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a new subsection (d) to section 55-142 (foreign corporations) permits the agent to handle this matter. It is of limited interest, but of considerable utility to agents serving corporations by furnishing a registered office and agency.

A 1965 amendment²⁰ added, to the tail-end of the Uniform Stock Transfer Act, a new section 55-97.1 authorizing stock transfer through transfers and pledges of shares within a central depository system, such as the New York Stock Exchange has available through its Clearing Corporation. The provision is identical with section 8-320 of the Uniform Commercial Code which was adopted when the Code was enacted in North Carolina.²¹ Since the Code will be effective July 1, 1967, it is difficult to see why the same language was added to the corporation law, especially as a dangling appendix to the soon-to-be-repealed Stock Transfer Act, unless possibly it was intended to make immediately effective this new and sophisticated mode of transfer.

ERNEST L. FOLK, III*

Corporations—Stock Options—Validity and Federal Tax Requirements

The stock option plan as an incentive device for key corporate personnel has come into widespread use. Although the prime factor for the growth of such plans in the corporate community has been the favorable tax treatment of the proceeds, compliance with the requirements of the Internal Revenue Code provisions,¹ necessary to obtain capital gains rates, is not per se sufficient to insure the validity under state law of a plan challenged by a minority stockholder.² Thus, a corporation seeking to adopt an option plan must

²⁰ N.C. Sess. Laws 1965, ch. 843.

²¹ N.C. GEN. STAT. § 25-8-320 (1965).

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¹ INT. REV. CODE OF 1954, §§ 421-425.

² [S]ince, under the Internal Revenue Code, the favored position with respect to options granted as part of compensation to corporate officials can be obtained only if the options are exercised while in the corporation's employ, the result will be to persuade the optionees to remain in the corporation's employ. Even if the inferences . . . are justified, they are dependent entirely upon the present state of the federal taxing policy and, as such, too insecure in nature to be regarded as a condition of the stock option plan designed to insure that the corporation will receive the contemplated benefit.

Kerbs v. California Eastern Airways, 33 Del. Ch. 69, 77, 90 A.2d 652, 657 (Sup. Ct. 1952).

recognize the requirements of local corporation statutes³ as well as the provisions of the Internal Revenue Code if the plan is to achieve its desired effect.⁴

The courts have been reluctant to prescribe a set of minimum requirements⁵ by which a corporation can insure the plan will not be invalidated if attacked as a waste of corporate assets⁶ or as unreasonable compensation.⁷ It is clear that there must be at least legal consideration to the corporation for the grant of the options.⁸ Acquiring and retaining key personnel⁹ and securing contracts of employment¹⁰ are the two most common benefits received by the corporation, and the presence of either is usually deemed sufficient consideration to support the grant of the options.

The Delaware courts have abandoned testing the validity of stock options solely on the basis of legal consideration in the con-

³ Controversy resulting from the issuance of stock option plans by corporations upon the approval of the board of directors and stockholders involves the internal affairs of the corporation and is therefore governed by the laws of the state of the corporation's origin. *E.g.*, *Gaynor v. Buckley*, 318 F.2d 432 (9th Cir. 1963); *Beard v. Elster*, 39 Del. Ch. 153, 160 A.2d 731 (Sup. Ct. 1960).

⁴ Stock options may be granted for reasons other than the receipt of capital gains rates. For a discussion of the tax treatment of "non-statutory" stock options, those not specifically sanctioned by the Internal Revenue Code, see generally *Edwards, Executive Compensation: The Taxation of Stock Options*, 13 VAND. L. REV. 475 (1960). See also 44 GEO. L.J. 426 (1956); 35 N.C.L. REV. 160 (1956).

⁵ No rule of thumb can be devised to test the sufficiency of the conditions which are urged as insurance that the corporation will receive the contemplated benefit. The most that can be said is that in each case there must be some element which, within reason, can be expected to lead to the desired end. What that element may be can well differ in each case.

Kerbs v. California Eastern Airways, 33 Del. Ch. 69, 76, 90 A.2d 652, 657 (Sup. Ct. 1952).

⁶ Where a gift or waste of corporate assets is concerned, shareholder ratification is not effective against the protest of a minority stockholder. Shareholder ratification to be effective in these circumstances must be unanimous. *Rogers v. Hill*, 289 U.S. 582, 591 (1933). *Accord*, *Kaufman v. Shoenburg*, 33 Del. Ch. 211, 91 A.2d 786 (Ch. 1952); *Rosenthal v. Burry Biscuit Corp.*, 30 Del. Ch. 299, 60 A.2d 106 (Ch. 1948).

⁷ 5 FLETCHER, CYCLOPEDIA OF CORPORATIONS § 2143 (Rev. ed. 1952) [hereinafter cited as FLETCHER].

⁸ *Rosenthal v. Burry Biscuit Corp.*, 30 Del. Ch. 299, 60 A.2d 106 (Ch. 1948); 5 FLETCHER § 2142.

⁹ See *Wise v. Universal Corp.*, 93 F. Supp. 393 (D. Del. 1950); *Olson Bros. v. Englehart*, 211 A.2d 610 (Del. Ch. 1965); *Sandler v. Schenley Indus., Inc.*, 32 Del. Ch. 46, 79 A.2d 606 (Ch. 1951); *Eliasburg v. Standard Oil Co.*, 23 N.J. Super. 431, 92 A.2d 862 (Ch. 1952).

¹⁰ See *Wyles v. Campbell*, 77 F. Supp. 343 (D. Del. 1948); *Forman v. Chesler*, 39 Del. Ch. 484, 167 A.2d 442 (Sup. Ct. 1961).

tract sense, adopting instead a rule based on benefit to the corporation. The rule, first announced in the leading case of *Kerbs v. California Eastern Airways*,¹¹ has been stated as follows:

Each stock option must be tested against the requirements that it contains conditions, or that surrounding circumstances are such, that the corporation may reasonably expect to receive the contemplated benefit from the grant of the options, and there must be a reasonable relationship between the value of the benefits passing to the corporation and the value of the options granted.¹²

The presence of the legal consideration is partial but not conclusive assurance that the corporation will receive the benefit it expects to gain from the issuance of the options.

In the *Kerbs* case a stock option plan was adopted by an interested board, five of the eight directors ultimately benefiting under the plan. The proposal, approved by a majority of the stockholders,¹³ provided that the options were to be exercisable at any time within a five-year period and, in addition, could be exercised for a period of six months after the termination of the optionee's employment. In invalidating the plan, challenged by a minority shareholder as being without consideration to the corporation, the court found the fact that the optionee could have resigned and still exercised his option rights *in toto* did not reasonably insure that the corporation would receive the contemplated benefit—the retention of the services of the employee.

Although *Kerbs* stood on a lack of consideration to the corporation, the Delaware court indicated that, had consideration been present, it would investigate the reasonable relationship between the value of the options granted and the value of the services rendered even where the plan had been ratified by a majority of the stockholders.¹⁴ This approach, which amounts to judicial review of the

¹¹ 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952); Annot., 34 A.L.R.2d 839 (1954). See generally Dean, *Employee Stock Options*, 66 HAR. L. REV. 1403 (1952). See also Dwight, *Employee Stock Options: The Clydesdale Rule*, 52 COLUM. L. REV. 1003 (1952); 62 YALE L.J. 84 (1952).

¹² *Olson Bros. v. Englehart*, 211 A.2d 610, 612 (Del. Ch. 1965).

¹³ Ratification by a majority of the stockholders cures any voidable defect in the action of the board of directors and is effective for all purposes unless the action of the directors constitutes a gift of corporate assets or is *ultra vires*, illegal, or fraudulent. See *Keenan v. Eshleman*, 23 Del. Ch. 234, 2 A.2d 904 (Sup. Ct. 1938); 5 FLETCHER § 2139.

¹⁴ *Kerbs v. California Eastern Airways*, 33 Del. Ch. 69, 75, 90 A.2d 652, 656 (Sup. Ct. 1952). See note 13 *supra*.

business judgment of the directors, was even more evident in *Gottlieb v. Heyden Chem. Corp.*,¹⁵ decided simultaneously with *Kerbs*. In reversing summary judgment for the defendant corporation, the Delaware Supreme Court held that the interested board must satisfy the court that the option was as favorable a bargain to the corporation as if the directors had been dealing with outsiders. On rehearing, however, the court rested the burden of proof as to the reasonable relation between the values of the options granted and benefits received on the directors only absent shareholder ratification, noting that such approval would not preclude a judicial inquiry into the adequacy of consideration to the corporation where the board of directors was interested.¹⁶

The term "consideration" as used in the *Kerbs* and *Gottlieb* decisions is somewhat misleading, since it is apparent that there must be something more than the proverbial "peppercorn." In *Beard v. Elster*,¹⁷ the Delaware Supreme Court clarified the meaning of consideration as applied to stock options, noting that the use of this term in *Kerbs*

was possibly ill-advised since it is regarded, apparently, by some as a measurable *quid pro quo* 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.¹⁸

The *Beard* case, a pivotal decision in this area, applied to stock options the traditional Delaware policy of generously recognizing

¹⁵ 33 Del. Ch. 82, 90 A.2d 660 (Sup. Ct. 1952), *on reargument*, 33 Del. Ch. 177, 91 A.2d 57 (Sup. Ct. 1952); 101 U. PA. L. REV. 407.

¹⁶ On a motion for summary judgment by the defendants in a stockholder's action, the burden of proof, absent shareholder ratification, is on the interested directors to show to the court's satisfaction that the directors did, in fact, act in utmost good faith and exercised scrupulous fairness. The plaintiff does not have the burden of coming forward with further evidence to demonstrate that there was a genuine issue of material fact relating to the question of fairness until the moving defendant has discharged his burden of negating the plaintiff's claim of unfairness. If the stockholders ratified the plan, the burden of proof on the directors is reduced to showing that the terms of the plan were not so unbalanced as to amount to waste or that the question is such a close one factually as to fall within the realm of sound business judgment. *Alcott v. Hymen*, 40 Del. Ch. 449, 208 A.2d 501 (Sup. Ct. 1965).

¹⁷ 39 Del. Ch. 153, 160 A.2d 731 (Sup. Ct. 1960); 2 BOSTON COLLEGE INDUSTRIAL & COMMERCIAL L. REV. 405 (1961); 6 How. L.J. 213 (1960).

¹⁸ *Id.* at 160, 160 A.2d at 736.

the business judgment of the directors. Prior to *Beard* the Delaware courts had not clearly recognized incentive as sufficient benefit to the corporation to support an option.¹⁹ However, the courts had viewed incentive as the motivation for granting options but had required a showing that existing conditions or circumstances reasonably insured that the corporation would, in fact, receive the contemplated benefit.²⁰ Rather than conclude that incentive was not sufficient benefit to the corporation, the court placed the burden of proof on the objector to show that there was no reasonable relation between the values of the options granted and the services rendered.²¹ Absent such a showing, the proper solution was to accept the bona fide business judgment of the directors.²²

This view was carried to its logical conclusion in *Olson Bros., v. Englehart*.²³ The interested board of a derelict corporation, termed an "empty shell"²⁴ by the court, adopted an option plan later ratified by a majority of the stockholders. The court upheld the validity of the options even though several directors seeking to exercise them were no longer employed by the corporation. The fact that the directors had remained with the corporation until their services were no longer required vindicated the sound business judgment of the board.²⁵ As the objector had failed to demonstrate conclusively that the value of the options had no reasonable relation to the value of the services rendered,²⁶ the court accepted the directors' decision.

¹⁹ See *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 82, 90 A.2d 660 (Sup. Ct. 1952); *Kerbs v. California Eastern Airways*, 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952); *Rosenthal v. Burry Biscuit Corp.*, 30 Del. Ch. 299, 60 A.2d 106 (Ch. 1948).

²⁰ See *Kaufman v. Shoenburg*, 33 Del. Ch. 211, 91 A.2d 786 (Ch. 1952).

²¹ See note 16 *supra*.

²² After the *Kerbs* and *Gottlieb* decisions, Delaware amended its statute making directors' decisions as to consideration for the issuance of options conclusive absent actual fraud. DEL. CODE ANN. tit. 8, § 157 (Supp. 1964). See, e.g., N.C. GEN. STAT. § 55-46(f) (1965). *But see* *Frankel v. Donovan*, 35 Del. Ch. 443, 120 A.2d 311 (Ch. 1956).

²³ 211 A.2d 610 (Del. Ch. 1965).

²⁴ *Orzeck v. Englehart*, 41 Del. Ch. 223, 195 A.2d 375 (Sup. Ct. 1963).

²⁵ It appears that if the optionee remains in the corporation's employ until the contemplated benefit has passed to the firm, the court will uphold the option by the application of a test of "hindsight," despite an absence of conditions insuring its receipt. See *Olson Bros. v. Englehart*, 211 A.2d 610, 615 (Del. Ch. 1965); *Beard v. Elster*, 39 Del. Ch. 153, 165, 160 A.2d 731, 738 (Sup. Ct. 1960).

²⁶ The issue was "in the twilight zone where reasonable businessmen, fully informed, might differ." *Beard v. Elster*, 39 Del. Ch. 153, 165, 160 A.2d 731, 738 (Sup. Ct. 1960).

While state law controls the validity of stock options challenged by minority stockholders, it has been noted that the tax benefits gained by compliance with the Internal Revenue Code provisions²⁷ often motivate the adoption of a plan. In 1964, Congress, recognizing the abuses inherent under the old restrictive stock option provisions but convinced that stock options could provide incentive to key personnel, made radical amendments now appearing as sections 421 through 425 of the Code.²⁸ The former restrictive stock option provisions are now found in section 424 and, with certain exceptions, relate only to options granted prior to January 1, 1964.²⁹ The qualified stock option³⁰ is intended by Congress to replace the former restricted stock option as an incentive to personnel whose individual efforts influence the fortunes of their firm.³¹ This plan is to be distinguished from the employee stock purchase plan,³² required to be made available to all employees on a basis that does not discriminate in favor of supervisory or highly compensated personnel,³³ although both plans receive the favorable tax rates previously accorded the restricted stock option.

Although the new rules of the 1964 Revenue Act have substantially increased the technical difficulties of devising and exercising options,³⁴ the amended provisions have eased the burden of drafting a plan that complies with both state law and the Code requirements. The statute requires the existence of a written plan ratified by the stockholders,³⁵ which insures that they are apprised of and approve the plan.³⁶ This ratification would then seem to be sufficient in questions concerning the burden of proof as to the

²⁷ INT. REV. CODE OF 1954, §§ 421-425.

²⁸ See generally Baker, *Employee Stock Option Plans Under the Revenue Act of 1964*, 20 TAX L. REV. 77 (1964).

²⁹ INT. REV. CODE OF 1954, § 424(c)(3).

³⁰ INT. REV. CODE OF 1954, § 422.

³¹ H.R. REP. No. 749, 88th Cong., 1st Sess. 64 (1963); S. REP. No. 830, 88th Cong., 2d Sess. 88 (1964).

³² INT. REV. CODE OF 1954, § 423.

³³ INT. REV. CODE OF 1954, § 423(b)(4)(D).

³⁴ See Rubinfeld, *Qualified Stock Options: Some Developing Problems Under the 1964 Revenue Act*, 21 J. TAXATION 140 (1964). See also Baker *supra* note 28.

³⁵ INT. REV. CODE OF 1954, § 422(b)(1).

³⁶ In order to ratify effectively an option plan adopted by an interested board, shareholders must be given reasonably full information as to its advantages and disadvantages and ratification extends only to things about which the shareholders are informed. See *Gaynor v. Buckley*, 318 F.2d 432 (9th Cir. 1963); *Kaufman v. Shoenburg*, 33 Del. Ch. 211, 91 A.2d 786 (Ch. 1952).

reasonable relation between the options granted and the benefits received under state law.³⁷ Too, the requirement that the option price be the fair market value of the stock at the time the option is granted³⁸ reduces the compensatory nature of the option and is additional evidence of reasonableness.

Under the new tax provisions, the employee must remain in the corporation's employ at all times from the date of the granting of the option until a date three months before its exercise.³⁹ If the option complies with the statute in this respect, it would seem by implication to meet the requirements of state law that there be a valid contract of employment or other device to retain the continued services of the optionee as long as this is sufficient benefit to the corporation under the *Kerbs* test.⁴⁰ It would also seem to negate the court's argument in *Kerbs* that compliance with the Code provisions does not reasonably insure the corporation will receive the contemplated benefit.⁴¹ However, if the corporation is best to insure the continued services of the optionee, the plan should provide that the options granted may be exercised in installments spaced over the entire period of the option, in no event more than five years from the date of the grant of the option.⁴²

The new Internal Revenue Code provisions have forced firms to decide whether favorable tax rates are the primary reason for granting options. If so, the plan must recognize and comply with the Code requirements. Having complied with the tax statute the corporation still may exercise broad discretion as to the conditions that it may impose on the enjoyment of options by executives, but that must be included to insure benefit to the corporation as required by state law. A balancing of interests must be considered; for if too many restrictions are imposed on the employee's enjoyment of that right, the purpose of the plan, employee incentive, may well be defeated.

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³⁷ See note 16 *supra*, as to the burden of proof.

³⁸ INT. REV. CODE OF 1954, § 422(b)(4).

³⁹ INT. REV. CODE OF 1954, § 422(a)(2).

⁴⁰ See note 12 *supra*, and accompanying text.

⁴¹ See note 2 *supra*.

⁴² INT. REV. CODE OF 1954, § 422(b)(3). See, *e.g.*, *Gruber v. Chesapeake & O. Ry.*, 158 F. Supp. 593 (N.D. Ohio 1958).