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CORPORATIONS—PAYMENT OF OFFICERS FOR PAST SERVICES —RATIFICATION BY SHAREHOLDERS

In the past twenty-five years corporations in general have increased enormously in size and complexity. As a result, some prior legal concepts involving corporate law have become obsolete and in need of modernization. Accordingly, the Supreme Court of Pennsylvania, in a recent case, *Chambers v. Beaver-Advance Corporation*,[1] has modernized at least one facet of Pennsylvania corporation law and has raised a corporate question concerning which there probably will be litigation in the future.

The Beaver-Advance Corporation, organized under the laws of Pennsylvania, is in the business of manufacturing. The affairs of the corporation are, in accordance with its by-laws, conducted by three directors. The evidence at trial indicated that the company was growing and enjoying a lucrative income, although dividends had not been declared for many years. The directors, owning nearly all the stock, actively operated and managed the corporation.

In August 1950, at a special meeting of the board of directors, it was resolved that additional compensation be paid to the officers for the fiscal year ending in October 1950. The resolution also provided for future compensation based on a graduated percentage of the corporate net income with the officers to receive increasing amounts up to the year ending October 1954. For that year, and subsequent fiscal years, they were to receive 5 per cent of the company's net income. The terms of the resolution were substantially followed as to the amount of extra compensation, but there was no formal ratification of these bonuses by the shareholders until 1953. In December of that year the shareholders formally resolved:

> Resolved: That all of the actions of the Board of Directors and officers of Beaver Art Metal Corporation for and during the period from November 1, 1952 to the present date are hereby ratified, affirmed and approved by the stockholders.[2]

Similar resolutions were passed in December 1955 and November 1956, but the bonuses voted by the directors in 1956 could not be ratified because of a court restraining order. The remaining acts of the directors, however, were ratified.

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[1] 392 Pa. 481, 140 A.2d 808 (1958). Also noted 20 U. PITT. L. REV. 333; 34 N. Y. U. L. REV. 352.

[2] *Id.* at 484.

The board of directors apparently determined that the original bonus plan was not in effect because at the November 1956 meeting they passed a resolution which stated:

> Resolved: That bonuses be paid during December 1956 to the three officers. . . . The bonuses are to represent additional compensation for services rendered the company during the fiscal year ending October 31, 1956 and are to be accrued upon the books as of October 31, 1956.[3]

Thus, this is a case in which the directors were voting themselves a bonus after the end of a fiscal year. These bonuses, then, were not contracted for in advance, but constituted payments for past services. The court in the *Chambers* case also treated the situation as payments for past services. This made the outcome of the case an innovation in Pennsylvania law.

Plaintiff in the *Chambers* case became a shareholder in August 1954 by purchasing 43 per cent of the stock of the corporation. That year he, as a director, approved the payment of the additional compensation to the officers. At the meeting of December 1955 all of the shareholders, except plaintiff, voted in favor of the aforementioned general resolution approving the actions of the directors. He objected at that time, and also at the directors' meeting, to the payment of the additional compensation in the way of a bonus to the officers. He again voted "no" at the November 1956 meeting to the payment of the bonuses.

Plaintiff brought a complaint in equity against the corporation and the other two directors and shareholders to restrain them from paying themselves any bonus as president and secretary and, further, to restrain payment of a bonus to any other officer of the corporation.[4] Having heard arguments from counsel, the Supreme Court of Pennsylvania, citing and quoting from a case it had previously decided,[5] pointed out that it was perfectly proper, with certain exceptions,[6] for directors to vote their stock in a corporation so as to increase their own salaries.[7] Quoting from another case it had decided,[8] the court went further and stated that payment of bonuses to officers was normal practice in present day business operations.[9] The opinion then reasserted the position

[3] *Id.* at 485.

[4] For mention of other questions which were abandoned on appeal see: *Id.* at 483.

[5] Russell v. Patterson Co., 232 Pa. 113, 81 Atl. 136 (1911).

[6] " '. . . majority stockholders may not, as against the corporation and a minority stockholder, dissipate or waste its funds or fraudulently dispose of them in any way, either by ratifying the action of the board of directors in voting themselves illegal salaries or by any other act.' " Chambers v. Beaver-Advance Corp., 392 Pa. at 488, 140 A.2d at 808.

[7] " '. . . *the resolution of the stockholders ratifying the action of the directors in increasing the salaries was not invalid because it was done by the votes of the same individuals by whose votes the resolution of the board of directors was passed and two of them were the recipients of the salaries.*' " *Id.* at 487.

[8] Hornsby v. Lohmeyer, 364 Pa. 271, 72 Atl. 294 (1950).

[9] Chambers v. Beaver-Advance Corp., 392 Pa. at 490, 491 and 492.

that, absent illegality, a court should hesitate to substitute its judgment for that of the directors as to the proper manner in which to deal with the affairs of a corporation. The exceptions to the lower court's finding for the defendants were dismissed and the decision affirmed.

The net result of the case is that payment of bonuses for past services to officers of corporations governed by Pennsylvania law is clearly legal, and, by analogy, it would seem that payment for past services in any manner, even distribution of stock, is authorized. That this is a distinct change in Pennsylvania's position is readily apparent if one considers prior case law. It is settled in Pennsylvania that directors may be employed by the corporation as officers or, for that matter, as regular employees, and be paid for their services.[10] Until the present time, however, a director could not recover for services he had performed unless those services had been expressly contracted for in advance and payment therefor agreed upon.[11]

Illustrative of this latter rule is the case of *Loan Association v. Stonemetz*.[12] In that case Daniel Stonemetz, a member and director of a loan association, became chairman of the association's committee on short loans. After he had been acting in that capacity for some time the association passed a resolution giving him a salary which was retroactive in effect and amounted to payment for past services. The Supreme Court of Pennsylvania reversed a lower court award of compensation for the services and said in part:

> The resolution which gave the plaintiff [Stonemetz] his only hold, wanted the essential elements of a contract. . . . The agreement which the resolution embodied had no sufficient consideration for its support. . . . When the resolution was passed the consideration had been executed, for the services compensated by his verdict had been previously rendered, and there is no proof of a precedent or contemporaneous request.[13]

In *Althouse v. Cobaugh Colliery Co.*,[14] a decision cited by the plaintiff-appellant in the *Chambers* case,[15] the president of a corporation performed professional services as an engineer for the corporation. The engineering services were outside the scope of his normal duties as president. He brought an action of assumpsit to recover on the basis of quantum meruit for the value

[10] Sotter v. Coatsville Boiler Works, 257 Pa. 411, 101 Atl. 744 (1917).

[11] Brophy v. American Brewing Co., 211 Pa. 596, 61 Atl. 123 (1905); Provident Trust Co. of Philadelphia v. Crouse, 40 D. & C. 628 (1941).

[12] 29 Pa. 534 (1858).

[13] *Id.* at 535, 536. As to past services being a lack of consideration, see also: Moore v. Keystone Macaroni Mfg. Co., 370 Pa. 172, 87 A.2d 295 (1952).

[14] 227 Pa. 580, 76 Atl. 316 (1910).

[15] Brief for Appellant, p. 10.

of his services. The high court of Pennsylvania recognized the services as professional and beyond the scope of duty, but denied recovery, saying:

> The distinction is apparent, but it makes no substantial difference with respect to rule or policy. There is quite as much reason for requiring a corporate officer to show an express contract for compensation as a condition of recovery in one case as in the other.[16]

Absent a specific agreement to the contrary, there is a presumption in Pennsylvania that service as a director of a corporation is performed without compensation.[17] Further, the fact that services have been performed does not raise a presumption that there has been such an agreement.[18] Other methods of reimbursing persons for past services, which have been disallowed in Pennsylvania, include an option to purchase shares of stock,[19] stock issue,[20] and increase of an already fixed salary.[21]

Situations in which compensation for corporate officers has been provided for in advance of employment are themselves strictly limited. Salaries for services rendered by officers may be sustained by the courts, if reasonable, and, as previously pointed out, even though the directors voting have been voting for their own salaries.[22] Such transactions are, however, subject to careful scrutiny,[23] and resolutions in this area are subject to inquiry notwithstanding the fact that there has been a ratification by the majority of the stockholders.[24] The same general rule applies to bonuses, and they too must bear a reasonable relation to the services performed.[25]

From the foregoing it is evident that the *Chambers* case considerably relaxes the rigid control surrounding the method of compensating corporate officers. The *Chambers* opinion is explicit in ruling that prior case authority

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[16] Althouse v. Cobaugh Colliery Co., *supra* note 14 at 582, 583. That an officer of a corporation is not entitled to compensation unless it has been agreed upon prior to his entering the office see: Bair & Gazzam Mfg. Co. v. Vendersall, 36 Pa. Super. 615 (1908).

[17] Moser v. Malick, 20 Northumb. L.J. 254 (1949); See also: Thomas Martindale v. Wilson-Cass Co., 134 Pa. 348, 19 Atl. 680 (1890).

[18] Bair & Gazzam Mfg. Co. v. Vendersall, *supra* note 16; Thomas Martindale v. Wilson-Cass Co., *supra* note 16.

[19] Hothusen v. Edward G. Budd Mfg. Co., 52 F. Supp. 125 (1943).

[20] Wilson v. Brown, 269 Pa. 225, 112 Atl. 1 (1920).

[21] Carr v. Chartiers Coal Co., 25 Pa. 337 (1855). For an interesting case wherein an officer of a corporation killed while performing the duties of an employee which were beyond the scope of his office was held not to be an employee so as to qualify his widow for workman's compensation see: Carville v. Bornot & Co., 288 Pa. 104, 135 Atl. 652 (1927).

[22] Neff v. Twentieth Century Silk Corp., 312 Pa. 386, 167 Atl. 578 (1933).

[23] Flannery Bolt Co. v. Flannery, 16 F. Supp. 803, modified 86 F.2d 43 (1937).

[24] Neff v. Twentieth Century Silk Corp., *supra* note 22.

[25] Hothusen v. Edward G. Budd Mfg. Co., *supra* note 19.

prohibiting payment for past services to corporate officers is no longer law. The court stated:

> If the aforesaid authorities [26] stand for the proposition that the payment of a reasonable bonus or additional salary to a corporate officer for services during the current or the past (calendar or fiscal) year is illegal, even if ratified by a majority of the stockholders, they are no longer the law in Pennsylvania.[27]

It is submitted that payment for past services should, as the court held, be permitted. Such procedure enables a corporation to use sound retrospect rather than having to be "crystal gazers" as to what fortune will befall the organization in the coming year. It is, additionally, an excellent means of rewarding deserving individuals and encouraging greater production on the part of the employee.

The *Chambers* case raises a question which probably will be the center of attention in future court proceedings. The question is presented in the formal resolution passed in December 1953 by the shareholders of the Beaver-Advance Corporation which stated in part, ". . . all actions of the Board of Directors and officers . . . are hereby ratified, affirmed and approved by the stockholders." [28] Is this all that is necessary to effectively bind the shareholders and the corporation?

Generally, the same rules which govern natural persons in a principal-agent relationship also govern corporate bodies.[29] The shareholders' resolution in the *Chambers* case was the voice of the corporation, the principal, ratifying the acts of the directors, the agents.[30] It would seem, therefore, that the corporation has ratified all the acts of its officers and directors for the period indicated in the resolution. This, of course, would include acts of the agents which had not previously been authorized. This is not to ignore the precept, accepted in Pennsylvania, that before the unauthorized act of an agent is considered ratified by his principal, the latter must have knowledge of the material facts.[31] Notwithstanding this general maxim there is authority in Pennsylvania that ratification by a principal is effective where he ratifies without making further inquiry, although he knows he does not possess all material facts.[32] This

[26] Wilson v. Brown, *supra* note 20; Althouse v. Cobaugh Colliery Co., *supra* note 14; Martindale v. Wilson-Cass Co., *supra* note 17.

[27] Chambers v. Beaver-Advance Corp., *supra* note 1 at 491.

[28] *Supra* note 2.

[29] Camden & A.R.R. Co. v. Coxe, 18 W.N.C. 20 (1886).

[30] Loan Ass'n. v. Stonemetz, *supra* note 12 at 535.

[31] Culbertson v. Cook, 308 Pa. 557, 162 Atl. 803 (1932); Daley v. Iselin, 218 Pa. 515, 67 Atl. 837 (1907).

[32] Currie v. Land Title Bank & Trust Co., 333 Pa. 310, 5 A.2d 168 (1939).

is the position of the average shareholder voting in favor of a general ratification resolution such as the one in the *Chambers* case. Even more clearly it is the situation of the shareholder in a large corporation who gives a proxy of his voting power. Aside from fraudulent and illegal acts, should these people be subject to *any* unauthorized act which a corporate officer, unknown to them, may have performed? The court in the *Chambers* case seems to accept this sort of thing as a binding ratification. Unfortunately, for purposes of this discussion, the *Chambers* case is distinguishable and does not answer the question of whether or not the general sort of resolution found in that case will bind shareholders. The majority shareholders in that instance actually did have knowledge of the material facts. Nonetheless, the question is an interesting and provocative one and, as yet, is apparently unanswered in Pennsylvania.

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