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THE WAGES OF MANAGEMENT

ROBERT B. MAUTZ and GERALD W. ROCK*

Historically, the corporation evolved from an initial desire to collect private capital. The investment of shareholders seeking a profit was supervised by hired managers; the managers were controlled through annual stockholders' meetings or by stockholder representation in the form of a board of directors. Today, our modern corporate system has become the institutional system for our national economy.[1] Developing in larger and more impersonal units, the corporations that dominate the economy are private only in the sense that they are not owned by the state,[2] and they are influenced by social and political patterns transcending their economic objectives.[3]

The corporations of today have succeeded not only in collecting capital but in concentrating it; the familiar story of the 200 largest corporations[4] and their control over 50% of all corporate wealth has often been stated. More concretely, corporate size means that "one hundred companies the size of the American Telephone and Telegraph Co. would control all the wealth in the United States [and] employ all the working population."[5]

Who manages this vast concentration of public wealth; how much compensation is paid to them; who controls the determination of the amount of compensation; and what standards are used to measure the price paid to management?[6] These questions suggest

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[1]BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 18 (1954).

[2]*Id.* at 12. For a businessman's view that corporation managers control public entities and have a fiduciary role to the public, see Elfenbein. *The Mid-Century Decision Makers,* in 16 VITAL SPEECHES 325 (1950).

[3]Drucker, *The Future of the Corporation,* 185 Harper's 644 (1942).

[4]BERLE and MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 28-40 (1937).

[5]Means, *Separation of Ownership and Control in American Industry,* 46 Q.J. ECON. 68, 97 (1931). In 1955 American Tel. & Tel. Co. had assets of $10,000,000,000 as compared with an estimated national wealth of $1,326,000,000,000. See MOODY'S PUBLIC UTILITIES MANUAL 600 (1956); U. S. BUREAU OF CENSUS, STATISTICAL ABSTRACT 319, Table 393 (1957).

[6]For a stimulating sociological and practical analysis of the problem of corpo-

the purpose of this article: to summarize and contrast corporate compensation practices with traditional theories that are descriptive of economic practice and legal control.

Berle and Means, in their classic work on American corporations, have described traditional economic theory as the logic of property and the logic of profits.[7] When both of these theories are applied to modern corporate institutions, a conflict results. The logic of property demands that owners who risk their wealth receive the benefits resulting from that risk. As applied to corporations, the shareholders should receive the benefits of ownership; management, to whom the task of managing the property to produce a profit has been delegated, holds its power in trust for the benefit of the shareholders. In contrast, the logic of profits is based upon a profit reward as an inducement for skillful and efficient enterprise. Applied to corporations, the logic of profits results in the distribution of profits to management as an inducement to fulfill their function of efficient enterprise.

Division of the functions of ownership and enterprise produces this conflict in our theories when applied to economic activity. Most corporation reports emphasize both rationales to their shareholders when reporting compensation policies. A condensed, slightly exaggerated but typical report will read, "*Your* managers of *your* corporation are pleased to announce that *they* have established an incentive compensation plan providing for *additional* compensation so that *your* managers may share in the *profits* of *your* corporation created by *their* skill, loyalty and enthusiasm."

COMPENSATION PRACTICES

Neither the policies of American corporations upon which compensation practices are based nor the amounts paid to management are openly stated and discussed by American business beyond the minimum reports required to comply with existing legislation.[8] "Prior to 1934 compensation practices and policies were shrouded in mystery and considered too confidential to be discussed even at annual meet-

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rate power by a former president of the New Jersey Bell Telephone Co. see BARNARD, THE FUNCTIONS OF THE EXECUTIVE (1950), ORGANIZATION AND MANAGEMENT (1949).

[7]BERLE and MEANS, *op. cit. supra* note 4, at 333-44.

[8]PURDY, LINDAHL and CARTER, CORPORATE CONCENTRATION AND PUBLIC POLICY 99 (2d ed. 1950); for a report on the strong corporate opposition to disclosures by the SEC see Literary Digest, Apr. 20, 1935, p. 41.

ings of stockholders who were legal owners."[9] Only the introduction of securities legislation produced disclosure of corporate financial data including compensation. Although the Securities and Exchange Commission requires disclosure of the compensation of the three highest paid executives and the total compensation of all officers and directors for registration and proxy purposes, the amount of compensation of officers of corporations not required to register with the commission is still generally unavailable.[10] As late as 1951 *Fortune* stated: "The hard fact is that in the majority of companies today the paying of executives remains the most subjective and secretive of all management operations."[11]

Some early studies indicate that the large compensation of today is a recent development. Average payments in the decade 1904-1914 to the top three executives of corporations with capital in excess of $1,500,000 was $9,958.[12] The treatment of managerial executives by financial owner and control groups prior to 1914 was, so *Fortune* states, merely that of hired hands.[13] The average salary of the president of a large corporation was $10,000. Management, at that time, indicated that profit-sharing plans, then prevalent in Europe, would not produce greater corporate profits.[14] By 1929 industrial expansion had placed the manager in an independent and therefore powerful position resulting in an increase in salary levels to near the $100,000 range plus other compensation.[15] It was in that year that Eugene Grace of Bethlehem Steel received a salary of $12,000 and a bonus of $1,623,700.[16]

Today, average compensation levels have risen from those of 1929. Salaries are frequently but a small portion of total compensation, which is swollen by bonuses based upon an incentive or profit-sharing plan, stock options, retirement benefits, deferred payments, expense accounts, perquisites, and other devices for compensating executives.

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[9]BAKER, EXECUTIVE SALARIES AND BONUS PLANS 1 (1938).

[10]The effectiveness of the commission's disclosure requirements may be weakened by various devices of evasion. Failure to offer stock through an exchange and failure to hold stockholders' meetings are two examples.

[11]Stryker, *How Much Is an Executive Worth?,* Fortune, Apr. 1955, pp. 108, 110.

[12]Taussig and Barker, *American Corporations and Their Executives,* 40 Q.J. ECON. 1, 19 (1925).

[13]Stryker, *supra* note 11, pp. 108, 109.

[14]Taussig and Barker, *supra* note 12, at 29.

[15]Stryker, *supra* note 11, p. 108.

[16]WASHINGTON and ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 383 (rev. ed. 1951).

A 1956 survey of 641 companies listed on the New York Stock Exchange reported average compensation of the chief executive by industrial groups. Because it is mathematically incorrect to average the averages, a few examples will have to be selected to indicate present levels. At a profit level of $40,000,000, average payments to the chief executive of the corporation were as follows: in the aircraft industry, $173,000; auto parts, $190,000; heavy machinery, $200,000; public utilities, $105,000; steel, $202,000; textiles, $270,000.[17] A profit level of $3,000,000 produced compensation of approximately fifty per cent of the above averages.

It is apparent from these averages that some variation in compensation levels among industries exists. This variation is also true for earlier periods.[18] Within industries there is often such a startling disparity in compensation as to raise a doubt concerning the presence of a competitive factor in the determination of compensation.

An examination of some corporations within an industry will indicate this variation. Three major steel corporations, in 1956, paid widely different amounts of compensation judged either by absolute amounts or as a percentage of assets, profits, or dividends. As the table[19] indicates, the compensation of the three highest paid executives of Republic Steel and United States Steel was almost identical, although Republic's assets were nearly $3,000,000,000 less, income after taxes was only 26% of United States Steel's and dividends only 27%. Bethlehem Steel, with assets of 54% of U. S. Steel's, income after taxes of 46% and dividends of 57%, paid compensation equal to 282% of that paid by U. S. Steel.

Corporation	Assets	Income Before Taxes	Income After Taxes	Dividends	Compensation to Three Highest Executives
Republic	$ 857,000,000	$185,000,000	$ 90,000,000	$ 41,000,000	$ 701,000
Bethlehem	2,090,000,000	321,000,000	161,000,000	82,000,000	1,988,000
U. S. Steel	3,836,000,000	693,000,000	348,000,000	145,000,000	734,000

[17]Patton, *Annual Report on Executive Compensation,* Harv. Bus. Rev., Sept.-Oct. 1957, p. 125. One might contrast these figures with the median salary of presidents of state universities, which in 1953 was $15,000. Nat'l Educ. Ass'n Res. Bull., Dec. 1953.

[18]A 1935 survey of 264 executives showed average compensation to be as follows: industrials $79,200, public utilities $48,600, railroads $40,600. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 275 (1945).

[19]Compiled from MOODY'S INDUSTRIAL MANUAL 2456, 2568, 2921 (1957) and Business Week, May 25, 1957, pp. 113 *et seq.*

A similar comparison can be made for retail stores. With assets of $508,000,000, Woolworth's returned an income after taxes of $35,000,000 and declared $25,000,000 in dividends;[20] Penney's $403,-000,000 of assets produced an income after taxes of $47,000,000 and dividends of $35,000,000.[21] Penney's paid its top executive $105,000,[22] and Woolworth's paid compensation of $222,000 to its chief executive.[23]

This extreme range of salaries is a constant occurrence. An earlier study displayed this same variation in 51 large industrial corporations with average assets of $178,000,000. Measured as a percentage of earnings, compensation of policy-making executives averaged 2.9% in 1929 and 4.9% for the years 1928 through 1936. However, the variation of the percentage of compensation paid by corporations ranged from 0.5% to 16.6% in 1929 and 0.8% to 41.9% for the 1928-1936 period.[24] This variation was attributed to a lack of attention and knowledge of directors.[25] This same variation has continued in post-war years.[26]

Another approach to compensation levels and their relationships is to examine the list of executives receiving bonuses of over $250,000 a year. *Fortune* reports that there were thirty-six executives in that category in 1955.[27] Of these thirty-six, twelve were employed by General Motors, and their aggregate salaries and bonuses totaled $6,266,000.[28] Ten executives of Bethelehem Steel divided a total of $4,459,000. Seven duPont executives received $2,904,000, and four Ford executives earned $2,110,000. These figures account for thirty-three of the thirty-six executives.

A comparison of assets, earnings, and dividends of the corporations employing these executives reveals variations that cast some doubt on the incentive factor of compensation, at least in the sense that in some corporations more economic results are required to achieve a specified income than in others. The net income of General Motors for 1955 was $1,189,477,082.[29] Bethelehem's net income was over

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[20]MOODY'S INDUSTRIAL MANUAL 1605 (1957).
[21]*Id.* at 1625.
[22]Business Week, May 25, 1957, p. 113.
[23]*Ibid.*
[24]BAKER, *op. cit. supra* note 9, at 238.
[25]*Id.* at 243.
[26]BLACKETT, MANAGEMENT COMPENSATION 36 (1953).
[27]Dec. 1956, p. 130.
[28]This is not necessarily the total compensation received by these executives.
[29]MOODY'S INDUSTRIAL MANUAL 2509 (1956).

$1,000,000,000 smaller: $180,191,708.[30] However, the incentive compensation plan of each corporation produced income of approximately equal size to its executives. The income of the ten General Motors executives equaled 0.9% of the declared dividends, that of the ten Bethelehem executives 6.4% of Bethelehem's dividends. U. S. Steel, with a net income of $761,000,000 compared with Bethelehem's $180,000,000, did not have a single executive among the top thirty-six receiving the largest bonuses.

Litigation in prior years focused attention on extreme cases in which compensation levels seemingly bore no relation to profit or return on capital and exceeded the incentive function. For example, during a seventeen-year period twenty executives of Bethlehem Steel Corporation received a total compensation of $31,000,000 compared with total dividends for the period of $44,000,000.[31] During a four-year period in which no common stock dividends were declared, although net income totaled $68,000,000, the executives of Bethlehem received $6,800,000 in compensation.[32]

In another case, that of the General Motors bonus system introduced in 1923 and terminated in 1929, a corporation, Managers' Securities Company, was established to receive 5% of the net income of General Motors in excess of a 7% return on invested capital. The shares of this corporation were sold to General Motors executives, who then received the benefits of the new corporation. Since the Managers' Securities Company invested in General Motors stock, which pyramided in value during the 1920's, an investment of $50,000 in 1923 entitled the executive to receive cash and stock worth $2,500,000 at the termination of the plan in 1929.[33] Ford Motor Company recently provided a similar compensation device by permitting thirteen executives to own all the stock of newly formed Dearborn Motors. Because of its relationship with Ford, this corporation became quite profitable, and *Time* reported that "The Ford Motor Company will soon buy up the stock of Dearborn Motors at a price

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[30]*Id.* at 2614.

[31]132 NATION 669 (1931).

[32]*Ibid.*

[33]WASHINGTON and ROTHSCHILD, *op. cit. supra* note 16, at 115. Further examples of compensation popularly regarded as excessive and public reaction to the revelation of amounts paid can be found in Literary Digest, July 29, 1933, p. 7; Oct. 28, 1933, p. 8; Dec. 9, 1933, p. 6; June 10, 1933, p. 8. For a report of corporate opposition to the publication of compensation figures by the SEC see *id.* Apr. 20, 1935, p. 41.

which will give the holders huge capital gains taxable at only 26%."[34] Ford also granted a stock option in 1953 to officers and directors, which, based on the 1956 public offering of Ford stock, provided paper profits of $41,500,000 for the group.[35]

The relationship between compensation and dividends may be viewed in another way. The salary and bonus of the president of General Motors totaled $775,000 in 1955.[36] The corporation's stock closed at $46 a share at the end of that year,[37] and dividends amounted to $2.17. If a shareholder desired to receive an income equal to the president's, he would need 357,140 shares of General Motors stock or an investment of $16,428,440. Aspiring executives who might be disgruntled with the organizational procedures of large corporations were reminded of a similar thought in an article in *Nation's Business*.[38] It was pointed out that the president of a large chain store corporation who received $330,000 a year would, if he were in business for himself, need to invest $8,250,000 in order to receive his present income. In addition, under the heading "Do You Still Get a Thrill out of Competition?" it was observed that once one had established such a business, receiving income would simply be a matter of keeping the doors unlocked in contrast to the earning of a corporate salary, which, based upon corporate competition, involves the only real competition surviving today.

Except within the broadest ranges, compensation appears not to be related in any discernible manner to gross income of the corporation, amount of profits, dividends paid, capital invested, or the amount of money required to motivate economic man.

Methods of Compensation

The methods of payment to executives are varied. Current payments may be made by salary, bonus (cash or stock), profit sharing, stock options, and stock purchases. Deferred compensation can be in all of the above forms in addition to pensions, annuities, and insurance purchased for the executive. Salaries may be deferred by the use of the future service consultant device, which provides for

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[34]Time, May 18, 1953, p. 105.

[35]Rothschild, *Financing Stock Purchases by Executives,* Harv. Bus. Rev., Mar.-Apr. 1957, p. 136.

[36]Fortune, Dec. 1956, p. 130.

[37]New York Times, Dec. 31, 1955, p. 20.

[38]Oct. 1947, p. 39.

payment after retirement on condition that the executive remain available for consultation.[39] A 1956 survey of 641 corporations listed on the major stock exchanges indicated that 90% provided retirement plans for the chief executive, 26% offered some form of deferred income, and stock option plans were offered by 55% of the companies.[40]

Stock options and purchases may be financed in ingenious ways. For example, a corporation may sell stock to its executive, who may borrow the purchase price from the corporation. The executive's stock is returned to the corporation to secure the loan, and the dividends produced by the stock are used to discharge the indebtedness. This transaction is often accompanied by an agreement that the corporation may repurchase the stock at the original price if the executive leaves the employment of the corporation; an understanding may also exist that should the stock fall in price the corporation will not press the executive for payment of the loan.

Without an exhaustive study of material on file with the Securities and Exchange Commission it is impossible to determine the amount of executive compensation paid by these different devices. All that can be done here is to indicate some of the characteristics of each method of compensation and, because of their complexity, the difficulties that shareholders may have in evaluating these plans. For example, the General Motors bonus plan introduced in 1923 involved four corporations and a variety of contracts. Managers' Securities Company was incorporated and sold $5,000,000 worth of its class A and class B stock to General Motors. This money and $28,800,000 worth of preferred stock were paid to E. I. duPont de Nemours & Co. in exchange for the delivery from duPont of the 148,509 shares of its subsidiary, General Motors Securities Company, representing 2,250,000 shares of General Motors stock. General Motors contracted to pay to Managers' Securities Company 5% of the net earnings of General Motors per year after deducting from the earnings an amount equal to 7% of the employed capital. General Motors then sold the class A and class B stock of Managers' Securities Company to 70 selected executives.[41] This is the plan by which an investment of $50,000 by an executive in 1923 produced an estimated $2,500,000

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[39]See examples in WASHINGTON and ROTHSCHILD, *op. cit. supra* note 16, at 543-59.

[40]Patton, *supra* note 17.

[41]Mallery v. Managers' Securities Co., 1 F. Supp. 942, 943 (D. Del. 1932). See Cohn v. Columbia Pictures Corp., 117 N.Y.S.2d 809 (Sup. Ct. 1952), for a recent case involving an expense account.

in 1929.[42] This plan was conceived "for arousing and sustaining the zeal, enthusiasm, fidelity, and loyalty of managing executives of" General Motors.[43] The Ford plan involved compensation through the appreciation of the stock, owned by Ford executives, of Dearborn Motors; the latter corporation owed its profitability to its relationship with Ford.

The use of deferred compensation plans permits tax savings to executives if payments are received at a time when the executive's income is subject to a lower taxable rate. Frequently the saving to the executive is at the expense of a tax saving to the corporation and hence is to the detriment of the shareholders. Plans most advantageous to the executive, permitting deferment of taxable income to later years, frequently preclude the corporation from deducting from its income the payments in the current year, and sometimes even in the year when compensation is paid.[44] The use of such plans is reported to have increased greatly from 1927 to 1947.[45] Over 900 corporations of 1,087 listed on the New York Stock Exchange reported the use of deferred compensation plans for executives.[46]

The extensive use of these plans counteracts the idea that the size of payments to executives is an inconsequential problem because of high rates of taxation. Management has available many methods of providing compensation with reduced tax liability.[47] The argument that the current high rate of individual tax in the upper income brackets provides a built-in safeguard against managerial desire for increased compensation has little factual basis. The growth of deferred compensation plans along with other devices for placing retainable income in the hands of management demonstrates that taxation does not limit total compensation; it merely changes the techniques of reward. Also, deferred compensation plans may be a motivation for management to seek higher salaries, even though the bulk of the increase may be paid in taxes, because of the practice of basing deferred payments on a percentage of present salary.

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[42]WASHINGTON and ROTHSCHILD, *op. cit. supra* note 16, at 115.

[43]Mallery v. Managers' Securities Co., *supra* note 41. A complicated method of alleged indirect compensation is set forth in Prospectus of the Phillips Petroleum Co., Feb. 7, 1957, p. 17.

[44]HALL, EFFECTS OF TAXATION: EXECUTIVE COMPENSATION AND RETIREMENT PLANS 70-84 (1951).

[45]*Id.* at 38.

[46]Lasser and Rothschild, *Deferred Compensation for Executives,* Harv. Bus. Rev., Jan.-Feb. 1955, p. 89.

[47]*Ibid.*

It has been observed that deferred compensation plans, because they provide for the loss of deferred benefits if the executive prematurely terminates his employment, reduce the mobility of executives; an executive desiring to change positions will need considerably more money if he is to compensate for the loss of deferred benefits from his present position. In this way deferred payment plans may produce a frustrated, dissatisfied management because of their tendency to "trap" the executive in the corporation.[48]

One further method of compensation is available: expense accounts. Information is rare on this method, and the extent of its use and the amounts received can only be suggested. *Newsweek* reports: "As the officer of a Detroit firm puts it: 'Give a man membership in a country club and don't crowd him too much regarding whom he is entertaining, and you've given him a nontaxable fringe benefit.' "[49] *Life* adds, "What the smaller executives can do by indirection, the boss of the firm can do without any beating around the bush at all. In fact the expense account is a recognized way of rewarding executives . . . ."[50] These rewards include town or hotel apartments, hunting lodges, yachts, airplanes, country club memberships, meals, and Miami conventions at appropriate seasons.[51]

The Incentive Function

Management compensation policies are supported by management on the basis of their incentive value.[52] This is particularly true when compensation is largely in the form of a bonus,[53] although additional reasons sometimes stated are to obtain and retain executives and to relate compensation to corporate earnings.[54] The validity of varying compensation levels as an incentive device is not neatly proved or disproved; judicial approval of incentive devices accepts their validity as axiomatic. There are some within the ranks of management who rate compensation at less than the customary value and place greater

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[48]DRUCKER, THE PRACTICE OF MANAGEMENT 152 (1954).

[49]May 20, 1957, pp. 87, 91.

[50]Mar. 9, 1953, pp. 140, 145.

[51]*Id.*, p. 140.

[52]See COPELAND, THE EXECUTIVE AT WORK 215-37 (1951).

[53]BAKER, *op. cit. supra* note 9, at 197. See General Motors Ann. Rep. 33 (1955), in which, in speaking of the bonus plan, it is stated: "Its purpose is to provide incentives and reward eligible employees who contribute to the success of the business . . . ."

[54]BAKER, *op. cit. supra* note 9, at 247.

emphasis upon personal association, psychological identification, and participation.[55] Others observe that those engaging in basic research over a period of years, whose discoveries may lead to immense profits, receive no incentive compensation but that one who tinkers with the organizational apparatus does.[56]

However, if compensation functions as an incentive device it may presumably be measured by profits. That is, the greater the compensation the greater should be the profits. Of course other factors, as, for example, the extent of responsibility, will affect compensation; still, they should not affect industry averages or comparisons in those instances in which managerial challenge is approximately equal.

The examinations of corporate compensation which have been made produce considerable scepticism about its incentive value. Professor John Baker of Harvard, after an extensive inquiry, found that "statistically, no significant relationship or correlation could be discovered between executive compensation and earnings."[57] The same writer found that the argument that bonus payments are made as an incentive supplement to a small salary is without factual support: a survey of 155 corporations indicated that of those with assets of over $30,000,000 paying no bonus the average salary for executives was $53,000; corporations paying salary and bonus paid an average salary of $54,000 and total compensation of $107,500. Hence bonus payments did not supplement small salaries.[58]

If compensation functions as an incentive device there should be a lack of stability and a fluctuation of total payments varying with profits. The practice, however, has been for executive compensation to remain relatively stable and to decline only slightly in less profitable years; years of increased profit are usually followed by increased compensation. Professor Baker found the total compensation of the three highest paid executives in corporations with assets in excess of $178,-000,000 to be $251,000 in 1928, $243,000 in 1931, $210,000 in 1934, and $236,000 in 1936. For large corporations with less than $178,-000,000 in assets the figures were $182,000, $191,000, $150,000, and $185,000 in the same years.[59] The decline in compensation is hardly

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[55]*E.g.*, BARNARD, THE FUNCTIONS OF THE EXECUTIVE 139-60 (1950).

[56]DRUCKER, THE PRACTICE OF MANAGEMENT 151 (1954).

[57]Baker, *Executive Compensation Compared with Earnings*, Harv. Bus. Rev., Winter 1936, pp. 213, 224.

[58]Baker, *Incentive Compensation Plans for Executives*, Harv. Bus. Rev., Autumn 1936, pp. 44, 54-55.

[59]Baker, *Executive Compensation Payments by Large and Small Industrial*

commensurate with the reduced corporate income of the depression years.

Total compensation to executives remained relatively stable in spite of the reduction of the number of corporations paying a bonus from 70.9% in 1928 to 28.6% in 1935.[60] This occurred because the elimination of bonus payments was often accompanied by salary increases; one half of the 138 largest corporations maintained or increased salaries to managers during the depression years.[61]

The decline in bonus payments during the depression was due partly to lack of sufficient profit to provide for a bonus fund; however, some corporations *eliminated* their bonus plans.[62] If bonus plans are used for incentive purposes it is rather incongruous to eliminate them during years of decreased profits when most corporations are seeking ways to increase income.

Ironically, bonus plans were re-established immediately after the second world war; an American Management Association survey reported that the number of corporations with existing bonus plans for executives increased from 20% in 1945 to 40% in 1949.[63] *Fortune* estimates that total managerial bonus rewards increased from $330,000,000 in 1947 to $615,000,000 in 1956.[64] This occurred in a period of increased national prosperity during which the increase in corporate income was probably unrelated to management activity. The elimination of bonus plans in a period when profits are needed and their re-establishment when profits are likely to occur does not support their incentive characteristics.

Other methods of compensation reveal the same inconsistency between the incentive function and the amount of payment. Although detailed studies are unavailable, fragmentary evidence supports this conclusion. The Ford bonus plan was adopted just after the second world war in a period of increasing prosperity and appreciating values. The American Woolen Company established a pension plan benefiting its chief executive only one year before his retirement by providing him with an annual pension of $54,000.[65] Although per-

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Companies, 53 Q.J. ECON. 404, 429 (1939).

[60]*Id.* at 431. Corporations studied were those with assets of over $100,000,000.

[61]Frederich, *Big Salaries and Bounses,* 238 NORTH AMERICAN REVIEW 225 (1934).

[62]BAKER, EXECUTIVE SALARIES AND BONUS PLANS 20, 183 (1938).

[63]Patton, *Current Practices in Executive Compensation,* Harv. Bus. Rev., Jan. 1951, pp. 56, 61.

[64]Fortune, Dec. 1956, pp. 127, 130. It is also reported that bonus payments soon are viewed as vested rights.

[65]Fogelson v. American Woolen Co., 170 F.2d 660 (2d Cir. 1948).

haps an appropriate award for prior underpaid years, such a contract cannot be supported on an incentive basis.

Ancillary Problems

The most prominent problem accompanying managerial compensation is the failure to reveal to shareholders the amounts paid to management. One study of twenty-four steel corporations for the period 1928-1936 revealed that only four of the ten corporations having a bonus plan reported to shareholders the amount of the annual payments to management. Few of the plans had been approved by shareholders, and often their existence was suggested only by a stray balance sheet item.[66] The bonus plans of thirty large industrial corporations adopted just prior to the second world war were not mentioned in the company reports of fourteen.[67] The large payments to Bethlehem Steel executives, an average of $814,993 a year to the president from 1918 to 1930, were not reported to shareholders,[68] nor were the payments to the management of the American Tobacco Company[69] and some payments under the General Motors plan.[70] The National City Bank of New York bonus fund, providing that from annual profits an amount equal to 8% of the capital should be set aside for shareholders and that 20% of the remaining profits should be distributed to the management, was adopted without shareholder approval, and the amounts received by executives were never revealed.[71]

Securities legislation has now produced disclosure of managerial compensation for corporations within the jurisdiction of the Securities and Exchange Commission. The effectiveness of these disclosure requirements may be questioned; based upon the theory that disclosure will permit the shareholder to protect himself, obstacles are present in the proxy system and in the reluctance of the judiciary to interfere with the amount of compensation. However, this problem of secrecy remains for corporations not within the commission's jurisdiction.[72]

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[66]BAKER, EXECUTIVE SALARIES AND BONUS PLANS 155 (1938).

[67]*Id.* at 200.

[68]WASHINGTON and ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 383 (rev. ed. 1951).

[69]*Id.* at 387. $729,000 in 1929 and $1,284,000 in 1930 to the president.

[70]Winkelman v. General Motors Corp., 44 F. Supp. 960, 974-76 (S.D.N.Y. 1942).

[71]WASHINGTON and ROTHSCHILD, *op. cit. supra* note 68, at 395.

[72]LOSS, SECURITIES REGULATION 619 (1951). Many large corporations need not

A second problem arises in accounting and computation procedures. Determination of the basis for a bonus fund based upon a percentage of the profits may induce management to manipulate accounting procedures to produce greater profits and a larger bonus. Directors of General Motors were held liable for over $2,000,000 because of accounting errors.[73] The bonus fund of the American Tobacco Company was miscomputed to the extent of $2,018,033,[74] and the directors of the National City Bank of New York were declared liable for $1,703,703 for miscalculation of the bonus fund.[75] In situations in which management controls the corporation and can resolve any conflict as to the manner of treatment of transactions, the competing interests of management and shareholders are not submitted to an independent judgment. Although the SEC has compelled the aura of secrecy to be lifted in a limited segment with respect to the amount of managerial compensation, the primary corrective device at work in the area of accounting discretion is the standardization of accounting procedures. With a trend established in many companies toward boards of directors composed primarily of inside directors, the shareholders must rely to an increasing extent upon the integrity and discretion of the recipient of the bonus to determine the components of the income upon which that bonus is computed. Management is evidently not always eager to adopt standardized accounting practices or to submit its determinations to the scrutiny of independent auditors.[76]

The interest of shareholders in dividends can conflict with the interest of management in compensation. A shareholder's proposal to reduce salaries of executives earnings more than $25,000 a year proportionate to any reduction in corporate earnings or dividends was opposed by the management of Loew's, Inc., on the basis that the management might not be responsible for the decline in earnings and

comply with the disclosure provisions of the SEC statutes, *e.g.*, Humble Oil & Ref. Co., Aluminum Co. of America, and Great Atlantic & Pacific Tea Co.

[73]Winkelman v. General Motors Corp., 44 F. Supp. 960 (S.D.N.Y. 1942).

[74]Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct.), *aff'd w/o opinion,* 263 App. Div. 815, 32 N.Y.S.2d 131 (1st Dep't 1941).

[75]Gallin v. National City Bank, 155 Misc. 880, 903, 281 N.Y. Supp. 795, 819 (Sup. Ct. 1935).

[76]See, *e.g.*, the opposition of management to a shareholder's proposal for independent auditors in Securities and Exch. Comm'n v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947). See also Weinberg, *A Corporation Director Looks at His Job,* 27 HARV. BUS. REV. 585 (1949), for a statement of the desirability of outside directors.

dividends.[77] Another proposal by a shareholder of Pan American Airways Corporation to limit the *bonus* compensation fund to the amount of distributed dividends was opposed as an unwise restriction of the directors' judgment.[78]

The possibility of fortuitous "incentive compensation" payments may be illustrated by the American Woolen Company situation. In 1933 the market price of wool doubled, which enabled the company to earn $7,000,000 profit after seven years of deficit amounting to a net loss of $23,000,000. However, the unexpected profits permitted a bonus payment of $600,000 to three officers in addition to their salary payments of $165,000.[79]

The difficulty of establishing a basis for compensation is obvious. Some writers have urged that statistical data on average payments by industry, size, sales, and profits should be used as the basis for compensation.[80] At the present time neither prevailing industrial standards related to the data nor competitive factors appear to be the basis for the measurement of compensation.[81] Indeed, the data frequently is not available in detail, and, when it is, there is no indication of current widespread use.

CORPORATE CONTROL

A student of political parties once declared that ultimate control of a party flows to those who are able to control the organizational apparatus.[82] The same phenomenon occurs in corporate organization. Of course, in our economic and property ideas, shareholders, as owners, exercise ultimate control over corporations. The operational decisions are necessarily made by managers, but this group is observed and checked by the directors, who are the chosen representatives of the shareholders. Basic decisions of the managers that require financing will have to face the further test of the judgment of the market place,

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[77]See WASHINGTON and ROTHSCHILD, *op. cit. supra* note 68, at 49, n.48.

[78]*Ibid.*

[79]BAKER, EXECUTIVE SALARIES AND BONUS PLANS 71 (1938).

[80]See Howe, *Price Tags for Executives,* Harv. Bus. Rev. May-June 1956, p. 94; Patton, *Building on the Executive Compensation Survey,* Harv. Bus. Rev., May-June 1955, p. 84.

[81]See Towl, *Patterns of Executive Compensation,* Harv. Bus. Rev., July 1951, pp. 25, 27.

[82]See OSTROGORSKI, DEMOCRACY AND THE ORGANIZATION OF POLITICAL PARTIES (1908).

where stern and conservative financiers will give a practical judgment by lending or refusing to lend to the corporation.

This theory purports to state the basis of corporate activity, and society accepts this basis as desirable. To believe that this theory is descriptive of all forms of corporate practice is illusory. It may be an accurate description of nineteenth century corporations or small corporations of today; it inadequately describes present large scale corporate institutions. The exercise of financial control by a group that owns a small fraction of stock is a familiar picture.

Modern developments have produced still another control group of greater prevalence: management. Many factors contributed to the growth of managerial control: dispersion of stock ownership, inertia of shareholders, legal limitations on shareholders' rights, the proxy engine. The convergence of these and other factors has resulted in managerial control of many corporations and the power of management to determine the amount of managerial compensation.

The initial factor that makes managerial control possible is the separation of ownership and management. Neither officers nor directors are substantial owners of stock in large corporations. In the 200 largest corporations the median percentage of stock ownership of all officers was .32% in 1939; nonofficer directors owned a median percentage of 1.11, and the median of total management ownership was 2.11%.[83] The median value of common stock owned by 246 executives in 149 large corporations was $71,600 in 1935.[84] Examination of proxy statements of ten large corporations does not demonstrate that stock option plans have caused a significant increase in these figures.[85] The investigations into the extent of management ownership may be summarized by stating that "management, even in smaller companies, tends to participate only to a minor extent in corporate ownership, and that in the larger companies particularly the holdings of officers and directors are very small indeed."[86] Statements are frequently made urging greater managerial stock ownership as a means of relating the interests of management and the corporation in increased profits; however, the only study located indicates that there is no cor-

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[83]Gordon, Business Leadership in the Large Corporation 27 (1945).

[84]*Id.* at 299.

[85]Union Carbide Co., Rochester Gas & Elec. Co., Pure Oil Co., Monsanto Chemical Co., Household Finance Corp., Gulf Oil Co., Dow Chemical Corp., Dayton Power & Light Co., General Motors, Chrysler Corp.

[86]Gordon, *Stockholdings of Officers and Directors in American Industrial Corporations*, 50 Q.J. Econ. 622, 640 (1936).

relation between ownership by management and profits.[87]

Lack of managerial stock holdings may only reflect the more significant development of dispersion of stock ownership. In 1900 the total capital stock in all corporations in the United States was $62,000,000,000, and this stock was owned by 4,400,000 book stockholders; in 1928 $92,000,000,000 of stock was owned by 18,000,000 book owners.[88] In 1955 the shareholdings in 857 large publicly held corporations numbered 22,000,000; the number of persons owning stock had risen in that year to over 9,000,000, an increase of 86% since 1927.[89] In many corporations this diffusion of ownership has eliminated concentrated holdings. The largest stockowner in the Pennsylvania Railroad, for example, owned only .3% of the total stock. The combined ownership of the twenty largest shareholders amounted to only 2.7% of the outstanding stock.[90] This situation is found extensively in modern corporations, and the general trend of dispersion of ownership has been a continuing development in this century.[91]

This trend of dispersion, which means that more people are sharing in ownership, could mean that the basis of control has been diffused if there existed active, representative directors. Just the contrary is true: the boards are frequently either inactive and mere formalities or they are officer dominated.[92] As early as twenty years ago officers constituted 36% of the membership of the boards of 155 giant corporations[93] and composed 43% of the board membership of the 84 industrial corporations in the group.[94] A selective study of 25 of these industrial corporations reveals the following distribution of 372 directors: 191 officers, 56 bankers, 69 important stockholders, 56 miscellaneous.[95]

When boards are not composed of a large proportion of officers the problem of inactivity of directors or of officer domination is still present. In Professor Robert Gordon's study of business leadership he observes:[96]

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[87]BAKER, EXECUTIVE SALARIES AND BONUS PLANS 94-95 (1938).

[88]BERLE and MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 56 (1937).

[89]Forbes, Sept. 1, 1957, p. 15.

[90]BERLE and MEANS, *op. cit. supra* note 88, at 48.

[91]See KIMMEL, SHARE OWNERSHIP IN THE UNITED STATES (1952).

[92]Bates, *The Board of Directors,* 19 HARV. BUS. REV. 72 (1940).

[93]GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 119 (1945).

[94]*Id.* at 119.

[95]*Id.* at 122.

[96]*Id.* at 131.

> "For the majority of the corporations studied, the available evidence strongly suggests that ratification of management proposals by the board is largely a formality. The great majority of executives interviewed stated or implied that their boards were 'passive' or that approval of management recommendations was 'nominal' or 'automatic.' "

By "passive" he means that the board does not actively exercise an independent power of veto or approval over management decisions.

The judgment of still another group that could limit the power of management, although perhaps only slightly regarding compensation, is the judgment of the market place. However, even this traditional restraint is disappearing: the corporate necessity for new capital solicited from the market place has been solved by "growing their own." Profits and funds from depreciation reserves have permitted corporations to finance expansion from internal sources to such an extent that, in a sense, they could dispense with shareholders. Mr. Owen D. Young of General Electric replied "that is right" when asked, "[Y]our general experience parallels that of Mr. Stettinius' company [U. S. Steel] in that from your internal sources, after you had arrived at this period of relative maturity, you could do the financing without tapping outside savings?"[97] When asked, "General Motors is virtually a self-contained unit in the sense that it has little or no need to go to the public markets for financing?" Mr. Sloan replied, "That is absolutely correct."[98]

This process of internal financing continues. In the eleven-year period 1947-1957 American corporations received $206,000,000,000 in profits after taxes, of which $103,000,000,000 was distributed as dividends and $103,000,000,000 was retained by the corporations.[99] These savings permitted corporations in 1956, for example, to finance $36,000,000,000 of expansion by $24,800,000,000 from internal savings and to utilize external sources for only $11,500,000,000.[100] During the eight-year period 1946-1953, $150,000,000,000 was spent by all American businesses for capital expenditures. Of this amount 64% was internally financed, 18% was raised by current bank borrowing, 12% was provided by bonds and notes, and 6% was secured by the sale of

[97]Quoted in Chase, *Capital Not Wanted,* 180 HARPER'S 225, 231 (1940).
[98]*Ibid.*
[99]U. S. BUREAU OF CENSUS, STATISTICAL ABSTRACT 494, Table 615 (1958).
[100]*Id.* at 497, Table 620.

stock.[101] This development has made the shareholder and the financier almost unnecessary, and the restraint of the judgment of the market place constitutes a factor of decreasing importance as a limitation upon the power of management.

In addition to the shareholder's weakened economic position, severe legal limitations are placed upon his power to counteract the power position of management. Early incorporation practices placed stringent limits upon the power of the corporation and gave extended rights to shareholders.[102] The competition of states to secure corporations has caused a reversal of this situation, producing simple and flexible incorporation statutes that weaken the power of investors.[103] The legal changes have been legion:[104] the disappearance of the power to remove directors at will, the introduction of nonvoting stock and blank stock, the exceptions to the pre-emptive right doctrine, the power to reclassify rights of shares, the use of voting trusts, and the authorization of corporations to own stock, which results in holding company control. All of these changes have had the effect of increasing the power of management and decreasing the power position of the individual shareholders. Professor Dodd comments:[105]

> "Many of these developments have been necessary in order to adapt the business corporation to modern industrial and financial conditions, though some of them, such as the abolition of preemptive rights, are easier to reconcile with an unorthodox theory that corporate managements hire capital, than with our traditional assumption that shareholders, as owners of corporate capital, hire managers."

The most recent limitation on shareholders' power over management is in the area of derivative suits. Because this type of suit may lead to a large personal settlement with the plaintiff, which frequently may dispose of the matter more easily from the viewpoint of

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[101]BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 37-38 (1954).

[102]See BERLE and MEANS, *op. cit. supra* note 88, at 127-38.

[103]See Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage,* 39 VA. L. REV. 141 (1953); Dodd, *Statutory Developments in Business Corporation Law, 1886-1936,* 50 HARV. L. REV. 27, 34, 57 (1936); Hornstein, *Legal Controls for Intracorporate Abuse — Present and Future,* 41 COLUM. L. REV. 405, 431-32 (1941).

[104]BERLE and MEANS, *op. cit. supra* note 88, detail these changes at 127-206.

[105]Dodd, *The Modern Corporation, Private Property, and Recent Federal Legislation,* 54 HARV. L. REV. 917 (1941).

management than does a trial, whatever the merits of the claim, the procedure may be readily abused. Although the most obvious remedy would be to prohibit unsupervised private settlements and thus reduce the motive for personal gain, the states have not always followed the federal courts in this procedure.[106] To prevent the abuses of the derivative suit the trend is to limit the power to begin the suit.[107] An initial limitation results from the contemporaneous ownership rule, requiring the shareholder to have owned the stock at the time the wrong occurred.[108] The strength of the derivative suit is further diluted by recent "security for expenses" legislation.[109] This legislation requires that shareholders owning less than a specified percentage of stock must post security for the expenses of the defendant corporation and officers, including expenses for attorney's fees.[110] Many of the states adopting this legislation already have statutes authorizing indemnification of management for expenses incurred in derivative suits.[111] The constitutionality of the security for expenses legislation has been sustained,[112] and it has been held that the state statutes apply to suits brought in federal courts.[113]

It is ironic that the legal limitations upon the investor resulting from the liberalized corporation statutes have been supported on the ground that the shareholder's derivative suit and his new right to vote by proxy[114] would protect him.[115] However, use of proxies has not constituted an effective method of managerial control by shareholders. It is obvious that the use of a proxy will demand, as a minimum, complete and reliable disclosure of information upon

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[106]FED. R. CIV. P. 23 (e) requires court approval of settlements and notice to all shareholders. A rule that the shareholder holds the proceeds of a settlement in trust for the corporation would limit the motivation for personal gain. See Young v. Higbee Co., 324 U.S. 204 (1945).

[107]See Caplin, *supra* note 103, at 148.

[108]*E.g.*, N.J. STAT. ANN. §14:3-16 (Supp. 1958); N.Y. GEN. CORP. LAW 61; PA. STAT. ANN. tit. 12, §1321 (1953).

[109]*E.g.*, N.J. STAT. ANN. §14:3-15 (Supp. 1958); N.Y. GEN. CORP. LAW §61-b; PA. STAT. ANN. tit. 12, §1322 (1953).

[110]See Note, 52 COLUM. L. REV. 267 (1952).

[111]Caplin, *supra* note 103, at 148. See also Ballantine, *Abuses of Shareholders' Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CALIF. L. REV. 399 (1949).

[112]Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949); Lapchak v. Baker, 298 N.Y. 89, 80 N.E.2d 751 (1948).

[113]Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949).

[114]See Axe, *Corporate Proxies*, 41 MICH. L. REV. 38 (1942).

[115]Hornstein, *The Future of Corporate Control*, 63 HARV. L. REV. 476 (1950).

which to base a decision. Yet state law regulating disclosure and the solicitation of proxies is virtually nonexistent,[116] and regulation is limited to those corporations within the jurisdiction of the Securities and Exchange Commission.[117]

The information available to a shareholder who is not protected by the commission has been examined for industrial corporations traded on the New York Curb Exchange on an unlisted basis. The proxy solicitation material used by eighty-eight of these corporations for shareholder meetings to elect directors did not reveal the names of the nominees in 84% of the meetings; in 97% of the cases there was no disclosure of management remuneration, and 95% of the material contained no disclosure of management's security holdings.[118] In one case investigated, the proxy statement was printed on the back of the dividend check, so that endorsing the check gave management a proxy unless the endorser specifically stated otherwise.[119]

Corporations obligated to comply with the disclosure and proxy solicitation requirements of the Securities Exchange Act of 1934 must make extensive disclosures to shareholders. Regulations promulgated by the commission[120] require management to furnish, in its proxy solicitation statement, the amount of compensation paid to officers and directors in direct remuneration, pensions, and retirement benefits and deferred payments to be made, as well as the purchase and market price of stock options. If action is to be taken with respect to any compensation plan, the proxy solicitation statement must include the material details of the plan and the amounts which would have been received by directors and officers during the last fiscal year if the plan had been in operation. There must be an indication that management is soliciting the proxy, and the matters to be voted upon must be separately stated, with an opportunity for the shareholder to specify approval or disapproval of each issue. Solicitation of proxies is prohibited unless each person solicited is furnished with a proxy statement containing the required information.

Shareholders are accorded some active rights under the regulations.[121] If a shareholder desires to solicit proxies, management is re-

[116]Emerson and Latcham, *SEC Proxy Regulation: Steps Toward More Effective Stockholder Participation,* 59 YALE L.J. 635 (1950).

[117]Securities Exchange Act of 1934, 48 STAT. 881, 892 (1934), 15 U.S.C. §78 (1), (n) (1952); 17 C.F.R. §240.14a-2 (Supp. 1958).

[118]LOSS, SECURITIES REGULATION 619 (1951).

[119]*Ibid.*

[120]17 C.F.R. §240.14a, sched. 14A (Supp. 1958).

[121]17 C.F.R. §240.14a-7,8 (Supp. 1958).

quired to furnish him a list of security holders or to mail to the security holders, at the expense of the shareholder, the material that he furnishes. This rule is designed to meet "the problems, and sometimes nearly practical impossibility under state law, of securing a list of stockholders' names and addresses . . . ."[122] Another provision obligates management to include in its solicitation material a proposal of a shareholder if it is a proper subject. There is also a prohibition against a refusal to vote solicited proxies to counteract the management practice of simply not voting unfavorable responses.[123]

A series of amendments to the regulations in 1954 restricted rather than expanded shareholders' rights under the proxy section.[124] The period of time prior to management proxy solicitation by which a shareholder must submit a proposal that is to be included in the management proxy was lengthened from thirty to sixty days in order to give management more time to study the proposal.[125] This time extension has been criticized on the basis that the shorter time has not placed a burden on management. Only 1.9% of the yearly average of 1,660 proxy statements filed with the commission from 1943 to 1952 contained shareholder proposals, and 93% of these proposals were recurring, identical proposals concentrated in a few major areas.[126] The effect of the longer period of time is to require a shareholder to submit his proposal prior to the time he receives the corporation's annual report.[127]

The shareholder proposal rule prior to 1954 permitted management to omit the proposal if it had failed to gain 3% of the vote at its last submission. This rule was amended to permit omission if the proposal had failed to receive 6% at its second submission and 10% at its third vote within the preceding three years. The effect of the amendment is to eliminate over one half of the proposals.[128] Lewis

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[122]EMERSON and LATCHAM, SHAREHOLDER DEMOCRACY 44 (1954); see FLA. STAT. §608.39 (1957) for the Florida requirements. See also Note, 26 U. CINC. L. REV. 288 (1957).

[123]EMERSON and LATCHAM, SHAREHOLDER DEMOCRACY 43 (1954).

[124]Bayne, Caplin, Emerson, Latcham, *Proxy Regulation and the Rule-Making Process: The 1954 Amendments,* 40 VA. L. REV. 387 (1954).

[125]The rule states that a proposal submitted "more than 60 days in advance of a day corresponding to the first date on which management proxy soliciting material was released to security holders in connection with the last annual meeting of security holders shall prima facie be deemed to have been submitted a reasonable time before solicitation." 17 C.F.R. §14a-8a (Supp. 1958).

[126]Bayne, Caplin, Emerson, Latcham, *supra* note 124, at 393.

[127]EMERSON and LATCHAM, SHAREHOLDER DEMOCRACY 97 (1954).

[128]See Emerson, *Some Sociological and Legal Aspects of Institutional and In-*

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D. Gilbert, who is dedicated to attending shareholders' meetings with a view toward greater shareholder participation and who, in recent years, has introduced 75% of all shareholder proposals under this rule, insists that proposals receiving only a small percentage of the votes are nonetheless very effective in inducing management to satisfy shareholders.[129]

Perhaps the most critical change by the amendments for the purpose of control over compensation involves the decision in *Securities and Exchange Commission v. Transamerica Corp.*[130] In that case management attempted to use a bylaw requiring that notice of amendments be contained in the notice of the meeting to prevent shareholders from voting on a proposed amendment. The rule governing shareholder proposals required the subject to be one "which is a proper subject for action by the security holders."[131] The corporation argued that the Delaware corporation law permitted the charter to delineate the powers of directors and shareholders and that its charter vested all powers of the corporation in the board of directors; consequently, the shareholder's proposal failed the "proper subject matter" test of the rule. The court refused to sustain this argument and forced the corporation to include the shareholder's proposal, since Delaware law did not exclude shareholder action in this area.

The Securities and Exchange Commission amended its rules: the prior rule required the inclusion of a shareholder's proposal "which is a proper subject for action by the security holders";[132] the amended rule permits management to exclude the proposal if "the proposal as submitted is, under the laws of the issuer's domicile, not a proper subject for action by security holders"[133] or if "the proposal consists of a recommendation or request that management take action with respect to a matter relating to the conduct of the ordinary business operations of the issuer."[134] A recent proposal by a shareholder of Standard Oil Company to appoint a committee to investigate executive compensation was excluded by the commission under the "proper

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dividual Participation Under SEC's Shareholder Proposal Rule, 34 U. DET. L.J. 528, 543 (1957).

[129]See GILBERT, DIVIDENDS AND DEMOCRACY 128-36 (1956).

[130]163 F.2d 511 (3d Cir. 1947), *cert. denied,* 332 U.S. 847 (1948).

[131]17 C.F.R. §240.14a-8a (1949).

[132]*Ibid.*

[133]*Id.* §240.14a-8-C-1. This is not a significant change; it merely states the *Transamerica* rule.

[134]*Id.* §240.14a-8-C-5.

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subject" rule.[135] Gilbert fears that these provisions may easily be interpreted to exclude executive compensation from the area of shareholder proposals.

Proxy solicitation legislation is designed to correct the relative power positions of management and opposing shareholders by insuring a flow of information to shareholders. "It was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of great corporations by a very few persons was the abuse at which Congress struck in enacting Section 14 (a)."[136] The protection afforded, however, does not seriously affect the practical problems facing shareholders' attempts either to remove current management or to limit managerial power and compensation. An attempt to change the management involves expenses for attorneys, accountants, public relations experts, professional proxy solicitors, printing, and even entertainment.[137]

In any contest for proxy votes on proposed policies, management has great advantages. The inertia of most shareholders provides the initial advantage to management and makes most shareholder meetings a formality.[138] If proxy solicitation is necessary, management may employ professional solicitors whose contacts with brokers permit easy access to lists of beneficial owners of stock held by the broker. In one recent contest, for example, forty-five per cent of the outstanding shares were registered in the names of brokers.[139] In addition, management may use corporate funds to finance its campaign if the issue is one of policy as distinct from personnel.[140]

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[135]See Bayne, *The Basic Rationale of Proper Subject,* 34 U. DET. L.J. 575, 598 (1957).

[136]Securities and Exch. Comm'n v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied,* 332 U.S. 847 (1948); Note, 57 YALE L.J. 874 (1948); 20 So. CAL. L. REV. 355 (1947); 96 U. PA. L. REV. 286 (1947).

[137]ARANOW and EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 485-90 (1957). The recent New York Central contest cost management $875,000 and the insurgents $1,308,773.

[138]Latcham and Emerson, *Proxy Contest Expenses and Shareholder Democracy,* 4 W. RES. L. REV. 5 (1952). For a humorous account of a General Motors' shareholders meeting see The New Yorker, June 17, 1950, p. 52.

[139]Emerson and Latcham, *Further Insight into More Effective Stockholder Participation: The Sparks-Withington Proxy Contest,* 60 YALE L.J. 429, 438, 450 (1951). Rules of the N. Y. Stock Exchange provide for equality of treatment in proxy contests if members of the Exchange know of an impending contest.

[140]Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D. Del. 1941); Empire So. Gas Co. v. Gray, 29 Del. Ch. 95, 46 A.2d 741 (Ch. 1946); *In re* Zickl, 73 N.Y.S.2d 181 (Sup. Ct. 1947).

The proxy machinery has hardly secured shareholders the right of representation.[141] The lack of active leadership in opposition to management frequently vests corporate control by default in those currently in power.[142] Sometimes management's power is literally by default through the simple expedient of not soliciting proxies. This results in lack of a quorum and thus perpetuates the control of existing management and exempts the corporation from complying with the Commission's solicitation requirements.[143] The present system has been summarized by one writer as follows:[144]

> "However, as presently employed — with the proxy machinery completely dominated by the managers of industry, with the nominations for directors being made by the managers themselves, and with the shareholders being denied the opportunity of making independent nominations in management's proxy statements — the proxy system of voting has become an anti-democratic device, destructive of any real system of checks and balances against possible managerial abuse, and operating in contravention of our fundamental notions of fair play."

The recent growth in institutional ownership has further accentuated the concept of the hiring of capital by management. Investment funds holding stock in operating corporations are interested primarily in the market performance of the stock for the benefit of their own stockholders. These funds now have total assets of over $9,500,000,000.[145] An analysis of the voting behavior of these investment funds on shareholder proposals beneficial to the investors reveals that "investment companies are doing little or nothing toward fulfillment of their obligation as shareholder participants in corporate affairs . . . ."[146]

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[141]For the problems involved in gaining information from management see GILBERT, DIVIDENDS AND DEMOCRACY (1956).

[142]Bernstein and Fischer, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy,* 7 U. CHI. L. REV. 226 (1940).

[143]EMERSON and LATCHAM, SHAREHOLDER DEMOCRACY 48 (1954). In 1952, 24% of the companies registered with the SEC did not file proxy material. A 1941 recommendation by the SEC would have obligated corporations to furnish in annual reports the information required to be disclosed in proxy solicitations. At present, however, this information still need not be included in the annual report. See Emerson and Latcham, *SEC Proxy Regulation: Steps Toward More Effective Stockholder Participation,* 59 YALE L.J. 635, 675 (1950).

[144]Caplin, *supra* note 103, at 151.

[145]U.S. News & World Report, May 31, 1957, p. 124.

[146]Emerson, *Some Sociological and Legal Aspects of Institutional and Individual*

Thus shareholders are further removed from the exercise of control over management.

The legal limitations summarized above and the practical obstacles involved in competing with managerial control of proxy machinery have resulted in extensive control of corporations by management. It is difficult to measure the exact proportion of corporations controlled by management, for this measurement involves a lengthy empirical study. Berle and Means, after examining the 200 largest nonfinancial corporations, concluded that, in 1929, 44% of the corporations were management controlled, representing 58% of the wealth of the corporations studied.[147] Another 21%, representing 22% of the corporate wealth, were controlled by a legal device, as, for example, a voting trust. This type of control did not represent majority or minority control and probably meant, in effect, management control. Thus at least 58% and possibly 80% of the corporate wealth of the 200 largest corporations was controlled by management.

A later study of 155 of the largest 200 corporations indicates a greater frequency of managerial control.[148] The two most dominant control groups were other corporations, a situation more prevalent in utilities and rails, and management, which was the situation most prevalent in industrial corporations. There is evidence that the number of corporations controlled by management has increased.[149] Peter Drucker, a philosopher turned corporation consultant, has recently observed:[150]

> "[T]he corporation has become autonomous. The stockholders are only one special group of outsiders with a claim to profits. They neither control nor run the property of the corporation; they know nothing about it in most cases. Management is autonomous too. It appoints its own successors without even consulting stockholders. It is rarely removed by stockholders except after a catastrophe such as bankruptcy. In the larger corporation with widely distributed stock ownership it would be impossible for the stockholders to try to control or to oust the corporation executives, even if they wanted to. Manage-

Participation Under the SEC's Shareholder Rule, 34 U. DET. L.J. 528, 547 (1957).

[147]BERLE and MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 94 (1937).

[148]See Gordon, *Ownership by Management and Control Groups in the Large Corporation,* 52 Q.J. ECON. 367, 387 (1938).

[149]See BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 25-42 (1954).

[150]Drucker, *The Future of the Corporation,* 185 HARPER'S 644, 646 (1942).

ment is thus neither controlled by the legal owners of the properties nor responsible to them."

Shareholders need not be the only check upon management. Competition by and for managers could function as a device preventing excessive managerial control and compensation. Individual actions, however, are increasingly submerged by large and complex structures. Entry into management ranks by outsiders is increasingly difficult. Although the growth of the managerial group has been viewed as a democratic, professional movement,[151] our present knowledge indicates that social mobility, the possibility of new social groups entering the managerial group, is much less than we had supposed.[152] *Fortune* observes that "there are also signs that an increasing proportion of younger managers, unlike their elders, are sons of men who were themselves executives. Thus there arises the unhealthy possibility of a self-perpetuating managerial elite."[153] It also reports that there is surprisingly little circulation among companies by executives.

Who controls the wages of management? It is accurate to say that it is usually management. There is the possibility of danger in such a situation from the viewpoint of the shareholder and that of the public.

JUDICIAL CONTROL

The rules governing the authority for and validity of compensation paid to executives derive from corporation, contract, and agency doctrines. Attacks upon compensation will focus upon the lack of authority of the corporation as to the amount of compensation paid or the particular manner of payment; payment may be disputed on the basis of the presence or validity of a contract; the propriety of the acts of directors and officers may be challenged because of bad faith, self-dealing, or fraud. A violation in any of these areas may result in a characterization of waste, spoilation of assets, gift, or fraud. The precise question in dispute, excessiveness of compensation, for example, will usually not be given isolated analysis by the court but will be related to and confused with problems of corporate authority or the propriety of the acts of the corporation's agents in terms of self-dealing. Another confusion found in the cases results from the

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151Walker and Riera, *Wall Street, Main Street & Co.*, 179 HARPER'S 142 (1939).
152See 22 COMMENTARY 367 (1956).
153Fortune, Jan. 1955, pp. 84, 122.

failure to make legal distinctions between closely held and publicly held corporations, even though the courts arrive at different results in the two situations. A further complicating factor is whether a director, officer, or officer-director is involved.

The authority of the corporation to pay its directors is often declared to be dependent upon a statutory, charter, or bylaw provision.[154] Many courts hold only that there is a presumption that directors serve without pay in the absence of an express agreement.[155] The corporation's authority to fix the compensation of officers may be exercised through the directors.[156] The basis of authority for payment of compensation to officer-directors has presented a traditional problem area and is often merged with contract doctrine.

The Florida Supreme Court has stated that "directors of a corporation are precluded from fixing their own compensation for services, to be rendered as offcers of the corporation, unless they are expressly authorized to do so by the charter or by the stockholders."[157] Most jurisdictions, however, consider the problem of officer-director compensation in contractual terms and permit payment when there is an express agreement between the officer-director and the corporation as to the authority of the board of directors.[158] Even in the absence of an agreement, the presumption that an officer-director serves without compensation may be overcome by evidence of the performance of services beyond those of a director and an understanding that the director-officer expected payment.[159] If all the formalities are ignored, however, even ratification by the board of directors or shareholders will not preclude corporate recovery of the compensation.[160]

The area of greatest difficulty regarding officer-directors in those

[154]Godley v. Crandall & Godley Co., 212 N.Y. 121, 105 N.E. 818 (1914).

[155]Fox v. Artic Placer Min. & Mill. Co., 229 N.Y. 124, 128 N.E. 154 (1920); Security Sav. & Trust Co. v. Coos Bay Lumber & Coal Co., 219 Wis. 337, 263 N.W. 187 (1935).

[156]Godley v. Crandall & Godley Co., 212 N.Y. 121, 105 N.E. 818 (1914).

[157]Redstone v. Redstone Lumber & Supply Co., 101 Fla. 226, 232, 133 So. 882, 884 (1931).

[158]Ransome Concrete Mach. Co. v. Moody, 282 Fed. 28 (2d Cir. 1922); Cox v. First Nat'l Bank, 10 Cal. App. 2d 302, 52 P.2d 524 (1935).

[159]Vaught v. Charleston Nat'l Bank, 62 F.2d 817 (10th Cir. 1933); Johnson v. Tri-Union Oil & Gas Co., 278 Ky. 633, 129 S.W.2d 111 (1939); Spence v. Sturgis Steel Go-Cart Co., 217 Mich. 147, 186 N.W. 393 (1922).

[160]Monterey Water Co. v. Voorhees, 45 Ariz. 338, 43 P.2d 196 (1935); Fields v. Victor Bldg. & Loan Co., 73 Okla. 207, 175 Pac. 529 (1918). *But see* Lewis v. Matthews, 166 App. Div. 107, 146 N.Y. Supp. 424 (1st Dep't 1914).

instances in which there is an express agreement is the problem of self-dealing. The presence of a charter or bylaw permitting the officer-director to vote will remove this problem,[161] and most courts do not regard the officer-director's participation as self-dealing if his vote is not necessary to secure adoption of the resolution or contract fixing his salary.[162] However, the officer-director may not be counted for the purpose of determining the presence of a quorum.[163] A system of cross-voting in which each executive abstains from voting as his compensation is being determined will not avoid the self-dealing rule.[164] The domination of a board by a single individual may cause the court to disregard the ostensible regularity of procedure and conclude that self-dealing was present.[165]

Ratification by shareholders of acts of directors will cure the deficiency of self-dealing in jurisdictions in which self-dealing contracts are voidable at the option of the corporation but not void.[166] Even without ratification, a self-voted contract that is only voidable may be sustained by a showing of the director's good faith.[167] The usual effect of the "voidable" and "ratification" rules is to shift the burden of proving the validity of the action. Although ratification will cure the lack of authority of the board of directors under agency doctrine, it will not preclude application of the doctrine of waste if the compensation is excessive.[168]

The corporation's authority to provide different types of compen-

[161]Piccard v. Sperry Corp., 48 F. Supp. 465 (S.D.N.Y. 1943), *aff'd,* 152 F.2d 462 (2d Cir.), *cert. denied,* 328 U.S. 845 (1946); Adams v. Mid-West Chevrolet Corp., 198 Okla. 461, 179 P.2d 147 (1946).

[162]*E.g.,* Anderson v. Calaveras Cent. Min. Corp., 13 Cal. App. 2d 338, 57 P.2d 560 (1936); Clark v. American Coal Co., 86 Iowa 436, 53 N.W. 291 (1892); Wellington Bull & Co. v. Morris, 132 Misc. 509, 230 N.Y. Supp. 122 (Sup. Ct. 1928), *aff'd mem.,* 226 App. Div. 868, 235 N.Y. Supp. 906 (1st Dep't 1929).

[163]Mortensen v. Ballard, 218 Ark. 459, 236 S.W.2d 1006 (1951); Blish v. Thompson Automatic Arms Corp., 30 Del. Ch. 538, 64 A.2d 581 (Ch. 1948); Newcomer v. Mountain Springs Ice & Cold Storage Co., 63 So. Dak. 81, 256 N.W. 359 (1934). *Contra,* Fountain v. Oreck's, Inc., 245 Minn. 202, 71 N.W.2d 646 (1945).

[164]Mallory v. Mallory-Wheeler Co., 61 Conn. 131, 23 Atl. 708 (1891); Stoiber v. Miller Brewing Co., 257 Wis. 13, 42 N.W.2d 144 (1950).

[165]Monterey Water Co. v. Voorhees, 45 Ariz. 338, 43 P.2d 196 (1935); Lillard v. Oil, Paint & Drug Co., 70 N.J. Eq. 197, 56 Atl. 254 (Ch. 1903).

[166]Kerbs v. California Eastern Airways, Inc., 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952); Putnam v. Juvenile Shoe Corp., 307 Mo. 74, 269 S.W. 593 (1925).

[167]Church v. Harnit, 35 F.2d 499 (6th Cir. 1929); Albrecht v. Bellinger, 8 P.2d 983 (Wash. 1932); *cf.* Orlando Orange Groves Co. v. Hale, 107 Fla. 304, 144 So. 674 (1932).

[168]See note 166 *supra.*

sation to its officers and officer-directors appears established, and the greatest problem is the sufficiency of the consideration by the executive in plans that provide other than a direct salary.

A judicially recognized form of incentive compensation is the stock option plan.[169] The problems in this area are the consideration furnished by the executive and the doctrine of pre-emptive rights. If the option plan is designed to retain the employment of the executive by providing for the exercise of the option only during continued employment, the corporation has received a sufficient consideration.[170] The option is invalid when it is not designed to retain the executive.[171] Invalidity of the plan because of pre-emptive rights of shareholders may easily be avoided by using authorized but unissued shares, treasury shares, or shares purchased on the market.[172]

Bonus plans, including stock bonuses,[173] have been widely accepted as proper methods of compensation.[174] Because of the abuse of stock bonuses by promoters there is some suspicion concerning the fair evaluation of services rendered for the bonus. Ratification by shareholders of a bonus plan will force a shareholder to prove unreasonableness[175] if he chooses to attack the plan, a task practically impossible in publicly held corporations. Even without ratification, in the absence of self-dealing the shareholder will also be required to prove the compensation unreasonable.[176]

Pension plans may be established by the corporation; the problem of their validity centers upon whether the consideration of the execu-

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[169]Harker v. Ralston Purina Co., 45 F.2d 929 (7th Cir. 1930); Diamond v. Davis, 38 N.Y.S.2d 103 (Sup. Ct.), *aff'd,* 265 App. Div. 919, 39 N.Y.S.2d 412 (1st Dep't 1942), 292 N.Y. 554, 54 N.E.2d 683 (1944).

[170]McQuillen v. National Cash Register Co., 27 F. Supp. 639 (D. Md. 1939), *aff'd,* 112 F.2d 877 (4th Cir.), *cert. denied,* 311 U.S. 695 (1940); Gottlieb v. Heyden Chem. Corp., 99 A.2d 507 (Del. Ch. 1953); Kerbs v. California Eastern Airways, Inc., 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952).

[171]Holthusen v. Edward G. Budd Mfg. Co., 52 F. Supp. 125 (E.D. Pa. 1943); Kerbs v. California Eastern Airways, Inc., *supra* note 170.

[172]Yasik v. Wachtel, 25 Del. Ch. 247, 17 A.2d 309 (Ch. 1941); see Drinker, *The Preemptive Right of Shareholders to Subscribe to New Shares,* 46 HARV. L. REV. 586 (1930).

[173]Winkelman v. General Motors Corp., 39 F. Supp. 826 (S.D.N.Y. 1940).

[174]Rogers v. Hill, 289 U.S. 582 (1933); Winkelman v. General Motors Corp., *supra* note 173.

[175]Rogers v. Hill, 289 U.S. 582 (1933).

[176]Seitz v. Union Brass & Metal Mfg. Co., 152 Minn. 460, 189 N.W. 586 (1922); see Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct. 1941); Gallin v. National City Bank, 152 Misc. 679, 273 N.Y. Supp. 87 (Sup. Ct. 1934).

tive is past or future. An agreement to pay a pension in exchange for future services by the executive will be sustained.[177] If the pension is established for past services, contract doctrine will invalidate the payment.[178] An agreement to render advisory and consulting services after retirement will be sufficient, however.[179] Pension plans established just prior to the retirement of an officer who is the principal beneficiary may be attacked on the doctrine of waste even though the stated purpose of the plan is to induce the employment of other executives.[180]

A life insurance policy for $300,000 purchased by the corporation for the benefit of the employee's family has been sustained as a benefit to the corporation, and the employee's promise to remain with the corporation for a specified number of years was held sufficient consideration.[181]

Compensation based upon a percentage of the profits of a corporation is sustained,[182] although compensation based upon share ownership is invalid because the payments must relate to employment and the services performed.[183]

The primary problem of control by the judiciary over the amount of managerial compensation may proceed in two broad areas. The first involves the question of compliance with the provisions of the charter and bylaws in the formality of adoption: the legal doctrines that provide guides for judicial decisions are phrased in terms of technical compliance with requirements of ratification by or notice to shareholders, violation of the fiduciary relationship through self-dealing, secrecy, miscomputation, and the presence and validity of contracts. The second area is a direct evaluation of the amount of compensation to determine if it is excessive, unreasonable, and constitutes a waste of corporate assets.[184]

Controls that are technical in nature, such as compliance with

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[177]Holmes v. Republic Steel Corp., 69 N.E.2d 396 (Ohio C.P. 1946), *modified,* 84 Ohio App. 442, 84 N.E.2d 508 (1948).

[178]Plowman v. Indian Ref. Co., 20 F. Supp. 1 (E.D. Ill. 1937).

[179]Holmes v. Republic Steel Corp., *supra* note 177.

[180]Fogelson v. American Woolen Co., 170 F.2d 660 (2d Cir. 1948).

[181]Cohn v. Columbia Pictures Corp., 117 N.Y.S.2d 809 (Sup. Ct. 1952).

[182]Rogers v. Hill, 289 U.S. 582 (1933); Orlando Orange Groves Co. v. Hale, 107 Fla. 304, 144 So. 674 (1932); Gallin v. National City Bank, 152 Misc. 679, 273 N.Y. Supp. 87 (Sup. Ct. 1934).

[183]Scott v. P. Lorillard Co., 108 N.J. Eq. 153, 154 Atl. 515 (Ch.), *aff'd,* 109 N.J. Eq. 417, 157 Atl. 388 (Ct. Err. & App. 1931).

[184]Rogers v. Hill, 289 U.S. 582 (1933).

requirements as to quorum or notice, may be more easily and mechanically applied. Judicial limitations upon compensation have most frequently taken the form of application of such technical rules.[185] One recent study reviewed forty-four cases involving closely held corporations in which an issue of reasonableness of compensation was presented.[186] Classified according to a holding or strong dictum that the compensation was reasonable or unreasonable, twenty-seven were in the former category and seventeen in the latter. The compensation of the chief executive ranged from $1,500 to $24,800 in cases in the reasonable list and from $3,600 to $29,076 in the unreasonable list. Although some cases purported to use standards, such as industry comparisons, prior compensation, and compensation of other officers of the corporation, all but two of the cases in which compensation was declared unreasonable involved self-dealing. Self-dealing in itself may not be the deciding factor, since in ten cases a finding of reasonableness was made although self-dealing was present. The importance of the results is that in the absence of self-dealing courts are reluctant to find compensation unreasonable. Only one case was "found in which the court even referred to percentages of earnings, volume of business, or the like for the purpose of determining the propriety of executive compensation."[187] Shrinkage of purchasing power through inflation was mentioned in only one of the forty-four cases;[188] no case mentioned the increased tax rates. Both of these variables are frequently argued as justifying larger payments to management in publicly held corporations.

Attacks upon the compensation policies of large, publicly held corporations were infrequent prior to the depression, probably because of the confluence of a number of factors, including prosperity and a lack of information by shareholders.[189] The intimacy of the relationship in closely held corporations had provided information to shareholders that resulted in extensive litigation; the first attacks upon publicly held corporations proceeded upon the theories established by such prior litigation and were based upon allegations of self-dealing, fraud, and excessive amounts.

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[185]See Carson, *Current Phases of Derivative Action Against Directors*, 40 MICH. L. REV. 1125 (1942).

[186]WASHINGTON and ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 367-79 (1951).

[187]*Id.* at 370.

[188]Poutch v. National Foundry & Mach. Co., 147 Ky. 242, 143 S.W. 1003 (1912).

[189]See Berendt v. Bethelehem Steel Corp., 108 N.J. Eq. 148, 154 Atl. 321 (Ch.

In *Rogers v. Hill*[190] the United States Supreme Court overcame the reluctance of the court of appeals to interfere with the amount of compensation and affirmed the power of a court of equity to inquire into the compensation of managers to determine if it is excessive. However, the self-dealing associated with the determination of excessive compensation that appears in closely held corporations does not appear as frequently when large corporations are involved. Managers are not majority shareholders trying to convert a "partner's" dividends into their own under the guise of compensation.[191] A greater awareness of proper legal corporate procedures and the ability through the proxy machinery to gain shareholder approval or ratification limits the court's application of the technical controls. A management that is able to control a corporation through proxy voting will have little difficulty in establishing a board of directors apparently disinterested in management's compensation.

Without the ability to pronounce "fraud," "bad faith," or "self-dealing," the courts find the question *Is this executive being paid too much?* more designed to produce a neurosis than an answer. Although courts express a willingness to inquire to determine if executive salaries are excessive, the result of such an inquiry is almost invariably to resolve the question in favor of the reasonableness of the payments.

The reliance of the courts upon the disinterested good faith of directors when excessiveness is the issue involved is illustrated by *Gallin v. National City Bank*,[192] in which payments to Mr. Charles E. Mitchell, the chief executive, of $1,156,200 in 1927, $1,417,000 in 1928, and $1,375,534 in 1929 were upheld. The legal rationale for the decision apparently is that the directors were disinterested and acted in good faith. Mr. Mitchell, who was employed by both a holding and an operating company, testified that the directors of the National City Company probably knew what the company was paying him and that the directors of the National City Bank may not have known the amounts the bank paid him.[193] The shareholders were never informed of the amount of executive compensation; indeed, the bank's earnings were not reported to them prior to 1931.

1931).

[190]289 U.S. 582 (1933).

[191]For a discussion of this problem see BAKER and CARY, CASES AND MATERIALS ON CORPORATIONS 472 (3d ed. 1958).

[192]152 Misc. 679, 273 N.Y. Supp. 87 (Sup. Ct. 1934), referee's report, 155 Misc. 880, 281 N.Y. Supp. 795 (Sup. Ct. 1935).

[193]WASHINGTON and ROTHSCHILD, *op. cit. supra* note 186, at 396, n.60.

The cases involving large corporations in which excessiveness of compensation has been posed as an issue have consistently denied shareholder recovery based on that theory.[194] The famous American Tobacco Company bonuses, approved by shareholders through proxy voting, survived this test. Alleging that the president's average compensation of $400,000 a year from 1929-1939 was excessive, the plaintiffs also insisted that the $230,179 paid to the president's son in 1939, compared with $64,273 the prior year, was excessive and "due to the discernment by the father of genius in the son."[195] The son had worked for another corporation from 1932 to 1935, where his services were valued at only $3,000 a year. The plaintiffs suggested that the figures would speak for themselves, and the court replied:[196]

> "The figures do speak, but just what do they say as a matter of Equity? They are immense, staggeringly so. Even so, is that enough to compel the substitution of the Court's judgment for that of the stockholders? Larger compensation has been judicially approved."

The court observed:[197]

> "Courts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province. Courts are concerned that corporations be honestly and fairly operated by its directors, with the observance of the formal requirements of the law; but what is reasonable compensation for its officers is primarily for the stockholders."

The perturbing factor to the court was "finding a rational or just gauge for reviewing these figures were I inclined to do so. No blue-

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[194]*E.g.,* Winkelman v. General Motors Corp., 44 F. Supp. 960 (S.D.N.Y. 1942); McQuillen v. National Cash Register Co., 27 F. Supp. 639 (D. Md. 1939), *aff'd,* 112 F.2d 877 (4th Cir.), *cert. denied,* 311 U.S. 695 (1940); Diamond v. Davis, 38 N.Y.S.2d 103 (Sup. Ct.), *aff'd,* 265 App. Div. 919, 39 N.Y.S.2d 412 (1st Dep't 1942), *aff'd,* 292 N.Y. 552, 54 N.E.2d 683 (1944); Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct.), *aff'd* 263 App. Div. 814, 32 N.Y.S.2d 131 (1st Dep't 1941).

[195]Heller v. Boylan, 29 N.Y.S.2d 653, 678 (Sup. Ct. 1941).

[196]*Id.* at 671.

[197]*Id.* at 680.

prints are furnished. The elements to be weighed are incalculable; the imponderables, manifold."[198]

Another court declared its willingness to grant relief if the compensation was wasteful; excessive compensation, however, is merely an error, and interference with directors' erroneous judgment would interfere with private business, causing initiative and just rewards to disappear.[199] The courts rely, very simply, on the business judgment rule, and the application of the rule evidences an extreme reluctance to interfere with the amount of compensation.[200] Although references are sometimes made to assets, profits, and dividends, it is doubtful that these factors are influential.[201]

Application of the standard of reasonableness has produced no empirical results, no specific standards, only cursory comparisons of industrial levels, and no limitation on compensation. The shareholder, ignored by management and relatively powerless in large corporations, can expect little aid from the courts. The most favorable result of litigation is likely to be an out-of-court settlement. Past litigation, which established some technical landmarks, and the threat of future litigation with its attendant publicity have perhaps reduced managerial compensation. In the final analysis managerial compensation is not controlled by shareholders; it is not controlled by directors; it is not controlled by the courts. Its form may be altered by the tax structure, but taxes are not a limiting control. Compensation may be restrained by all of these elements with an assist from public opinion. Even this latter factor is diluted by the individual American dream of great wealth and the equation of power and wealth. The ultimate present control is the integrity and conscientiousness of management.

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[198]*Id.* at 679.

[199]McQuillen v. National Cash Register Co., 27 F. Supp. 639, 653 (D. Md. 1939).

[200]See Carson, *supra* note 185.

[201]See WASHINGTON and ROTHSCHILD, *op. cit. supra* note 186, at 416.