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Corporations—Employee Stock Options—Consideration.—Beard v. Elster

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Corporations—Employee Stock Options—Consideration.—*Beard v. Elster*.¹—A disinterested Board of Directors of American Airlines, Inc. formulated a stock option plan pursuant to which certain key employees could purchase the company's stock at a favorable rate at any time within five years if, at the time of purchase, the employee was in the service of the company. The plan was submitted to the stockholders and ratified by a majority vote. In a derivative suit against the optionees, the plaintiff stockholder sought to compel the surrender to the corporation of the shares purchased under the plan, contending that the plan constituted an unlawful gift of corporate assets in that it lacked consideration to the corporation. Affidavits filed by the defendants declared that they had knowledge of the plan prior to its adoption, that the plan induced them to remain in the corporation's employ and that their salaries were below the average salaries of employees in comparable companies. The Chancery Court denied defendants' motion for summary judgment. The Supreme Court of Delaware reversed. HELD: Where a disinterested board of directors in the exercise of their independent business judgment determines both that a certain stock option plan will be of benefit to the corporation and that within the plan itself or in its surrounding circumstances there are sufficient assurances that such benefit will actually accrue to the corporation and where such judgment is one which reasonable businessmen might make, the plan is not open to attack as an unlawful gift of corporate assets.

Because of highly favorable tax treatment,² stock option plans have become, of late, a popular and efficacious means of supplementing the compensation of select employees.³ While executive compensation plans have always been open to shareholders' derivative suits challenging them as constituting "gifts of the corporate assets,"⁴ a particularly annoying thorn has been the 1952 Delaware Supreme Court decision of *Kerbs v. California Eastern Airways*.⁵ It was upon the authority of that case that the Vice-Chancellor in the lower court held the option plan in the instant case to be invalid.⁶

In the *Kerbs* case a stock option plan was adopted by a board that was "interested," since five of the eight directors were ultimate beneficiaries under the plan. As approved by a majority of the stockholders, the plan provided that options pursuant to it could be exercised at any time within a period of five years. Moreover, such options could be exercised within six months

¹ 160 A.2d 731 (Del. Sup. Ct. 1960).

² Internal Revenue Code of 1954, § 421, permits executives to postpone the tax on profits from "restricted" stock options until disposal of the stock purchased under the option, and, in some cases, provides capital gains rather than ordinary income treatment of option profits.

³ See Patton, Current Practices in Executive Compensation, 29 Harv. Bus. Rev. 56 (1951).

⁴ *Rosenthal v. Burry Biscuit Corp.*, 30 Del. Ch. 299, 60 A.2d 106 (Ch. 1948); *Sandler v. Schenley Industries, Inc.*, 32 Del. Ch. 46, 79 A.2d 606 (Ch. 1951).

⁵ 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952).

⁶ *Elster v. American Airlines*, 148 A.2d 343 (Del. Ch. 1959).

after the termination of the employment of the optionee. The court held the plan to be invalid, stating, "the validity of a stock option plan under which selected personnel of a corporation may acquire a stock interest in the corporation depends directly upon the existence of consideration to the corporation and the inclusion in the plan of conditions, or the existence of circumstances which may be expected to insure that the contemplated consideration will in fact pass to the corporation."⁷ Since an employee might have resigned and yet have been allowed to exercise his option within six months, the plan was ". . . deficient because it is not reasonably calculated to insure that the defendant [corporation] will receive the contemplated benefit,"⁸ i.e., the retention of the services of the optionees.

The case had a disconcerting effect⁹ on the corporate bar, not only because its use of the word "consideration" seemed to require a contractual arrangement between company and optionee, but also because it implied that the court intended more closely to scrutinize the reasonableness of the relation between the value given and the value received, an area of decision usually reserved for the business judgment of management.¹⁰ Indeed, in *Gottlieb v. Heyden Chemical Corp.*,¹¹ a case decided as a companion to and under the rule of *Kerbs*, where again an interested board had approved a stock option plan which was later ratified by a majority of the shareholders, the Supreme Court ordered a remand to the Chancery Court to consider whether the anticipated benefit to the corporation was fairly related to the value of the plan. Thus while the legal consideration necessary for a simple contract might be satisfied by the proverbial "peppercorn," insofar as stock option plans were concerned, apparently something more was required. The *Kerbs* opinion was in obvious need of clarification.

The instant case of *Beard v. Elster*¹² purports to be that clarification. The court first directed its attention to its use of the word "consideration" in phrasing the rule in *Kerbs* and admitted that "the choice of this word was possibly ill-advised since it is regarded, apparently, by some as a measurable quid pro quo."¹³ . . . It, of course, by the very nature of things, cannot be that. It is incapable of measurement except in terms of business judgment that the plan will spur employees on to greater efforts which in the long run will benefit the corporation."¹⁴

After reviewing the holdings of the *Kerbs* and *Gottlieb* cases the court

⁷ Supra note 5, at 74, 90 A.2d 652 at 656.

⁸ Id. at 75, 90 A.2d 652 at 656.

⁹ See Dwight, *Employee Stock—Option Plans: The Clydesdale Rule*, 52 Colum. L. Rev. 1003 (1952).

¹⁰ *Clamitz v. Thatcher Mfg. Co.*, 158 F.2d 687 (2d Cir. 1947).

¹¹ 33 Del. Ch. 82, 90 A.2d 660 (Sup. Ct. 1952).

¹² Supra note 1.

¹³ Here the court cited *Lieberman v. Becker*, 155 A.2d 596 (Del. Sup. Ct. 1959). An interesting point here is that the judge who in the *Lieberman* case misconstrued the rule in *Kerbs* was the same judge who wrote the *Kerbs* decision—Justice Wolcott. To compound the interest of the situation, the judge who is now observing all this misconstruing, the author of *Beard v. Elster*, is the same—Justice Wolcott.

¹⁴ Supra note 1, at 736.

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declared that it was reaffirming the rule of *Kerbs* and stated that, "All stock option plans must be tested against the requirement that they contain conditions, or that surrounding circumstances are such, that the corporation may reasonably expect to receive the contemplated benefit from the grant of the options."¹⁵ In addition, this anticipated benefit is to be reasonably related to the value of the options granted. A full application of this "test" to the stock option plan involved would seem to require the same result of invalidity found in *Kerbs*, for factually it is very difficult to distinguish the two plans. Just as the optionee in *Kerbs* might resign and still exercise his option within six months, there was nothing whatsoever in the plan in *Beard* to prevent the optionee from exercising his option and then resigning. In both cases the companies would just as surely be deprived of their employees' service and with the same degree of immediacy. This, in substance, was the plaintiff stockholder's contention, and in view of what appeared to be the paramount consideration of the court in *Kerbs*, it seemed sound. At this point, however, the court invoked the familiar "sound business judgment rule" which in other cases has protected actions taken by a disinterested board with regard to the disposition of corporate assets.¹⁶ After considering the facts filed in the defendants' affidavits and finding that the plan was one on which reasonable businessmen could differ, the court decided that it was precluded from second-guessing the sound business judgment of a disinterested board as to the fairness of the plan to the corporation. The plan was valid and *Kerbs* and *Gottlieb* were to be distinguished in that there the boards were interested.

Thus, although the court states that "all" stock option plans are to be measured by the *Kerbs* "test," one wonders, in light of the extreme emphasis accorded the fact of director disinterest, whether the court is refusing to apply any test to stock option plans formulated by a disinterested board. Or, at least, does it apply any test other than to inquire whether the directors were interested or disinterested?

However, even this latter interpretation of the case cannot be taken with any high degree of certainty for the opinion is vague as to what weight the court actually placed on the facts declared in the optionee's affidavits. While the fact of director disinterest is to be given "utmost consideration," the facts of the affidavits are still to be "considered." What the court would do with a case that did not possess such supporting facts is unclear. The court might find the plan to be valid, stating again that they will not second-guess the judgment of a disinterested board, or they might hold it to be invalid and distinguish it from *Beard v. Elster* in that here there were such supporting facts. At any rate the case represents a substantial retreat for the Delaware Supreme Court from its harsh position originally taken in *Kerbs v. California Eastern Airways*.

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¹⁵ Supra note 1, at 737.

¹⁶ See, e.g., *Blish v. Thompson Automatic Arms*, 30 Del. Ch. 538, 64 A.2d 581 (Sup. Ct. 1948).