annual audit.<sup>61</sup> The computation of the bonus

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covery by the Corporation of any portion of the amount so charged, the amount so recovered shall not be included in adjusted consolidated net earnings of the Corporation and its subsidiaries for the purpose of computing the Executive's percentage compensation.”

58. Where a salesman's contract provided that he was to receive a percentage of the “net profits” of the business for a given year, and there was no express provision that the company's normal accounting methods should be followed, it was held that losses due to bad debts previously on the books and not charged off until the year in question should not be considered in computing the salesman's compensation. See *Stein v. Strathmore Worsted Mills*, 221 Mass. 86, 92, 108 N. E. 1029, 1031 (1915); *cf. Hubbard v. New York, N. E. & W. Investment Co.*, 14 Fed. 675 (C. C. D. Mass. 1882).

59. See note 4 *supra*.

60. In *Bettendorf v. Bettendorf*, 190 Iowa 83, 179 N. W. 444 (1920), the court was called upon to construe a contract giving the executive a percentage of the net earnings of the Bettendorf Axle Company “which may have accrued exclusively from the railway department [of the Axle Company].” This provision was enforced literally, the court stating that the intention was to “eliminate deductions owing to loss in other departments.”

61. Otherwise, of course, where the corporation has a fiscal year other than the calendar year.

Dates for payment are set as follows: *BLOOMINGDALE A*, ¶ 3 A: “as soon as may be after the determination of said basic net earnings [after the close of each fiscal year]”; *BURLINGTON*, ¶ 5(4): “within thirty days after the completion of the annual audit of the Corporation by its accountants”; *WOOLWORTH A*, ¶ 4, and *WOOLWORTH B*, ¶ 4: “annually as soon as may be convenient after January first but not later than March first.”

normally takes place at the close of the audit, and should be made by the corporation's regular public accountants.<sup>62</sup> It is customarily provided that the accountants shall follow accepted accounting practice in making the computation,<sup>63</sup> and that their determinations shall bind both the corporation and the executive.<sup>64</sup>

"Accepted accounting practice," however, is not quite the positive solution of all difficulties that lawyers would like to consider it. Accountants can differ in their views as frequently as lawyers can; their craft is subject to almost as many variables and guesses as the law. Earnings, after all, are not something fixed and concrete—they are not to be computed by subtracting disbursements from cash receipts. Rather, they represent an informed estimate of income, guided by accounting conventions which, although they may be valid in a majority of cases, may not bear a very direct relation to the realities of a particular business.<sup>65</sup> When our contract provides, therefore, that the computation of earnings shall be made according to accepted accounting practice, and that the decision of the company's auditors shall be final, we must realize that we have in fact entered into something very similar to an arbitration agreement, and that the honesty and good judgment of the arbitrators will be of great importance.

Equally important, however, is the role of the directors. Subject to what has been said above regarding special earnings formulae, it is ordinarily wise to have the contract recognize expressly the power of the directors to reduce the amount of the corporation's net earnings by setting up whatever reserves for losses and contingencies they, in the exercise of good business judgment, deem necessary. One of the principal criticisms of percentage contracts is that the executive will be tempted to exercise his influence in the direction of keeping the corporation from adopting a conservative policy in respect to such matters as depreciation, writing off assets of doubtful value, making provision for contingencies, and the like. An independent and conscientious firm of accountants can, of course, be of great service in this connection. However, an accountant may be put in a very embarrassing position if the corporation president,

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62. BURLINGTON, ¶ 5(2); COLUMBIA A, ¶ 5; FAIRBANKS B, ¶ (a).

63. ALLIED, ¶ 4 ("good accounting practice"); BLOOMINGDALE A, ¶ 3 D ("usual practice of the employer and accepted accounting methods"); BURLINGTON, ¶ 5(2); COLUMBIA A, ¶ 5.

64. ALLIED, ¶ 4; COLUMBIA A, ¶ 5.

65. See 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 253. An honest failure to take sufficient depreciation may inflate purported earnings just as misleadingly as fraudulent misstatement. Compare BAKER, 228. The courts, on the other hand, sometimes seem a little too certain as to just what "net profits" are. See Orlando Orange Groves Co. v. Hale, 107 Fla. 304, 313, 144 So. 674, 677 (1932), *s. c.*, 119 Fla. 159, 161 So. 284 (1935); Stein v. Strathmore Worsted Mills, 221 Mass. 86, 88, 108 N. E. 1029, 1030 (1915); *In re* The Spanish Prospecting Co., Ltd., [1911] 1 Ch. 92, 98-101.

holding a percentage contract, informs him that a questioned asset such as an account receivable should be carried on the books without write-down in view of its possible recovery in value, even though the accountant believes that the facts would justify a substantial write-down. The accountant knows that there can be a reasonable difference of opinion on such matters, and that he is hardly justified in viewing the executive's stand as based entirely on personal motives. To relieve the accountant of the entire burden of responsibility in such a situation, it may be advisable for the board of directors to assign a committee of its members to supervise the completion of the annual audit<sup>66</sup> and the computation of the executive's percentage compensation.

An additional reason for close supervision by the directors of the computation of percentage payments lies in the fact that they may be held personally liable for any over-payments. Stockholders' suits have in several instances been brought against directors on the allegation that compensation payable under a bonus contract was computed by the bonus-receiving executives themselves, that the computation was incorrect, and that the directors are liable for their negligence in not having seen to it that the compensation was properly computed and confined to the correct amount.<sup>67</sup> The directors should therefore see to it that the computation is made by disinterested persons and carefully checked by disinterested representatives of the board.<sup>68</sup> If an important difference of opinion arises, it may be advisable to take the matter before the entire board — perhaps even to draft and adopt an amended contract.<sup>69</sup>

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66. As to a somewhat similar committee set up by the DuPont Co., see Annual Report (1939) E. I. duPont de Nemours & Co., p. 21.

67. As to a suit of this nature recently brought against certain officers and directors of the F. W. Woolworth Co., see N. Y. Times, July 10, 1940, p. 27, col. 4.

68. In *Gallin v. Nat. City Bank*, 152 Misc. 679, 273 N. Y. Supp. 87 (Sup. Ct. 1934), cited *supra* note 5, the plaintiff stockholders alleged that not only was the compensation paid excessive but that it had been wrongly computed. The court referred both these issues to a referee, whose report is to be found in 155 Misc. 880, 281 N. Y. Supp. 795 (1935). The referee said in part: "It was incumbent upon the directors to see to it that the formula was followed with strict impartiality and they could not delegate this duty to those who would participate in the fund or to others who acted under the supervision and guidance of the latter. The board of directors and executive committee of the company, to insure the proper computation of the management fund, should have intrusted that work to officers or employees in no manner interested in the management fund. Failure so to do constituted a breach of their duty as directors and subjects them to liability for the restoration of moneys improperly paid through such erroneous computations of the management fund." 155 Misc. 880, 893, 281 N. Y. Supp. 795, 808 (1935).

69. In *Gallin v. Nat. City Bank*, cited *supra* notes 5 and 68, the referee discussed certain losses suffered by the corporation which were not deducted from net profits in the computation of additional compensation (155 Misc. 880, 893-903, 281 N. Y. Supp. 795, 808-818 (1935)), and held the directors liable for their failure to deduct. The referee stated: "The record shows clearly that whenever the executive committee and board of directors of the bank desired to modify the formula so as to eliminate a loss, whether

Not only do bonus contracts offer a great temptation to the executives to set up systems of accounting which will show an unduly high margin of profit, and methods of computation which will enlarge the bonus, but they may lead to the adoption of corporate policies which will increase present profits at the expense of the company's future. Under certain contracts according to which executives are paid on the basis of profits, without any limitation on total amounts payable or any provision for the prior payment of dividends, a premium is put on increasing the gross profits of the company by any possible means, such as merger or consolidation with other companies, regardless of the fact that the net return per share on the increased corporate capital will in all probability be subject to the law of diminishing returns, to the detriment of the individual stockholders.<sup>70</sup> This difficulty is not easily solved. It would be foolish to forbid the expansion of the company simply to guard against such occurrences. It might, of course, be possible to have the contract provide that bonus compensation should not be payable unless and until dividends were paid upon a basis which would maintain the original earning power of each share of the company's capitalization. Even assuming that such a provision would be workable, there would still be no means of assuring the stockholders that each share would have the same degree of earning power that it would if the company had been left in its original uncombined condition. Here, again, it is the honesty and diligence of the board of directors upon which reliance must ultimately be placed.

#### *The Merger Clause.*

"5. The Corporation will not consolidate or merge into or with another corporation, or sell all or substantially all of its assets to another corporation, unless such other corporation (hereinafter re-

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charged to surplus or as a current operating loss, they effected such modification of the formula by an express resolution or action duly adopted at a regular or special meeting of the executive committee or the board." 155 Misc. 880, 895, 281 N. Y. Supp. 795, 810 (1935). The referee seems to have proceeded on the basis that any such modification of the formula by express action of the executive committee or the board of directors would justify a corresponding change in the computation. All of the adjustments made by the referee (with imposition of liability) seem to be on account of items which were not made the subject of express resolution—usually losses not properly charged against earnings available for compensation. *Quare*, however, whether this may be taken to mean that any modification of a computation formula made by the executive committee or the board of directors in favor of an executive, so that his compensation can be figured on a more advantageous basis, is to be regarded as valid and proper. An amendatory contract, adopted with all the formality of the original agreement, is often advisable, and perhaps even necessary. See note 18 *supra*.

70. See *Raynolds v. Diamond Mills Paper Co.*, 69 N. J. Eq. 299, 315, 316, 60 Atl. 941, 948 (1905); *Berendt v. Bethlehem Steel Corp.*, 108 N. J. Eq. 148, 149, 154 Atl. 321 (1931); cf. *Summers, A Comparison of the Rates of Earning of Large-Scale and Small-Scale Industries* (1932) 46 Q. J. Econ. 465, 479; *Livermore, The Success of Industrial Mergers* (1935) 50 Q. J. Econ. 68.

ferred to as the 'Successor Corporation') shall assume this agreement; and upon such assumption the Executive and the Successor Corporation shall become obligated to perform the terms and conditions hereof; provided, however, that

- (a) The Executive need not be named as chief executive of the Successor Corporation, and his duties shall be such as shall be prescribed by the Board of Directors of the Successor Corporation;
- (b) The Executive's percentage compensation shall be based as nearly as may be upon the earnings attributable to the assets owned by the Corporation at the time of any such consolidation, merger or sale, and shall be determined by the independent accounting firm employed by the Successor Corporation as its auditors, the determination of such accounting firm to be final and binding upon the Successor Corporation and upon the Executive."

The problem dealt with in this clause is obviously a delicate one. The executive hardly wishes to interfere with his corporation's proper expansion through combination with another enterprise. In fact, if he is to be the head of the combined enterprises, he will usually welcome the idea — perhaps for the reasons discussed above. On the other hand, the use of the merger or consolidation device to demote or displace an unwanted executive is one which might occur to a hostile board of directors — fruitless as the attempt might ultimately prove.<sup>71</sup> While modern statutes and case law generally provide some means for protecting creditors of a merging corporation,<sup>72</sup> the position of a claimant under a contract naming him as "chief executive" of the corporation is a particularly difficult one.<sup>73</sup> What is to be done if *A* Corporation has a contract with *B* hiring him as "chief executive," *X* Corporation has a similar contract with *Y*, and then *A* Corporation merges with *X* Corporation? If the parties can agree, well and good. If not, trouble will result. Accordingly, if combinations are probable, the executive will usually try to clarify the situation in advance. Frequently, however, the executive does not succeed in getting a clause as favorable to him as the one which is given above.<sup>74</sup>

71. Compare *Small v. Sullivan*, 245 N. Y. 343, 157 N. E. 261 (1927). The writer, in collaboration with Carl H. Fulda, is preparing an article on the use of the merger device, and other similar expedients, to evade corporate obligations.

72. See STEVENS, *CORPORATIONS* (1936) 754-758; Note (1921) 15 A. L. R. 1112, 1133; N. Y. STOCK CORP. LAW §§ 85, 90.

73. Compare *Ducasse v. American Yellow Taxi Operators, Inc.*, 224 App. Div. 516, 231 N. Y. Supp. 51 (2d Dep't 1928) (claimant contracted to supply all taxi meters needed in business of *A* Corp.; *A* Corp. later merged with *B* Corp.); *Levy Leasing Co. Inc. v. Bank of America Nat. Ass'n*, 143 Misc. 365, 256 N. Y. Supp. 406 (Munic. Ct. 1932).

74. COLUMBIA A, ¶9: "This agreement shall be binding upon and shall inure to the benefit of any corporation which, by consolidation, merger or otherwise, shall succeed to the business of Columbia and/or any of its subsidiaries."



*The Covenant Against Competition.*

"6. The Executive agrees that during the period of his employment he will not make any other corporate affiliations without the approval of the Board of Directors of the Corporation. The Executive further agrees that during the period of employment, and during a further period of two years after leaving the employ of the Corporation, whether upon the expiration of this contract or otherwise, he will not directly or indirectly engage in the production or the manufacture or the distribution of any products similar to those manufactured or sold by the Corporation, either for his own benefit, or for or with any person, firm or corporation whatsoever other than the Corporation."

This clause supplements paragraph 2 (the performance clause).<sup>75</sup> The restrictions imposed on the executive, which vary a good deal in strictness,<sup>76</sup> are of course to be interpreted in the light of the "rule of reason."<sup>77</sup>

*The Illness and Incapacity Clause.*

"7. Notwithstanding anything herein contained,

- (a) In the event that the Executive shall, during the term of his employment hereunder, fail to perform his duties hereunder owing to illness or other incapacity and such illness or other incapacity shall continue for a period of more than \_\_\_\_\_ months,

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ESQUIRE, ¶7: "Anything herein to the contrary notwithstanding, in the event it is determined by the Company to effect a merger or consolidation of the Company with any other corporation or business or to dispose of the entire or substantially the entire business of the Company to another corporation or business, and in that connection it becomes advisable in the judgment of the Board of Directors to modify the terms of employment above set forth, it is understood that the Board of Directors may so modify said terms of employment and in the event Smart is not satisfied with such modification, he shall be released from his obligations hereunder."

FEDERATED, ¶4: "During the continuance of this agreement of employment, the Employer will continue in active business and will not change its name or the nature of its business; and it will not sell, lease or exchange all or substantially all of its assets, including its good will, or do any other acts tending to prevent the full performance of this agreement."

75. See pp. 41-42 *supra*.

76. COLUMBIA A, ¶2: "Paley agrees to devote his entire time, skill and attention to such business and during the term of such employment agrees not to engage in any other business or occupation; but such prohibition shall not extend to the supervision by Paley of his personal investments."

WOOLWORTH A, ¶2: "Party of the second part also agrees that during the term of this contract or during a term of five years after the expiration or cancellation of same, he will not be interested, directly or indirectly, in any competing store or business within a radius of ten miles of any store of party of the first part, or impart any trade secrets or information that might be harmful to party of the first part, and that during the term of this contract, he will not be interested in or transact any other business that will interfere with his duties under this contract without first having obtained the consent of the party of the first part."

77. See 5 WILLISTON, CONTRACTS (rev. ed. 1936) § 1643.

the Corporation shall have the right, by notice<sup>78</sup> sent by registered mail addressed to him at ....., to terminate the Executive's employment hereunder as of a date (not less than 30 days after the date of the sending of such notice) to be specified in such notice, and the Executive shall be entitled to receive his fixed compensation and his percentage compensation as provided in paragraphs 3 and 4 hereof to the last day of the calendar month in which such notice shall be sent; provided, however, that if, prior to the date specified in such notice, the Executive's illness or incapacity shall have terminated and he shall have taken up and performed his duties hereunder, the Executive shall be entitled to resume his employment hereunder as though said notice had not been given.

- (b) In the event of the Executive's death during the term of his employment hereunder, the Executive's legal representatives shall be entitled to receive his fixed compensation and his percentage compensation as provided in paragraphs 3 and 4 hereof to the last day of the calendar month in which the Executive's death shall have occurred."

Many employment contracts do not contain provisions as to the termination of the contract prior to the expiration of the fixed term or as to steps to be taken in the event of illness or incapacity. Negotiation on these subjects is likely to be difficult, and both sides will often prefer to leave the matter unmentioned in the contract, to be decided as best it may when and if difficulty later arises. Doubtless, however, a reasonable effort should be made to reach a prior agreement on the subject; perhaps certain contingencies can be met by insurance coverage. Provisions terminating the contract in the event of the executive's death, resignation, or permanent disability, and giving a pro rata share of the bonus in such event, are, however, fairly frequent.<sup>79</sup>

78. A provision as to notice may well be inserted in a separate clause later in the contract. See note 88 *infra*.

79. See BLOOMINGDALE A, ¶4; BURLINGTON, ¶5(3); WOOLWORTH A, ¶7; WOOLWORTH B, ¶7. ALLIED, ¶7, makes no provision as to resignation.

BURLINGTON, ¶5(3), reads as follows: "If, while in the employ of the Corporation or of any of its subsidiary companies, Love should die before the last day of any calendar or fiscal year, or if this contract should be terminated by the Corporation for cause before the last day of any calendar or fiscal year, said additional compensation shall be computed as follows: The total amount of additional compensation for the calendar or fiscal year which would have been payable to Love in the event that he had lived or continued in the employ of the Corporation during such calendar or fiscal year shall first be computed. This sum shall be divided into as many equal parts as there are months in such fiscal period, and Love, or his personal representative, shall receive one of such parts for each month from the first day of said fiscal period to the last day of the third calendar month following the date of his death, or termination of employment as aforesaid. In no

Again, many contracts contain no provisions relating to the dismissal of the executive by the directors.<sup>80</sup> In this connection, it should be noted that statutory provisions to the effect that the directors may remove any "officer, agent or employee . . . at pleasure" do not necessarily mean that the dismissal of an officer prior to the expiration of his contract term will be without risk to the corporation. In such a case, the dismissed officer may have an action for damages against the company.<sup>81</sup>

*Inflation Clauses.* Provisions protecting the executive against the consequences of currency inflation deserve special mention, though they are not in wide use. Of course, a participation contract's very nature provides a certain amount of such protection, at least in the case of businesses which are expected to be benefitted by inflation. On the other hand, in the many lines of business which are expected to suffer seriously if inflation occurs, a percentage contract does not protect the executive. In such a case, the enterprise might suffer so severely from the consequences of inflation that it would be unconscionable or even fruitless for the executive to try to exact a higher salary. Occasionally, however, one finds cases in which it is not clear what the effect of inflation would be upon the particular business, and the executive not only wishes to obtain a percentage of the profits but wants to be sure that in the event of inflation his fixed salary will be increased. The old-fashioned gold clause being no longer available, attention has been turned to various means of establishing a measure of inflation and causing the amount of compensation to be varied accordingly. While this is not the place to attempt to discuss the vast problem of efforts to guard by contract against the consequences of inflation, it may, nevertheless, be pointed out that, in spite of the provisions of the gold clause resolution, some measure of protection is apparently still obtainable in the form of provisions basing compensation upon commodity prices or similar indices.<sup>82</sup>

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event, however, shall the additional compensation be computed upon a period beyond the last day of the calendar or fiscal year in which such death occurs or in which such employment is terminated as aforesaid."

See also WOOLWORTH A, ¶ 8, and WOOLWORTH B, ¶ 8, discussed *infra* note 80.

80. WOOLWORTH A, ¶ 6, and WOOLWORTH B, ¶ 6, provide for termination by either party on thirty days' written notice. Each of these contracts provides for the hiring of a substitute at the employee's expense, in the event of an illness of less than four months (¶ 8).

81. See *In re Paramount Publix Corp.*, 90 F. (2d) 441 (C. C. A. 2d, 1937) (interpreting N. Y. STOCK CORP. LAW, § 60), (1937) 50 HARV. L. REV. 518.

82. See Nussbaum, *Multiple Currency and Index Clauses* (1936) 84 U. OF PA. L. REV. 569, and Dawson & Coultrap, *Contracting by Reference to Price Indices* (1935) 33 MICH. L. REV. 685. Subsequent to these articles came the decision in *Guaranty Trust Co. v. Henwood*, 307 U. S. 247 (1939), 8 GEO. WASH. L. REV. 232, which held that the gold clause resolution (Joint Resolution of June 5, 1933, 48 STAT. 112) governs domestic dollar obligations containing alternative provisions for payment in foreign currency. The

*Other Clauses.* The contract provisions discussed above — and particularly those contained in paragraphs 1 through 7 — are normally the only ones included in percentage compensation contracts. However, additional clauses are occasionally found,<sup>83</sup> such as one giving the executive an expense allowance,<sup>84</sup> protecting his status,<sup>85</sup> providing for arbitration of difficulties,<sup>86</sup> hinting at future rewards,<sup>87</sup> making provision as to the sending of notices by one party to the other,<sup>88</sup> and cancelling all previous agreements between the parties.<sup>89</sup> Many corporations have recently adopted by-laws providing for the indemnification of directors and others

opinion, by Mr. Justice Black, states: "Congress sought to outlaw all contractual provisions which require debtors, who have bound themselves to pay United States dollars, to pay a greater number of dollars than promised." 307 U. S. 247, 258 (1939). Does this statement mean that any contract attempting to increase the debtor's obligation, upon the occurrence of inflation, will be stricken down? It would seem that contracts providing for the measurement of the obligation in terms of shifting standards of value, such as shifting commodity price averages, are still valid. In one recently drawn percentage compensation contract with which the writer is familiar, a clause was inserted making the amount of the executive's monetary participation (though not the percentage rate) fluctuate in accordance with the figure for "all commodities" in the Index of Wholesale Commodity Prices published by the United States Department of Labor.

83. The ALLIED contract is unusual in that it contains a covenant to cause a named subsidiary of the corporation to pay a fixed salary to the executive in addition to the compensation to be paid by the company; it also contains an agreement to pay the executive a fixed sum annually for life, beginning in 1945. These two provisions introduce additional problems not necessary to be discussed here.

84. ALLIED, ¶ 6: "For each of the fiscal years commencing February 1, 1940, and terminating January 31, 1945, upon Puckett's written request, Puckett shall receive from time to time an allowance for entertainment expenses up to but not exceeding Ten Thousand Dollars (\$10,000) in any such fiscal year."

BURLINGTON, ¶ 6: "Love understands and agrees that the services required of him by this contract in consideration of the salary and additional compensation which are provided herein include the duty to incur individually, in the interest of the Corporation's business, certain expenses for entertainment and other like expenses in amounts under all the circumstances reasonably commensurate with his salary and additional compensation and his position. When Love is traveling on engagements devoted immediately and directly to the business of the Corporation, however, he is expected to render expense accounts which will be paid as such by the Corporation."

85. FEDERATED, ¶ 6, grants the executive "office space and accommodations and assistants and similar attributes of office suitable to the dignity of his office . . ." The same contract, ¶ 2, provides that the executive's duties "shall be substantially the same character as those which he has performed for the Employer during the last three (3) years . . ."

86. COLUMBIA A, ¶ 7, contains an arbitration clause of the standard type.

87. The following provision is fairly typical:

EASTERN, ¶ 3: "Notwithstanding this agreement or the provisions hereof, Rickenbacker shall be eligible for an increase in rate of compensation, if granted by the Corporation or for participation in any extra-compensation or profit-sharing plan which the Corporation may at any time adopt."

88. BURLINGTON, ¶ 8; EASTERN, ¶ 9.

89. ALLIED, ¶ 9; FEDERATED, ¶ 5.

against litigation and other expense; in the case of such corporations, parallel indemnification provisions might well be included in the employment contracts of their executives.<sup>90</sup>

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This Article was written to aid the lawyer in dealing with a practical problem. It will not satisfactorily have fulfilled its purpose, however, if it has not indicated that the legal practitioner who is called upon to prepare a profit-sharing contract has a real opportunity to serve the public interest. That opportunity lies in preparing and seeking to obtain the adoption of a contract which will be fair to stockholders and management alike. Some years ago, Mr. Justice Stone referred, in a speech, to violation of fiduciary duties by corporation managers, mentioning instances in which they had taken for themselves "huge bonuses from corporate funds," and added:

"There is little to suggest that the Bar has yet recognized that it must bear some burden of responsibility for these evils. But when we know and face the facts we shall have to acknowledge that such departures from the fiduciary principle do not usually occur without the active assistance of some member of our profession, and that their increasing recurrence would have been impossible but for the complaisance of a Bar, too absorbed in the workaday care of private interests to take account of these events of profound import or to sound the warning that the profession looks askance upon these, as things that 'are not done.'"<sup>91</sup>

The existence of a substantial public sentiment against the use of percentage compensation contracts cannot be denied. Part of this is undoubtedly due to the feeling that corporation executives are already sufficiently well paid, and that the development of the company's earning power is exactly the thing for which they receive salaries. Anything additional, it is felt, is in the nature of a gratuity or windfall. Another reason for this attitude perhaps lies in the fact that we customarily think of profit-sharing as being coupled with responsibility for losses. A partnership, after all, is not a one-sided arrangement; profits are shared, but so are the risks of the enterprise. The executive's bonus arrangement looks very much like an attempt to get all the advantages of a partnership without its disadvantages. A parallel is to be found in the law's treatment of hybrid securities: if we try to give a bondholder voting rights and a share in the profits, or if we try to give a stockholder a

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90. See Washington, *Litigation Expenses of Corporate Directors in Stockholders' Suits* (1940) 40 COL. L. REV. 431, 452; Comment (1940) 49 YALE L. J. 1423, 1435; Washington, *The SEC and Directors' Indemnity*, soon to be published in the Columbia Law Review.

91. Stone, *The Public Influence of the Bar* (1934) 48 HARV. L. REV. 1, 9.

mortgage on the assets in order to secure his stock investment, our efforts are not likely to meet with much success.<sup>92</sup> Profits, most of us are still inclined to feel, should go to those who risk their capital and subject themselves to the possibility of standing a loss. The answer can, of course, be made that the executive is risking his own talents and earning power. Technically, also, the mere fact that an employee takes part of his wages in the form of a share of the profits of the enterprise will not of itself make him a partner.<sup>93</sup> Nevertheless, this underlying feeling persists, and constitutes one of the reasons why executives' profit-sharing contracts must be carefully and fairly drawn.

The writer has not attempted to make a case for the universal use of such contracts. They have many drawbacks, and it is not every business which can adopt them to advantage. Nevertheless, it is submitted that a profit-sharing contract fairly drawn and fairly adopted, with careful observance of the warning given by Mr. Justice Stone, can be and should be a legitimate source of satisfaction to the legal draftsman.

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92. See *Stephenson v. Go-Gas Co.*, 268 N. Y. 372, 380, 197 N. E. 317, 320 (1935); Uhlman, *The Law of Hybrid Securities* (1938) 23 WASH. U. L. Q. 182; Comment (1936) 45 YALE L. J. 907.

93. See UNIFORM PARTNERSHIP ACT, § 7 (4a). And, of course, "a corporation cannot enter into a partnership." Compare, however, *Stone v. Wright Wire Co.*, 199 Mass. 306, 308, 85 N. E. 471, 472 (1908).