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## NOTES

### *Stockholder Attacks on Voluntary Group Pension Plans*

A pension plan is a program adopted to provide for the livelihood of employees or their beneficiaries through payment of benefits without regard to profits.<sup>1</sup> Benefits may be realized upon the retirement, disability, or death of the employee. Such a plan may be voluntarily adopted by an employer, or it may be the product of a collective bargaining agreement.<sup>2</sup> Plan benefits are usually composed of two elements: (1) past service benefits based on length of service with the company prior to adoption of the plan; and (2) future service benefits based on service with the company between the date of adoption of the plan and the employee's retirement date.<sup>3</sup>

It is generally accepted that current economic and social demands place a moral duty upon employers to furnish a system and means for providing old age benefits.<sup>4</sup> This duty is often fulfilled by the adoption of a pension plan. In this way pension plans operate to benefit society as a whole. But there are also corporate benefits. Pension plans operate to retire superannuated employees. This means actual savings in payroll, since an older employee's pension will not cost the company nearly as much as allowing him to continue working at a high hourly wage.<sup>5</sup> Employee morale also will be improved because retirement of superannuated employees will clear the ranks for promotion.<sup>6</sup> Finally, public relations will be improved because a pension plan adds to the prestige of the employer in the community and attracts desirable employees.<sup>7</sup>

Recognizing the meritorious social purpose of pension plans, Congress has afforded them special tax treatment.<sup>8</sup> If a plan qualifies under section 401(a) of the Internal Revenue Code of 1954, the employee's benefits are not taxable to him until the payments are distributed or made available.<sup>9</sup> Since the distribution usually is not made until after retire-

1. Treas. Reg. § 1.401-1(a)(2)(i) (1956).

2. Note, *Consideration For The Employer's Promise Of A Voluntary Pension Plan*, 23 U. CHI. L. REV. 96 (1955).

3. 2 WASHINGTON & ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 644 (3d ed. 1962).

4. See, e.g., *Busser v. Snyder*, 282 Pa. 440, 128 Atl. 80 (1925).

5. O'Neal, *Stockholder Attacks on Corporate Pension Systems*, 2 VAND. L. REV. 351 (1949).

6. *Ibid.*

7. Dix, *Retirement Allowance And Pension Plans*, 31 GEO. L.J. 22 (1942).

8. Full consideration of pension plan tax advantages is not within the scope of this note. For detailed discussion see CAVITCH, OHIO CORPORATION LAW, § 5.2 (1963).

9. INT. REV. CODE OF 1954, § 402(a)(1) [hereinafter cited as CODE §].

ment, the employee will be in a lower tax bracket. Capital gains treatment is permitted when total distributions payable to a particular employee are paid to him within one taxable year.<sup>10</sup> Again, if the plan qualifies, the company may deduct its contributions thereto subject to certain limitations.<sup>11</sup> Finally, if a qualified trust is utilized as a funding medium, the trust income will be tax exempt.<sup>12</sup> Thus, the employer will not be required to contribute such a large amount to fund the trust.

Corporate authority to establish pension plans is generally recognized.<sup>13</sup> Minority stockholders, however, have argued that such plans are *ultra vires* in that they require expenditures for a purpose not expressed in the articles of incorporation and thus waste corporate funds.<sup>14</sup> This argument loses force when one realizes the corporate advantages of having a pension system. But because pensions are a proper subject of collective bargaining,<sup>15</sup> a lack of authority to adopt a pension plan could place the employer in a quandary. As a result, many states have expressly granted such authority by statute.<sup>16</sup>

Minority stockholders, however, continue to attack such plans. These attacks may be based upon arguments of past or inadequate consideration, either of which is said to amount to a waste of corporate assets.<sup>17</sup> This note will consider the validity of these attacks on voluntary group pension plans.<sup>18</sup> Past service and future service benefits will be discussed separately.

#### PAST SERVICE BENEFITS

An important issue concerning pension plans arises when they are adopted after some employees have ceased working, or are adopted shortly before other employees have reached retirement age. In these circumstances, the services still to be rendered are not worth the benefit proposed to be paid.<sup>19</sup> Minority stockholders thus may object on the ground that no consideration flows to the corporation from the employees and the corporation is therefore tendering a gift for past services.<sup>20</sup>

10. CODE § 402(a)(2).

11. CODE § 404(a).

12. CODE § 501(a).

13. 2 WASHINGTON & ROTHSCHILD, *op. cit. supra* note 3, at 641; O'Neal, *supra* note 5.

14. O'Neal, *supra* note 5.

15. *Inland Steel Co. v. NLRB*, 170 F.2d 247 (7th Cir.), *cert. denied*, 336 U.S. 960 (1948).

16. *E.g.*, N.D. CENT. CODE § 10-19-04(16) (1960); N.Y. GEN. BUS. LAW § 202(a)(13); ORE. REV. STAT. § 57.030(16) (1961); TEX. BUS. CORP. ACT. ANN., art. 2.02(17) (1956).

17. LATTIN, CORPORATIONS 239 (1959).

18. A group pension plan is one which covers more than one or two employees.

19. 2 WASHINGTON & ROTHSCHILD, *op. cit. supra* note 3.

20. O'Neal, *supra* note 5.

Several authorities are often relied upon by minority stockholders to support their objection.<sup>21</sup> One such precedent is the case of *Beers v. New York Life Ins. Co.*,<sup>22</sup> in which the president of the defendant company resigned. The board of trustees authorized a pension of \$37,500, equal to one-half of his annual salary. Payment was not forthcoming, and plaintiff sued. Although he had promised to serve in an advisory capacity and not to compete with the company, the court found that the true consideration for the contract was past services. The board of trustees could not compensate for these services.

The case of *Railroad Retirement Bd. v. Alton R.R.*<sup>23</sup> involved the Railroad Retirement Act,<sup>24</sup> which gave a statutory right to a pension to carrier employees. Benefits were based in part on past service. The United States Supreme Court held the act unconstitutional on two grounds: first, Congress had gone beyond the scope of the commerce clause; and second, the imposition of liability for services already rendered and compensated deprived the railroad company of property without due process of law.

In *Dolan v. Heller Bros. Co.*,<sup>25</sup> the plaintiff, a former employee of the defendant company, brought an action for payments allegedly due under the company's pension plan. The plan had been adopted after the plaintiff was well over retirement age and only one year before he applied for a pension. The court held that since the plan had been adopted at a time when the plaintiff was past retirement age, his services could not have constituted a valid consideration for a pension.

In certain circumstances, the rule that past services do not constitute valid consideration for a pension has not been applied. Thus, where there has been an implied understanding between a company and an employee that the latter would receive additional compensation if the company prospered, the courts have found an implied contract binding the company.<sup>26</sup> Also, where an employee who is about to retire when the plan is adopted agrees to render future services, such as, working for a longer period of time,<sup>27</sup> leasing property at a reduced rental,<sup>28</sup> or remain-

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21. *Railroad Retirement Bd. v. Alton R.R.*, 295 U.S. 330 (1935); *Dolan v. Heller Bros. Co.*, 30 N.J. Super. 440, 104 A.2d 860 (Super. Ct., Ch. Div. 1954); *Beers v. New York Life Ins. Co.*, 20 N.Y. Supp. 788 (Sup. Ct. 1892).

22. 20 N.Y. Supp. 788 (Sup. Ct. 1892).

23. 295 U.S. 330 (1935).

24. 48 Stat. 1283 (1954).

25. 30 N.J. Super. 440, 104 A.2d 860 (Super. Ct., Ch. Div. 1954).

26. *Wineburgh v. Seeman*, 21 N.Y.S.2d 180 (Sup. Ct. 1940); *Holmes v. Republic Steel Corp.*, 84 Ohio App. 442, 84 N.E.2d 508 (1948).

27. *Ulman v. Sunset-McKee Co.*, 221 F.2d 128 (9th Cir. 1955).

28. *Markson v. Markson's Furniture Stores, Inc.*, 267 N.Y. 137, 195 N.E. 824 (1935).

ing loyal and not engaging in competitive employment,<sup>29</sup> such services have been held to constitute sufficient consideration for a pension. But the *Beers* case<sup>30</sup> remains as a warning that a court may find the future services to be rendered inadequate.

The *Beers*, *Alton*, and *Dolan* cases, however, do not appear to be sufficient authority to overcome the inference of payment of consideration for past services.<sup>31</sup> The *Beers* case involved a pension for a single executive. When a pension for an executive is provided under an individual, rather than a group plan, the policy reasons favoring group pension plans are absent. Thus a court will subject an individual plan to closer investigation to determine the adequacy of future services or whether the plan in reality is based on past services.<sup>32</sup> Although the *Dolan* case involved a group plan, the suit was brought by one employee, not to attack the plan, but to recover benefits under it.<sup>33</sup> While under such circumstances a court might hold that an agreement to pay a past service pension is not binding on a corporation for lack of consideration, it, nevertheless, still might be willing to recognize that the corporation has authority to pay past service pensions in view of the future benefits it will receive.<sup>34</sup> Furthermore, the *Beers* and *Dolan* decisions may have been influenced by extrajudicial circumstances.<sup>35</sup>

The *Alton* case is also not in point. The Railroad Retirement Act was violative of the due process clause of the United States Constitution in that it imposed a compulsory pension system upon the companies. When a plan is *voluntarily* adopted by a company there is obviously no federal or state compulsion. Therefore, no constitutional issue arises, and the question of whether past services constitute consideration is a matter of state law and is subject to local policy.<sup>36</sup> Moreover, the argu-

29. *Langer v. Superior Steel Corp.*, 105 Pa. Super. 579, 161 Atl. 571 (1932), *rev'd on other grounds*, 318 Pa. 490, 178 Atl. 490 (1935).

30. 20 N.Y. Supp. 788 (Sup. Ct. 1892).

31. "[T]his court is not persuaded that the *Beers* case, handed down by a New York court in 1892, is any safe guide to present day law in relation to corporate pension plans." *Good v. Modern Globe, Inc.*, 346 Mich. 602, 609, 78 N.W.2d 199, 203 (1956); "The result is unfortunate and to be deplored, but courts of original jurisdiction are necessarily constrained to follow the generally established rules of law." *Dolan v. Heller Bros. Co.*, 30 N.J. Super. 440, 445, 104 A.2d 860, 862 (Super. Ct., Ch. Div. 1954).

32. 2 WASHINGTON & ROTHSCHILD, *op. cit. supra* note 3, at 645.

33. For consideration of employees' rights under pension plans see Note, *Contractual Aspects Of Pension Plan Modification*, 56 COLUM. L. REV. 251 (1956); Note, *Legal Status of Private Industrial Pension Plans*, 53 HARV. L. REV. 1375 (1939).

34. O'Neal, *supra* note 5.

35. Life insurance scandals at the turn of the century possibly influenced the *Beers* decision. 2 WASHINGTON & ROTHSCHILD, *op. cit. supra* note 3, at 645. The *Dolan* decision could have been influenced by evidence introduced to prove that *Dolan*, rather than working for the company, was working for its president in a personal capacity.

36. *Osborne v. United Gas Improvement Co.*, 354 Pa. 57, 46 A.2d 208 (1946).

ment may be made that the Court in *Alton* should have limited itself to the validity of the act under the commerce clause.

Several decisions indicate that past services may constitute valid consideration for a pension.<sup>37</sup> In *Osborne v. United Gas Improvement Co.*,<sup>38</sup> minority stockholders sought to enjoin the implementation of a group pension plan. The plan provided benefits calculated upon employees' past tenure and was, therefore, said to be an illegal payment of compensation for past services. A state statute provided:

Every business corporation may grant allowances or pensions out of the earnings of the corporation to its directors, officers, or employees, for faithful and long-continued service, who have, in such service, become old, infirm, or disabled.<sup>39</sup>

The court held that the legislature intended to allow a corporation to grant pensions to those who have become old, infirm, or disabled, pensions which reflect long-continued service in the past.

In *Teich v. National Castings Co.*,<sup>40</sup> a plan was amended to provide an increase in benefits for participants already retired as well as those still employed. Plaintiff, a stockholder, contended that the amendment resulted in an unreasonable gift of corporate funds without reasonable or adequate consideration. The ex-president's pension was heavily attacked. The court stated that the corporation had received adequate consideration for the increase in the form of varied tangible and intangible benefits from service to the corporation, both before and after the ex-president's retirement.

These decisions represent the modern and better view. And while it may be argued that the holding in the *Osborne* case was based on a statute, the court also recognized that a pension plan which does not take into account past service would not furnish an adequate retirement allowance. This is especially true for older employees who are most in need of pensions, and, obviously, a company has a definite interest in seeing that its plan does not discriminate against older employees. Thus, even in the absence of the favoring statute, the decision probably would have been the same.

Courts should take a stronger position on this issue. When determining whether a group pension plan is supported by adequate consideration, the plan must be viewed as a contract between an employer and a group of employees, many of whom are hired in the future. The consideration for such a plan flows from the group to the company in the form of im-

37. *Teich v. National Castings Co.*, 201 F. Supp. 451 (N.D. Ohio 1962); *Osborne v. United Gas Improvement Co.*, 354 Pa. 57, 46 A.2d 208 (1946).

38. 354 Pa. 57, 46 A.2d 208 (1946).

39. *Id.* at 63, 46 A.2d at 211, *citing*, 15 P.S. § 2852-316. The present statute is substantially the same: PA. STAT. ANN. tit. 15, § 2852-316 (1958).

40. 201 F. Supp. 451 (N.D. Ohio 1962).

proved employee morale and better public relations. The fact that one or two individuals are about to retire and will receive pensions does not mean that consideration for the plan is not present. Past service is not the consideration. It is simply a fair method for computing benefits under the plan.<sup>41</sup>

There are additional arguments supporting a pension based on past service. In England, where the practice of granting pensions prevailed long before it was accepted in this country,<sup>42</sup> courts have been more liberal in recognizing pensions based on past services.<sup>43</sup> Also, in the United States, municipal corporations have been permitted to grant past service pensions regardless of constitutional limitations on gifts of public funds.<sup>44</sup> Even many government pensions take past service into account.<sup>45</sup> Thus, it may be said that the rules regarding past service pensions should and will be relaxed in the future.<sup>46</sup>

#### FUTURE SERVICE BENEFITS

Pension plans in which benefits are based on future service are not as legally objectionable as past service plans. It is well established that a corporation, acting through its board of directors, may hire officers and employees for a reasonable compensation.<sup>47</sup> This compensation need not be paid at once if the employee or officer chooses to receive it at a later time.<sup>48</sup> Thus, future service pension benefits are considered deferred compensation,<sup>49</sup> validating pension plans which take effect at the time employees commence employment.<sup>50</sup> The amount of the pension benefit, however, must be reasonably related to the extent of the future services to be rendered.<sup>51</sup> Overpayment would amount to waste or spoliation of corporate assets.

A benefit must be reasonably related to the future services to be rendered. This point has caused some difficulty in a few cases. In *Nemser v. Aviation Corp.*,<sup>52</sup> minority stockholders sought to enjoin the adoption

41. *Railroad Retirement Bd. v. Alton R.R.*, 295 U.S. 330, 374 (1935) (Hughes, C.J., dissenting).

42. O'Neal, *supra* note 5.

43. *E.g.*, *Cyclist's Touring Club v. Hopkinson*, [1910] 1 Ch. 179; *Henderson v. Bank of Australasia*, 4 T.L.R. 734 (1888).

44. *E.g.*, *Haldeman v. Hillegans*, 335 Pa. 375, 6 A.2d 801 (1939).

45. 2 WASHINGTON & ROTHSCHILD, *op. cit. supra* note 3, at 654.

46. *Ibid.*

47. 2 WASHINGTON & ROTHSCHILD, *op. cit. supra* note 3, at 642.

48. *Ibid.*

49. *Ibid.*

50. *E.g.*, *Hunter v. Sparling*, 87 Cal. App. 2d 711, 197 P.2d 807 (1948); *Cohn v. Columbia Pictures Corp.*, 117 N.Y.S.2d 809 (Sup. Ct. 1952).

51. *Ibid.*

52. 47 F. Supp. 515 (D. Del. 1942).

of a pension plan for only those employees earning over \$4200 per year. Participants in the plan were to contribute during the remainder of their service with the corporation on the basis of salary. When a participant attained age sixty-five, the corporation was to contribute whatever additional amount was necessary to purchase an annuity contract for that participant. The objections were that (1) the plan was a waste of corporate assets in that benefits bore no relation to the extent of the services to be rendered, and (2) the plan was inequitable because it was limited to officers and employees receiving a higher bracket of income. In support of their first contention, the minority stockholders presented the following illustration. Employee *A*, forty-four years of age, began twenty-six years ago as an office-boy. He now earns \$50,000 per year and would be entitled to a pension of \$14,250. The corporation would be required to contribute about \$99,000 for his annuity. Employee *B*, fifty-four years of age, began one year ago. He also makes the same amount as Employee *A* and would be entitled to the same pension. However, the corporation would be required to contribute about \$155,000 for his pension, because he will work ten years less than Employee *A* and, therefore, will not personally contribute as much.

The court encountered no difficulty in answering the second contention. By limiting plan participants to employees earning over \$4200, the corporation extended to higher paid employees the policy and protection of the federal social security laws. The first contention, however, seemed to present a dilemma. While recognizing that the benefit must bear some relation to the value of the services, the court simply held that "certain inequities are bound to arise in such a plan."<sup>53</sup>

Additional reasons may be urged in support of this decision. First, to evaluate the proficiency of each individual employee would have been time consuming and costly for the corporation. These problems were circumvented by basing benefits on salary, and this procedure is in accord with sound business practice. Second, discrimination in benefits among employees earning the same salary would have lowered employee morale and thus defeated one of the principal benefits of the plan for the corporation. Finally, the illustration utilized to support the first contention, although accurate, does not represent the normal situation. The greater number of corporate employees would earn much less than \$50,000. Therefore, the corporation would not be required to contribute excessive additional amounts for these employees.

The issue of whether a pension benefit is reasonable, however, arises most often when highly compensated executives and officers are included in a plan. Inclusion of such persons is fast becoming standard procedure, since pension plans represent a device to keep executives and officers con-

53. *Id.* at 518.



tented with their present positions.<sup>54</sup> But neither action by disinterested directors nor ratification by majority stockholders can justify payments which amount to a waste of corporate assets.<sup>55</sup>

The problem is well illustrated in *Fogelson v. American Woolen Co.*,<sup>56</sup> where two stockholders sought to enjoin the company from implementing a retirement plan for salaried employees. The plan used a percentage formula which gave consideration to both salary and length of service. The company also proposed to pay the entire past service liability into a trust in one lump sum. The president's salary had been \$100,000 for a number of years prior to the proposed adoption date of the plan. One year prior to this date his salary was increased by \$50,000. This increase caused his potential benefit to be \$54,000. The plaintiffs contended that the lump sum past service payment, the failure to set a maximum pension, and the amount of the president's pension all resulted in a waste of corporate assets.

The court refused to interfere with the business judgment of the directors in paying the past service liability in a lump sum and declining to set a maximum pension. There had been no clear abuse of discretion amounting to legal waste. The court held, however, that the reasonableness of the president's pension presented a triable issue of fact.<sup>57</sup> If the amount of the pension was to be justified, it had to be in the employer's interest to assure those with high salaries that they would retire on a pension computed upon the same formula as low salaried employees. The court also stated that whether the company could obtain an able executive upon the president's retirement without promising him a pension of \$54,000 was relevant to the issue of reasonableness.

Several other factors also bear weight in determining the reasonableness of an executive's pension. In the *Fogelson* case, the plan had received a favorable ruling from the Commissioner of Internal Revenue.<sup>58</sup> To acquire such a ruling, a pension plan must be one that does not "discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees."<sup>59</sup> The Commissioner's opinion that a plan does not so discriminate supports the contention that the amount of a pension is reasonable.<sup>60</sup> Furthermore, a majority of stockholders

54. LATTIN, CORPORATIONS 239 (1959).

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

56. 170 F.2d 660 (2d Cir. 1948).

57. The case was not retried. A settlement was entered into whereby the president was to receive a pension of approximately one half of the original amount.

58. Such a ruling permits the company to deduct the amount of its contributions to the plan from the income tax and exempts the income of the trust fund from taxation.

59. CODE § 401(a)(4).

60. *Moote v. Keystone Macaroni Mfg. Co.*, 370 Pa. 172, 87 A.2d 295 (1952).