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SOME LEGAL ASPECTS OF EMPLOYEE STOCK-PURCHASE PLANS

JEFFERSON B. FORDHAM*

A large body of literature has accumulated in the past two decades on the subject of employee stock-purchase and ownership.¹ Practically all of it, however, approaches the matter from the standpoint of policy or statistics.² This study is mainly concerned with the important legal problems involved. A brief factual survey is necessary at the outset.

Employee stock-purchase plans, though varying in details, may be said to include generally the following features: (1) A fixing of eligibility for participation. (2) A provision setting forth the kind and price of shares to be sold under the plan. (3) A fixing of the maximum subscription open to employees. (4) A method of payment for shares (usually by installments without the privilege of immediate full payment in cash). (5) A reservation by the company of title to shares till full payment. (6) Provisions governing such contingencies as temporary and permanent termination of employment. (7) An option to or an obligation upon the company to repurchase paid-up shares upon cessation of the employment. (8) Provisions as to the revocability of subscriptions. (Subscriptions are often made revocable at the option of employees without any forfeiture of previous credits.) (9) Special benefits to participating employees. (10) Time limits of the plan. (11) Reservation by the company of power to terminate the plan.

The more common purposes which they are set up to effectuate are these: (1) to stimulate systematic saving on the part of employees and afford them a convenient and paying investment;³ (2) to give the

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¹ See Laura A. Thompson, *A Selected Bibliography, Employee Stock Ownership in the United States*. From the Monthly Labor Review of the Bureau of Labor Statistics of the United States Department of Labor, for June 1927.

² Two particularly informative works are THE NATIONAL INDUSTRIAL CONFERENCE BOARD, INC., *EMPLOYEE STOCK-PURCHASE PLANS IN THE UNITED STATES* (New York 1928), and R. F. FOERSTER and ELSE DIETEL, *EMPLOYEE STOCK OWNERSHIP IN THE UNITED STATES* (Princeton 1926).

³ The E. I. du Pont de Nemours and Company state this purpose in their plan in this happy way: to afford "an incentive to employees to start the accumulation of income-producing property." Quoted in Foerster and Dietel, *op. cit. supra* note 2, at 7.

workers a share in the extra earnings during a prosperous business period; (3) to give the employees a share in the management; (4) to serve as additional compensation; (5) to stimulate the interest of the employees in the business and thereby increase their efficiency; (6) to minimize the turnover of labor; (7) to provide the business with ready capital.

The idea of offering stock to employees, little known or applied before the "turn of the century," and not extensively put to use until after the World War, is now being exploited by hundreds of corporations the country over, including such giants as the American Telephone and Telegraph Company, the United States Steel Corporation and the General Motors Corporation.⁴ It was estimated in 1928 that employees of American corporations held stock therein aggregating over \$1,000,000,000 in money value,⁵ or about one per cent of the stock holdings of the country. The employees often constitute a large percentage of the total shareholders but their holdings are usually relatively small.⁶

The forces of organized labor are not in sympathy with employee stock-purchase schemes but regard them as left-handed concessions or favors to mollify labor and enervate the labor program with its principle of collective bargaining.⁷ There are labor unionists who believe in democratizing industry through labor union capitalism, not by buying stock under company plans but by organizing labor's capital reserves through labor banks, labor savings and independent investment.⁸

Whatever may be the verdict of the controversialists, it is certain that the capitalists have started something of perceptible significance in the task of adjusting industrial relations, though doubtless unattended by a spirit of altruism in many instances. Conceivably public ownership of the elements of production will be the final outcome. Aside from the desirability of that ultimate possibility, labor

⁴Foerster and Dietel, *op. cit. supra* note 2, appendix B, at 103 *et seq.*

⁵National Industrial Conference Board, Inc., *op. cit. supra* note 2, at 39, 40.

⁶*Ibid.*, table at 39.

⁷*American Federation of Labor, Reports of the Executive Council at the 45th Annual Convention* (1925), at 21, 22. J. P. Noonan, President of the International Brotherhood of Electrical Engineers wrote in his comment upon "Labor Investment Suggestions" (1926), 33 *American Federationist* 1191, 1192, "we view the whole practice as vicious from a trade union standpoint at least—." But see the comment of Daniel J. Tobin, Engineer, on the same occasion at p. 1196 *et seq.*

⁸J. B. S. HARDMAN AND ASSOCIATES, *AMERICAN LABOR DYNAMICS* (1928), 44.

must rely for the effectuation of any program upon organization. The fact that labor's capital resources are relatively inconsequential does not invalidate the working conclusion that they are of great importance when mobilized.

It is the natural order of things that law follows rather than leads business. But it should never lag more than a step behind and here is a development worthy of at least a glance from the legal profession. In this connection the legislative follow-up of the development will be indicated as the discussion proceeds.

1. *Initiation of employee stock-purchase plans.*

By what authority are these plans adopted and put into operation? Certainly positive statutory authority is not essential though statutory inhibitions such as those against stock-watering and to protect pre-emptive rights must be observed. Some ten states have statutes authorizing these plans and in six instances stockholders' action is expressly required for the initiation of a plan.⁹ And it would be the part of prudence to submit the plan to the stockholders in any case even in the absence of statutory provision therefor. If a plan should necessitate the issuance of a new class of stock or an increase in capital stock, shareholders' action would be required unless the directors were expressly empowered to act. It seems, however, that treasury stock may be disposed of by directors' action alone, subject in some jurisdictions to pre-emptive rights.¹⁰

2. *Pre-emptive rights.*

The essential difficulty in this connection is that of adjusting the individualistic principle of pre-emptive rights to the advancement of the collective interests of the members of the corporate enterprise. Quite undesirable results may follow where a few shareholders

⁹ California, Laws of 1921, chap. 34, §1; Colorado, Laws of 1923, chap. 89, §2; Illinois, Laws of 1923, p. 282; Louisiana, Laws of 1928, Act 250, §28 (there is no express requirement but the use of the expression, "a corporation may" inaugurate a plan, suggests the necessity of corporate action); Michigan, Pub. Acts of 1921, Act 84, part II, chap. 2, §14, as amended by Pub. Acts of 1927, Act 335 (provides that "any corporation" with capital stock and organized for gain may inaugurate a plan); New Jersey, Laws of 1920, chap. 175, §2 (a) and (b); New Mexico, Code 1915, §939, as amended by Laws of 1921, chap. 19, §1 (here again the power is given to the corporation thus leaving to the corporate body the adoption of a method of exercising it); New York, Cons. Laws, §14, as amended by Laws of 1925, chap. 178; Ohio General Corporation Act, §122 (the choice of a method of exercising the power is left to the corporation); Pennsylvania, Laws of 1925, Act 368, §1, p. 679.

¹⁰ It has been held, however, that retired treasury stock is subject to pre-emptive rights. *Dunn v. Acme Auto and Garage Co.*, 168 Wis. 128, 169 N. W. 297 (1918).

by the exercise of pre-emptive rights may hold up important measures in the conduct of the business. Where such rights exist as to stock to be sold to employees they must be disposed of when the plan is adopted. In the absence of statute the adjustment could be effected in the corporate charter in the form either of a provision cutting off the pre-emptions of all shareholders, or an authorization for a stated majority of shareholders' votes to waive the pre-emptions of all,¹¹ or by a particular provision making all stock to be sold to employees free from pre-emptive rights.

Several states have by statute confirmed the pre-emptive rights of shareholders to a limited extent.¹² In doing so they have contributed to the confusion as to the character of the rights. Consequently, an effort to attain some clarity of concept about these rights is required before proceeding with our special problem.^{12a}

Pre-emptions have been allowed to stockholders in order that they might be able to maintain their relative positions in the corporate body. With the modern complexity of stock issues, involving issues with and without par value, with and without voting power, and numerous other bases for classification, it has become impossible to preserve a shareholder's relative position in every phase of his interest as such.¹³ As recently demonstrated, the only practicable or nearly practicable basis for the right is the preservation of voting power.¹⁴

¹¹ The new Indiana Corporation Law provides that there shall be no pre-emptive rights as to corporate stock save as fixed and declared by charter or by resolution of a board of directors acting under charter authority. Acts of the Indiana General Assembly, 1929, p. 734. This is quite a sane disposition of the business.

¹² Arkansas, Laws of 1927, Act 250, §19; Florida, C. L. 1925, §20; Louisiana, Laws of 1928, Act 250, §28, II; Nevada, Laws of 1925, chap. 177, §23; Ohio, Gen. Corp. Act, §35; Pennsylvania, Act of 1874, §17, as amended by Laws of 1876, p. 32, §2. The Uniform Business Corporation Act has no provision on pre-emptive rights. See UNIFORM LAWS ANN., vol. 9, Supplement—1928.

^{12a} The Arkansas statute, to take an example, provides that unless otherwise declared in the charter every stockholder shall upon a sale for cash of any new stock of the corporation of the same class as that which he holds have a right to his pro rata share at the price at which it is offered. Arkansas Laws of 1927, Act 250, §19. Under this statute where the charter of a corporation has not otherwise provided the relative position of a stockholder is maintained only as to his own class of stock and not as to the corporation. Thus it does not protect an old par stockholder from a new issue of non-par stock at a low figure though both his and the new are voting and fully participating shares. Moreover, the fact of a sale for cash has no relation to the conception of pre-emptive rights.

¹³ See A. H. Frey, *Shareholders' Pre-emptive Rights* (1929) 38 YALE L. J. 563.

¹⁴ *Ibid.* It is true that giving shareholders of one class of stock pre-emptions as to all new issues of that class is workable but generally it would be of no substantial value in preserving relative corporate status.

How to dispose of pre-emptive rights which threaten a given plan depends first upon the class and source of the stock to be issued. It has been held that pre-emptive rights exist only as to increases in capital stock and not as to new issues of originally authorized capital stock.¹⁵ But while few courts have had occasion to make more than an indefinite declaration that pre-emptions attach to "new stock" there is authority for the more logical view that the rights apply to new issues of originally authorized capital stock.¹⁶ It has been decided that treasury stock, bought in and retired, is upon re-issue subject to pre-emptive rights.¹⁷ But the resale by a corporation of fully paid-up shares, which had been donated to the company, has been held not subject to pre-emptive rights.¹⁸ It appears that the logic of the recognition of pre-emptive rights extends to ordinary treasury shares but the law as it is laid down in the cases is to the contrary.¹⁹ It is believed, however, that stock bought in the market for resale to employees is not subject to pre-emptive rights and many companies have followed this practice. In any event reference should be had to local statutes and decisions.

The legislatures which have made provision for stock sales to employees have, with a single exception,²⁰ attempted to provide for the settlement of the possible claims of a stockholder who votes against the adoption of a plan. The Ohio statute disposes of the matter summarily by providing that there shall be no pre-emptive rights as to stock to be sold to employees under the statute authorizing sale to the workers.²¹ It is provided in New Jersey that dis-

¹⁵ *Curry v. Scott*, 54 Pa. St. 270 (1867).

¹⁶ This is probably the most favored view. *Snelling v. Richard*, 166 Fed. 635 (C. C., S. D. N. Y. 1909); *Titus v. Paul State Bank*, 32 Idaho 23, 179 Pac. 514; *Bank of Montgomery v. Reese*, 26 Pa. 143 (1856). And see the dictum in *Crosby v. Stratton*, 17 Colo. App. 212, 68 Pac. 130, 132. (1902).

¹⁷ *Dunn v. Acme Auto and Garage Co.*, *supra* note 10.

¹⁸ *Crosby v. Stratton*, *supra* note 16. It is to be noted that "treasury stock" as the term is used here refers to stock once issued but now held by the corporation as a result of purchase or donation, and not, according to the definition in some of the texts, stock reserved out of original unissued capital for particular purposes. 5. *FLETCHER, CORPORATIONS*, pp. 5601, 5602. And see *Mackey v. Burns*, 16 Colo. App. 6, 64 Pac. 485, 488 (1900). Compare *Provident Trust Co. v. Geyer*, 248 Pa. 423, 94 Atl. 77 (1915).

¹⁹ See *State ex. rel. Page v. Smith*, 48 Vt. 266 (1876) and the dicta in *Borg v. International Silver Co.*, 11 F. (2d) 147 (C. C. A. 2d 1925) and *Bonnet v. Eagle Pass First Nat. Bank*, 24 Tex. Civ. App. 613, 60 S. W. 325 (1900). This is the Louisiana rule by statute, *Laws of 1928, Act 250, §28, II (b) (3)*.

²⁰ The New Mexico statute, Code 1915, §937, as amended by Laws of 1921, chap. 19, §1, simply authorizes the sale of stock to employees without reference to stock-selling plans.

²¹ *Ohio General Code Annotated*, §35, sub-sec. (b).

senting shareholders may sell their holdings to the company under an appraisal by three disinterested parties appointed by the circuit court of the county in which the corporation has its principal office upon petition of the dissenter.²² Since the statute provides that the appraisal is to be made without regard to any change in value due to the adoption of the plan a dissenter, whether he elects to sell or not, loses any pre-emptive rights that he might have had.

The California statute indicates a more careful effort to adjust the difficulty generated by a dissenter.²³ Recognizing the principle that existing law enters into contracts, this enactment provides the dissenter with an option to sell to the company (as under the New Jersey act) but only as to stock issued prior to the enactment of the statute. It permits the corporation to consent at the time when the appraisal is completed to issue the dissenter his pro rata share of the stock to be sold to the employees. Under the Colorado statute the dissenter may demand the right to his pro rata share but the right is waived if demand is not made in writing and within the period limited.²⁴ The Pennsylvania statute provides for an appraisal of the damages, if any, resulting to the dissenter by reason of the sale to employees as well as for an appraisal of the value of his shares.²⁵ The corporation may then elect to pay the damages or to buy the stock at the appraised value. And upon failure to do either within thirty days the damages become a judgment against it.

In Louisiana stock to be sold to employees may be so disposed of free from pre-emptive rights only with the written consent or the affirmative vote of the holders of a majority of shares entitled to exercise pre-emption with respect thereto.²⁶ It is provided in the same statute that only voting shares carry pre-emptive rights and they only as to shares allotted for other than cash, or to satisfy option or conversion rights and except as to treasury shares. In Michigan provision for a special kind of stock, "industrial stock," for sale to employees seems to obviate any trouble over pre-emptions.²⁷

Though it has required some space to present and discuss the subject of pre-emptive rights as it relates to employee stock-purchase plans the problem is not believed to be a very considerable one.

²² New Jersey, Laws of 1920, chap. 175, §2, sub-sec. (c).

²³ California, Laws of 1921, chap. 34, §3.

²⁴ Colorado, Laws of 1923, chap. 89, §3.

²⁵ Pennsylvania, Laws of 1925, Act 368, §2.

²⁶ Louisiana, Laws of 1928, Act 250, §28, sub-sec. (c).

²⁷ Michigan, Public Acts of 1921, Act 84, Part II, chap. 2, §14, as amended by Public Acts of 1927, Act 335.

There may be no dissenting shareholders in the given case. In most states the use of treasury stock already held or stock bought in the market for the purpose should avoid the difficulty. In Arkansas, for instance, all that would be necessary would be to issue a new class of stock to the employees since under the law of that state pre-emptions arise only in favor of holders of stock of the class to be sold.

3. *Paternalistic or single-level plans?*

It is a rather safe observation that the majority of employees who participate in employee stock-purchase plans do so for purposes of investment without any serious interest in gaining a foothold in the business.²⁸ Those workers who are eager for labor participation in ownership and management are not content with any paternalistic scheme of selling stock to employees. Where the workers are simply looking for investment opportunities it might be wiser to refrain from sinking all their savings in the future of a single enterprise and to spread the risk by more diverse investments. Thus if not content with the savings bank pace they might resort to investment trusts or set up some of their own, a plan not without risks, to be sure. And a company seeking to aid employees in investment may give them financial advice, or, after the fashion of Henry Ford, issue them secured investment certificates instead of stock.

But there is a belief both within and without the ranks of their promulgators that the plans are more than investment devices for employees. If it is sought to apply this belief and to operate plans with a view to giving employees some proprietary interest in the business the paternalism of the general run of plans should be abandoned. The paternalistic attitude of mind has even invaded the courts, as is illustrated by a decision fresh from the Supreme Court of Michigan.²⁹ There the statute permitted corporations to set up plans of stock-selling to employees "upon consideration of such faithful or continued employment" as they might prescribe. The statute requires no special benefits for employees unless such is the import of the clause quoted. Plans inaugurated under the statute and similar plans were exempted from the Blue Sky Law. In this case the Michigan court held that the plan before it did not come within

²⁸ This is the conclusion arrived at in the work of the National Industrial Conference Board, Inc., *op. cit. supra* note 2, at 155. It is there stated that like most small stockholders an employee stockholder is little interested in the management so long as his investment pans out.

²⁹ *Harvey v. Electric Refrigeration Corp.*, 246 Mich. 235, 224 N. W. 443 (1929).

the exemption because it did not give an appreciable advantage to employees even in connection with their employment as compared with that offered to the general public in the acquisition of stock. It does not appear that the statute warranted this paternalistic requirement. Services may be just as valuable a consideration for stock as cash. And under the words of the statute a corporation could require a high measure of "faithful and continued employment."

If employees are paid adequate wages they do not require paternalism and special benefits. Except for the installment payment feature stock should be offered to them on the same terms as to the public. Self-respecting workers do not like to be thought of as incompetents and objects of charity. Under this view of the subject the usual option given the employee to withdraw from his subscription at any time is an unnecessary concession, even if valid, a query hereinafter considered.

If voting privileges are not attached to his stock a possible stimulant to the employee's interest in the business is lost. To issue non-voting stock to employees is *prima facie* evidence that the company is fond of the old master and servant idea. The same line of reasoning commends common stock more strongly than preferred for this purpose; it carries more of the business risks and possibilities.

4. *Initiation of stock purchasing by labor.*

Approaching the problem from the other side, that is, the inauguration by labor of a movement toward labor participation in industrial ownership and management several interesting possibilities are presented. The only way in which labor has been able, *proprio vigore*, to get recognition in industry has been through organization. Notwithstanding the possibility, as urged,³⁰ that organization for investment would avail labor little in generally shifting the seat of capital, the organized purchasing and voting of shares by labor can bring, and has brought, results in several instances.³¹

An unified voting strength may be attained by employees in two principal ways: by voting trusts and by corporations erected to hold and vote their stock. The voting trust might be set up with trustees of their own selection to hold and vote the workers' shares. Whether

³⁰ Hardman and Associates, *op. cit. supra* note 8, chap. 3; "The New Capitalism," by Lewis Corey.

³¹ This is the suggestion of W. Jett Lauck in his book, *POLITICAL AND INDUSTRIAL DEMOCRACY IN THE UNITED STATES* (1926) in his discussion of the Philadelphia Rapid Transit Co. plan, at 301 *et seq.*

the employees regularly turned over part of their wages to the trustees with which to buy stock for their benefit or transferred their shares in trust after purchasing such themselves the result would be the same. In either case there would be a voting trust in fact. The principal features of such a scheme where the trustees buy the stock with employee contributions are embodied in the plan of the Philadelphia Rapid Transit Company, a plan, significantly enough, initiated by the corporation itself.³²

That there is nothing essentially objectionable about voting trusts is now generally conceded.³³ In a number of states voting trusts are expressly authorized and regulated by statutes.³⁴ A significant feature of most of those statutes in this regard is a provision that when a voting trust has been erected all stockholders not already participating may come into the trust according to the terms of the original declaration of trust.³⁵ By this means a coalition between the labor vote and other minority groups might be facilitated. Since the trustees would have been chosen in advance by labor, later entrants into the trust would know in advance how the stock would be voted. But there are states which overthrow voting trusts. The North Carolina court has gone so far as to declare them bad on considerations of public policy.³⁶

The second plan involves the setting up of a corporation by the employees either to take their contributions and buy stock or to take stock already purchased by the employees. The voting trust difficulty could be eliminated when necessary by having the voting corporation issue its shares in exchange for employees' shares in the principal company. If it might qualify as a non-profit corporation

³² For a summary of this plan see Foerster and Dietel, *op. cit. supra* note 2, at 151, 152.

³³ This is the thesis of Maurice Finkelstein in his article, *Voting Trust Agreements* (1926), 24 MICH. L. REV. 344. See also HARRY A. CUSHING, *VOTING TRUSTS* (1916) *passim*.

³⁴ Through 1928 the following states had statutes authorizing voting trusts: Arkansas and Nevada (voting trusts good for five years); California (statute applicable only to corporations organized to produce and market agricultural goods); Florida, Louisiana, Maryland, New Jersey, New York, and Ohio (voting trusts good for ten years).

³⁵ See for example the New York statute. Laws of New York, 1923, chap. 787, §50.

³⁶ *Harvey v. Linville Imp. Co.*, 118 N. C. 693, 24 S. E. 489 (1896); *Bridgers v. Staton*, 150 N. C. 216, 63 S. E. 892 (1909); *Shepherd v. Power Co.*, 150 N. C. 776, 64 S. E. 894 (1909); *Bridgers v. First Nat. Bank*, 152 N. C. 293, 67 S. E. 770 (1910).

which is doubtful,^{36a} the voting company could avoid some of the trouble and expense attached to corporate enterprises.

There is an English instance of a firm of partners organizing a limited company among its employees to enter the firm as a limited partner.³⁷ Under such an arrangement there would be no labor participation in management in this country because limited partners under the uniform³⁸ and individual state statutes³⁹ share in the management only at the risk of incurring personal liability. But, since the corporation would insulate the employee members against personal liability, they should not be averse to its entrance into the firm as an active partner.

Cumulative voting is another device helpful to employees in voting their stock to the best advantage. But it is a factor that they can utilize only where they find it because it is quite out of their control. Professor Ripley of Harvard has urged the merits of cumulative voting to labor with good cause but he failed to tell the workers how to get it when they did not already have it.⁴⁰ It appearing that there was no common-law right to vote cumulatively it has been held that there is no such power in the absence of statute granting it. But today thirty-three states have statutes either giving the right directly or providing that it may be given by charter or by-laws.

Two states, Massachusetts and New Jersey, have by statute authorized corporations to provide for the election by their employees of one or more members to the board of directors independently of stock ownership.⁴² During about a decade no similar legislation has

^{36a} Application of Pittsburgh Chevrolet Dealers' Ass'n., Inc., 146 Atl. 26 (Pa. 1929). Held—Corporation not in non-profit class where it is erected to increase the profits of a limited class.

³⁷ Messrs. Gilbert Brothers of Nantwich, England, was the firm in question, whose plan is described by Calvert Magruder in *Labor Copartnership in Industry* (1922) 35 HARV. L. REV. 910, 920, 921, citing a description thereof in *Report on Profit Sharing and Labor Co-partnership in the United Kingdom* (1920), issued by the Ministry of Labor.

³⁸ Uniform Limited Partnership Act, §7.

³⁹ See, for example, the North Carolina statute. N. C. Code (Michie 1927), §3273. And see BURDICK ON PARTNERSHIP (3rd ed. 1917), 411, MECHEM, ELEMENTS OF PARTNERSHIP (2d ed. 1920), 413.

⁴⁰ *Labor Investment Suggestions* (1926), 33 American Federationist 306, 307. On the same occasion he further advised the workers as follows: "—above all things insist that the position of the worker shall be as free and as self-respecting as that of every other member of the community who chooses to entrust his savings to others for management."

⁴¹ 2 THOMPSON, CORPORATIONS (3rd ed. 1927), p. 364; *State ex rel. Baumgardner v. Stockley*, 45 Ohio St. 304, 13 N. E. 279 (1887); *Gregg v. Granby Mining and Smelting Co.*, 164 Mo. 616, 65 S. W. 312 (1901).

⁴² New Jersey, Laws of 1920, chap. 175, §1, subsec. (d); Massachusetts, General Laws of 1921, chap. 156, §23.

appeared in other states. It is doubtful, however, if the idea will spread. Those in control must take the initiative in granting power away under the statutes. And it is probably felt that labor now has a chance at representation on boards of directors through normal channels.

5. *Employee subscription contracts—consideration.*

It is usually provided in employee stock-purchase plans that title shall not pass and the subscriber shall not become a shareholder until full payment. Otherwise, the general rule would operate, namely, that a subscription to stock without more constitutes the subscriber a stockholder immediately upon acceptance.

These plans quite commonly allow the employee to cancel his subscription at any time. Some provide that in the event of revocation by the employee-subscriber the stock shall be sold by the company and the proceeds applied first to the satisfaction of unpaid installments and costs of sale before paying the balance to the employee.⁴³ But the majority more liberally provide for the return to the employee of all credits plus interest.⁴⁴ Under the former type of provision there is no question of absence of consideration, because the employee's exercise of his option to revoke costs him something. It is in the latter sort of plan that a draftsman who desires to make it binding must be careful to inject a bit of legal consideration into a subscription agreement somewhere.

The best way to eliminate the whole difficulty is, as previously suggested, to draft the plan without giving an option to cancel. But let us assume that the inclusion of the option is insisted upon and it is desired at the same time to have the company bound at all events. If there is just a promise to buy in consideration for a promise to sell without more and no down-payment an option in one party to cancel, of course, renders the transaction not binding. But there may be elements of consideration in the collateral provisions of a plan entering into a subscription which would bind the company at all events.

⁴³ The stipulation in the Chicago, Rock Island and Pacific Railway Co. plan of 1923 was of this type. See the summary thereof in Foerster and Dietel, *op. cit. supra* note 2, at 113, 114.

⁴⁴ The plan of the American Telephone and Telegraph Company, as amended to May 1925, provided that upon revocation by the employee the company would return the amount of his credits with six per cent interest compounded quarterly. Reprinted in JAMES AND ASSOCIATES, *PROFIT SHARING AND STOCK OWNERSHIP FOR EMPLOYEES* (1926), at 286, 290.

There are at least three methods by which the contract may be made legally sufficient with respect to consideration over and above the simple device (still effective in some states) of putting the agreement under seal.⁴⁵ 1. There may be some executed consideration such as a down-payment. A sure step would be to require a non-returnable down-payment of a nominal sum. But without such a payment and notwithstanding the agreement of the corporation to return all credits including down-payments with interest upon cancellation, a returnable down-payment might supply a consideration by reason of the temporary loss to the employees. This may, true enough, be a rather flimsy affair since the employee could, by revoking at will, limit the loss of use of the money paid to a moment's time, but that, if specifically bargained for, would be enough.⁴⁶

2. The option may be limited.⁴⁷ This may be effected by such a simple provision as that it can not be exercised except upon thirty days' notice or only after the expiration of thirty days from the day the subscription was made. But the limitation should always be definite. Even then the transaction might not satisfy the courts. Thus in a recent New York case the Court of Appeals unnecessarily confused a corporation's limited option to repurchase stock upon termination of employment if the company had a sufficient surplus with an absolute option.⁴⁸ The decision of the court, however, rested mainly upon the New York statute making it a crime for directors to buy shares of a corporation's stock out of capital.

3. The agreement may contain other promises of a sort which do not render it divisible and which are absolutely binding on the subscriber. Thus the promise of the employee that he will take no stock in a competing corporation during the period of his employment will

⁴⁵ In all common law states, of course, where the rule has not been changed by statute a seal "conclusively imports" i.e. dispenses with the necessity for, consideration. North Carolina is in this class.

⁴⁶ It has not been thought necessary to state in the text of this paper that the idea that a contract must have mutuality of legal obligation to be legally enforceable is a misconception very nearly dissipated at this day. Such mutuality is often involved as a basis of consideration in bi-lateral agreements, as mutual promises, but it is never essential. It may be made the sole basis of consideration in a given instance. But the important point at law is—there must be consideration. 1 WILLISTON, CONTRACTS (1920) §140.

⁴⁷ Thus a promise of a purchaser of land to purchase if the title was satisfactory was held enforceable because he was bound to exercise honest judgment, which limited his option. *Hollingsworth v. Colthurst*, 78 Kans. 455, 96 Pac. 851 (1908).

N. E. 735 (1928).

⁴⁸ *Topken, Loring and Schwartz, Inc. v. Schwartz*, 249 N. Y. 206, 163 N. E. 735 (1928).

suffice. There is eminent authority for the view that a stipulation for the giving of written notice of the exercise of the option to cancel is consideration.⁴⁹ This is drawing the issue down to a fine point whether one regards the promise to give written notice as a limitation upon the option or a promise in itself constituting consideration. The North Carolina court, however, has recently subscribed to this view.⁵⁰

Assuming non-enforceability of the subscription contract when made, will subsequent payments give it binding effect? It may be, even in the case of a bilateral agreement, that there is nothing more than an option until it is acted upon. So in an Alabama case⁵¹ one lumber company had contracted to buy the output of another until it should notify the seller to discontinue cutting. The court held that the buyer upon cancelling after so much lumber was cut was responsible in damages for refusing to accept the remainder of the cut lumber. But, unlike an employee's subscription contract, that agreement was divisible. It is believed, however, that the employee's subscription might be rendered binding by subsequent payments if the contract specified the actual making of one or more installment payments as consideration for the company's entire undertaking.⁵²

6. *Provision for contingencies involved in termination of employment.*

A related question arises out of the provision for revocation of partially paid-up subscriptions in the event of termination of employment. No one answer would fit the requirements of every plan. The following general scheme is suggested as an equitable though none-too-easily applied arrangement to govern this contingency.

1. Death or permanent disability of the employee revokes the subscription. 2. Discharge for cause effects revocation. 3. The company has an option to cancel if the employee voluntarily quits the service. 4. Upon discharge without cause the employee has an

⁴⁹ Arthur L. Corbin, *The Effect of Options on Consideration* (1925), 34 YALE L. J. 571, 587.

⁵⁰ *Fawcett v. Fawcett*, 191 N. C. 679, 132 S. E. 796 (1926). And see *Gurfein v. Werbelovsky*, 97 Conn. 703, 118 Atl. 32 (1922); commented upon in (1923) 32 YALE L. J. 496.

⁵¹ *McIntire Export and Lumber Co.*, 165 Ala. 268, 51 So. 767 (1910). *Accord*: *Malloy v. Egyptian Tie and Lumber Co.*, 212 Mo. App. 429, 247 S. W. 469 (1923). In this latter case the defendant had written to the plaintiff stating "enter our order for all your oak ties till further notice." *Held*—unenforceable when made but the defendant is bound for the price of ties cut and delivered before "further notice."

⁵² See the advice of Professor Corbin, *loc. cit. supra* note 47, at 590.

option to revoke. It would be advisable to call upon independent parties to determine whether the discharge was for cause. 5. Temporary lay-offs do not revoke or give ground for revocation.

Another and more simple solution, which would not breed controversial questions, would be a provision that any permanent termination of the employment would revoke the erstwhile employee's subscription automatically. That provision would not defeat consideration because neither party could bring about revocation without giving up a subsisting legal relationship. There could then arise no controversies over such questions as whether the discharge was for cause.⁵³

7. Agreements and options to repurchase or resell stock.

Since a corporation is the party interested in keeping its employee-stock out of the hands of competitors and since the purpose of employee-ownership fails upon termination of employment the option is usually one reserved by the company to repurchase rather than one in the employee to resell. Options of either type are most common in the individual contracts of sale of stock to particular employees, usually of managerial rank.⁵⁴ An option of either kind will be enforced when it arises out of the agreement of the parties and such considerations as the rights of creditors are not involved.

Though statutes in some states⁵⁵ expressly authorize corporations

⁵³ In *Larkin v. Stewart*, 248 Ill. App. 152 (1928) the plaintiff, an employee of the Standard Oil Company of Indiana, had participated in its plan under which stock was purchased for employees by trustees, who were upon maturity of the plan to make over the stock to the participants. The plan made subscriptions revocable by discharge for good cause (of which the trustees were to be the sole judges). Plaintiff was discharged just prior to the maturity of the plan and in this action sought full benefits of the plan. *Held*: the granting of such relief below was error since under the plan the trustees were not required to determine that the discharge was for cause or to give the employee notice so that he might have a hearing as ruled by the trial court. This suit would hardly have been instituted had the plan simply provided that any permanent termination of the employment would revoke an employee's subscription.

⁵⁴ A number of cases involving these contracts is cited in the note to *Halsey v. Boomer*, 236 Mich. 328, 210 N. W. 209, 48 A. L. R. 622 (1926). See *Cobb v. Library Bureau*, 167 N. E. 765 (Mass. 1929).

⁵⁵ Connecticut, General Statutes, §3429; Delaware, Revised Code, chap. 65, §19; Florida, Corporation Law of 1925, §8, sub-sec. 3; Maryland, Bagby's Annotated Code, Art. 23, §50; Missouri, Revised Statutes, as amended by Laws of 1927, p. 394; Nevada, Laws of 1925, chap. 177, §9, sub-sec. 3; North Dakota, Compiled Laws of 1913, §4531; Ohio, General Corporation Act 1927, §41; Oklahoma, Compiled Laws of Oklahoma of 1921, §5320; Rhode Island, General Laws of Rhode Island, 1923, §5 (g), as amended by Laws of 1928, 1182, §1; South Dakota, Revised Code of 1919, §§8777, 8808. The Louisiana statute is especially significant in this regard. It authorizes a corporation to purchase its own stock when the purchase is to obtain stock for resale to employees

to deal in their own stock, the contrary is the law of others.⁵⁶ In New York it is a misdemeanor for directors to purchase stock in the corporation out of capital,⁵⁷ and it is generally understood that in any case, save under statutes allowing this course of action as a method of decreasing capital stock, a company may buy its own shares only out of surplus.⁵⁸ But even in states where corporations are forbidden to deal in their own shares a provision in a stock subscription giving the subscriber an option to resell to the company has been upheld as an essential inducement of the subscription.⁵⁹ The same reasoning would support a provision obligating the company to repurchase upon the occurrence of a stated contingency, such as termination of employment, which does not necessarily depend upon the will of the subscriber.⁶⁰

But options in the corporation to repurchase as distinguished from an agreement to repurchase or an option in the other party to resell have met with the objection that they are restraints upon alienation and void as such.

In *Lawson v. Household Finance Corporation*⁶¹ the plaintiff was seeking to compel the defendant to transfer shares to him on its books. The shares had been issued to D, an employee of the defendant, and upon the certificate was printed a provision of the charter and by-laws of the defendant giving it a twenty-day option to buy the shares at an appraised value arrived at without considering the company's good will, in the event the holder decided to transfer the stock. D sold to plaintiff in violation of the option provision. Plaintiff admitted that the defendant's business of making small loans on chattel mortgage security through the agency of scattered em-

under the statute providing for same and under a repurchase agreement with an employee, which reserves to the corporation the right to repurchase or obligates it to do so. Louisiana, Laws of 1928, Act 250, §23.

⁵⁶ Kentucky is an example. Carroll's Kentucky Statutes, 1922, §544.

⁵⁷ *Topken, Loring and Schwartz, Inc. v. Schwartz*, *supra* note 48, citing Consolidated Laws of New York, chap. 40, §664 (5).

⁵⁸ As generally stated it is the rule that agreements of a corporation to repurchase stock cannot be enforced where the rights of creditors would be infringed thereby. *Schulte v. Blvd. Gardens Land Co.*, 164 Cal. 464, 129 Pac. 582, 44 L. R. A. (N. S.) 156, Ann. Cas. 1914B, 1013 (1913); *Pender v. Speight*, 159 N. C. 612, 75 S. E. 851. And this has been held to apply in favor of other stockholders. *Sarback v. Kansas Fiscal Agency Co.*, 86 Kan. 734, 122 Pac. 113, Ann. Cas. 1913C, 415 (1912).

⁵⁹ *Schulte v. Blvd. Gardens Land Co.*, *supra* note 58.

⁶⁰ In *Strodl v. Farrish-Stafford Co.*, 145 App. Div. 406, 130 N. Y. Supp. 35 (1911) such an agreement was held valid at common law. *Koch v. Val Verde Mercantile Corp.* 4 S. W. (2d) 662 (Tex. Civ. App., 1928).

⁶¹ 147 Atl. 312 (Del. Chan. 1929).

ployees was peculiarly dependent upon individual efficiency for its success and that employee stock-ownership was conducive to this end. The decision of the court denying plaintiff relief was that the restrictions embraced in the terms of the option were reasonable with reference to their purpose and, therefore, valid.

If restrictions upon the alienation of stock are authorized by statute they are upheld.⁶² Under section 15 of the Uniform Stock Transfer Act⁶³ it is provided that there shall be no restriction upon the transfer of shares by virtue of any by-laws of the company, or otherwise, unless the restriction is stated upon the stock certificate. But to construe this statute to confer any positive authority upon corporations, even by implication, would hardly be consistent with its plain terms. It has been held in Illinois where this statute was deemed applicable that restrictions upon the general right to transfer shares, provided they are reasonable and not contrary to any law or public policy, are valid.⁶⁴ The court in the case cited upheld corporate by-laws giving the corporation through its directors the right to object to any proposed transfer of shares if they supplied another purchaser to take at the prevailing market price. But in a later Illinois case the other restrictions were held to be unreasonable.⁶⁵ There a mutual agreement between all the stockholders, which was made a by-law of the company, provided that none would sell any shares without the written consent of all the others, except among themselves, and that, should any member desire to sell, the purchaser must be approved by a majority of the members and become a party to the agreement. This arrangement was declared void because under it a majority of the stockholders could prevent a sale of stock.

Restrictions authorized in the charter of a corporation are generally upheld if they satisfy the test of reasonableness.⁶⁶ The Delaware case discussed above is an example.⁶⁷

⁶² Chaffee v. Farmers' Co-op Elevator Co., 39 N. D. 585, 168 N. W. 616 (1918).

⁶³ Up to 1928 twenty-one states had adopted the act.

⁶⁴ People ex rel. Rudaitis v. Galskis, 233 Ill. App. 414 (1924).

⁶⁵ People ex rel. Malcom v. Lake Sand Corp., 251 Ill. App. 499 (1929).

⁶⁶ Bloomingdale v. Bloomingdale, 177 N. Y. Supp. 873 (1919); Albert E. Tauchet, Inc. v. Tauchet, 163 N. E. 184 (Mass. 1928). And see the cases cited in Lawson v. Finance Corp., *supra* note 61, at 315. In the Bloomingdale case Ford, J., declared: "I have sought diligently but without success for a case impeaching the legality of reasonable restrictions upon the transfer of the stock of a corporation when they are imposed by the charter, articles of association, or certificate of incorporation, and notice of the restriction is stamped on the certificate of stock."

⁶⁷ Lawson v. Finance Corp., *supra* note 61.

As respects restrictions authorized or set out solely in the by-laws it has been held on the one hand that without at least charter,⁶⁸ and preferably, statutory⁶⁹ authorization the corporation is without authority to create such restrictions.⁷⁰ Again they have been defeated as unreasonable restraints upon alienation even though they simply reserved to the corporation a pre-emption in case a holder elected to sell his stock.⁷¹ On the other hand, there are decisions, which uphold, as reasonable, restrictions in the by-laws of the type last-mentioned.⁷²

Where the restrictions are imposed purely by agreement of the parties there should be little question unless they would substantially violate the public policy of keeping property alienable and readily subject to circulation. But there is no public policy against options. And as said in *Model Clothing House v. Dickinson*,⁷³ where the five members of a corporation had agreed not to sell their stock without giving the company and each other an opportunity to buy on the terms on which the sale was proposed, no reason appears why the mutual agreement of the type involved in that case could fairly be stamped an objectionable restraint upon alienation.

That, in brief, is the state of the decisions. Their lesson to the draftsman of an employee stock purchase plan is to make the company's option to repurchase upon termination of employment a bare option to buy at market prices, or, if the stock is not on the market, at the then value as determined by independent appraisers. Any disadvantage to the employee as a stockholder in this regard leaves an

⁶⁸ *Kinnan v. Sullivan County Club*, 26 App. Div. 213, 50 N. Y. Supp. 95 (1898); *Driscoll v. Mfg. Co.*, 59 N. Y. 96 (1874).

⁶⁹ *Kretzer v. Cole Bros. Co.*, 193 Mo. App. 99, 181 S. W. 1066 (1916).

⁷⁰ *Ireland v. Globe Milling Co.*, 19 R. I. 180, 32 Atl. 921 (1895); *S. C.*, 21 R. I. 9, 41 Atl. 258 (1898).

⁷¹ *Victor G. Bloede Co. v. Bloede*, 86 Md. 129, 34 Atl. 1127 (1896).

⁷² *Sterling Loan and Investment Co. v. Litel*, 75 Colo. 34, 223 Pac. 753 (1924); *Barrett v. King*, 181 Mass. 476, 63 N. E. 934 (1902). In the *Barrett* case Chief Justice Holmes threw out this interesting suggestion favorable to such restrictions: "Stock in a corporation is not merely property. It also creates a personal relation analagous otherwise than technically to a partnership . . . there seems to be no greater objections to retaining one's associates in a corporation than in a firm." Much the same view is expressed in *Lawson v. Finance Corp.*, *supra* note 61, at 317.

⁷³ 146 Minn. 367, 178 N. W. 957 (1920). A by-law giving the company a pre-emption assented to by positive vote of every shareholder would be, in effect, an agreement mutually entered into by all and should bind all like the express agreement in the case cited. It was held in *New England Trust Co. v. Abbott*, 162 Mass. 148, 38 N. E. 432, 27 L. R. A. 271 (1891) that a by-law, without considering its validity as such, which gave the company an option to buy upon any transfer of stock and which was printed upon all stock certificates bound the stockholder as an agreement with the corporation, or enforceable by the corporation.

opening for charges of unreasonable restraints upon alienation, whether well-founded or not. If the jurisdiction is one where corporations may not deal in their own shares the purpose of the usual option could be served as to closed corporations by reserving the option in favor of other shareholders.

8. *Fitting the plan to the industry.*

The foregoing discussion has been limited to labor's proprietary participation in business organized on the corporate basis because that largely marks the limits of the development. And this is not to be understood as meaning that all the legal problems and incidents have been disposed of. Other questions will always appear. Thus Blue Sky Laws must be complied with as to stock to be sold to employees.⁷⁴ Moreover, as a practical consideration attention must always be given to the size and character of the industry for which a plan is being drafted.

Though it is believed that the corporation is the type of business unit best adapted to the idea of labor participation in the ownership and control of industry, as thus far developed, the idea can be applied to other types.⁷⁵ In any case a plan for labor participation must be fitted to the business unit and not *vice versa*.

⁷⁴ See the case of *Harvey v. Electric Refrigeration Corp.*, *supra* note 29. The California statute providing for employee stock purchase plans expressly makes issues of stock thereunder subject to the Blue Sky Law. California, Laws of 1921, chap. 34, §4.

⁷⁵ The application of the idea to other forms of business organization than the corporate is discussed by Calvert Magruder, *loc. cit. supra* note 37. And see earlier in the present paper at note No. 37.