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LEGISLATION

Control of Corporate Indemnification: A Proposed Statute

*James H. Cheek, III**

The recent unprecedented increase in the number of suits filed against corporate executives under the federal antitrust and securities laws has again focused attention on the risks of executive liability and the corresponding problem of attracting top men as corporate directors. Faced with this dilemma, corporations have drafted bylaws providing for the maximum indemnification allowed under applicable state law. The state legislatures, on the other hand, have attempted to prevent misuse of the power to indemnify, while at the same time trying to insure adequate protection for those who serve as directors. Mr. Cheek argues that the legislatures have failed in their attempt to provide both directors and the investing public with satisfactory protection. He examines the two most advanced provisions to date—the 1963 New York Statute and the 1967 Delaware Statute—and then presents an approach which he feels more adequately reconciles the conflicting interests of these two groups.

I. INTRODUCTION

The indemnification of corporate personnel is not a new problem, for its origin may be traced to the depression years following 1929 when for the first time many directors and officers were named defendants in derivative suits and faced the possibility of large financial losses. As the risks increased, so did the corporate fear not only of personal liability but also of an inability to recruit responsible persons to serve as directors. As a result, in the early 1940's, corporations began to respond with bylaws intended to provide protection by indemnity.[1]

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1. Between 1939 and 1942 there were reportedly 169 resolutions and amendments to bylaws and articles of incorporation to provide for indemnification of directors and officers. Most of these changes were justified to the stockholders as necessary to obviate the difficulty of finding responsible persons willing to act as directors. Bates & Zuckert, *Directors' Indemnity: Corporate Policy or Public Policy*, 20 HARV. BUS. REV. 244 (1942).

Despite a flurry of early comment on this initial movement,[2] concentrated study of the problem[3] and enlightened statutory provisions[4] are only of recent vintage. The apathy exhibited toward indemnity from the early 1940's to the early 1960's may well be explained by the fantastic business growth of that period which left little cause for complaint. Yet despite continued good business conditions, concern over indemnification has again become widespread. The fear of liability and of the inability to attract top men as directors is still present; however, the fear is no longer based upon suits arising from bad business conditions but is due to other

2. *See, e.g., id.*; Hornstein, *Directors' Expenses in Stockholders' Suits*, 43 COLUM. L. REV. 301 (1943); Jervis, *Corporate Agreements to Pay Directors' Expenses in Stockholders' Suits*, 40 COLUM. L. REV. 1192 (1940); Steadman & Garrett, *Indemnification of Directors*, 8 BUS. LAW. 2 (1953); Washington, *Litigation Expenses of Corporate Directors in Stockholders' Suits*, 40 COLUM. L. REV. 431 (1940).

3. *See* G. WASHINGTON & J. BISHOP, INDEMNIFYING THE CORPORATE EXECUTIVE (1963); Bishop, *Current Status of Corporate Director's Right to Indemnification*, 69 HARV. L. REV. 1057 (1956); Bishop, *Indemnification of Corporate Directors, Officers and Employees*, 20 BUS. LAW. 833 (1965); Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92 (1966); *Insurance Against Liabilities of Directors and Officers—A Forum*, 22 RECORD OF N.Y.C.B.A. 342, 353-56 (1967).

4. As of 1953, there were only sixteen states in which there was statutory authority relating to the indemnification of directors. For a listing of those states, see Steadman & Garrett, *supra* note 2, at 2. Today 43 states have statutes with indemnification provisions and 20 of those states have reformed their legislation since 1960. *See* ALASKA STAT. § 10.05.009(15) (1968); ARIZ. REV. STAT. ANN. § 10-198 (Supp. 1968); ARK. STAT. ANN. § 64-309 (1966); CAL. CORP. CODE § 830 (Supp. 1968-69); COLO. REV. STAT. ANN. § 31-2-1(15) (Supp. 1964); CONN. GEN. STAT. ANN. § 33-320 (Supp. 1966); DEL. CODE ANN. tit. 8, § 145 (Supp. 1967); FLA. STAT. ANN. §§ 608.13(14), (15) (Supp. 1968); GA. CODE ANN. § 22-717 (Supp. 1968) (effective April 1, 1969); HAWAII REV. LAWS tit. 23, § 172-23(p) (Supp. 1965); IND. ANN. STAT. § 25-202(9) (Supp. 1968); IOWA CODE ANN. § 496A.4(15) (1962); KAN. GEN. STAT. ANN. § 17-3010 (Supp. 1968); KY. REV. STAT. §§ 271.125(11), 271.375 (1962); ME. REV. STAT. ANN. tit. 13, § 146 (Supp. 1968); MD. ANN. CODE art. 23, § 64 (Supp. 1968); MASS. GEN. LAWS ANN. ch. 156B, § 67 (Supp. 1968); MICH. COMP. LAWS § 21.10(1) (Supp. 1963); MINN. STAT. ANN. § 301.09(7) (Supp. 1968); MISS. CODE ANN. § 5309-04(o) (Supp. 1967); MO. ANN. STAT. §§ 351.355, 351.385(10) (1966); MONT. REV. CODES ANN. § 15-2204(o) (1967); NEB. REV. STAT. § 21-2004(15) (Supp. 1968); NEV. REV. STAT. § 78.070(6) (1967); N.J. STAT. ANN. § 14A: 3-5 (Supp. 1969); N.M. STAT. ANN. § 51-24-4(o) (Supp. 1967); N.Y. BUS. CORP. LAW §§ 721-26 (1963); N.C. GEN. STAT. §§ 55-19 to -21 (1965); N.D. CENT. CODE § 10-19-04(15) (1960); OHIO REV. CODE ANN. § 1701.13(E) (Baldwin Supp. 1967); ORE. REV. STAT. § 57.030(15) (1963); PA. STAT. ANN. tit. 15, § 410 (Supp. 1968); R.I. GEN. LAWS ANN. § 7-9-12 (1956); S.C. CODE ANN. §§ 12-12.2(18), 12-18.18 (Supp. 1968); S.D. SESS. LAWS ch. 22, § 4(15) (1965); TENN. CODE ANN. §§ 48-407 to -411 (Supp. 1968) (effective July 1, 1969); TEX. BUS. CORP. ACT art. 2.02(A)(16) (1956); UTAH CODE ANN. § 16-10-4(o) (Supp. 1967); VA. CODE ANN. § 13.1-3.1 (Supp. 1968); WASH REV. CODE ANN. § 23A.08-.020(15) (Supp. 1968); WIS. STAT. ANN. § 180.04(14) (Supp. 1968); W. VA. CODE ANN. § 31-1-18a (Supp. 1966); WYO. STAT. ANN. § 17.36.4(o) (Supp. 1965). Additionally the District of Columbia and Puerto Rico have indemnity provisions. *See* D.C. CODE ANN. § 29-904 (p) (Supp. 1968); P.R. LAWS ANN. tit. 14, § 1202(10) (Supp. 1962).

more compelling factors, such as the increased hazards of liability under the federal antitrust and securities laws. The recent liability imposed on the executives of General Electric and Westinghouse as a result of an antitrust violation acutely demonstrates the vulnerable position of an executive under the antitrust laws.[5] Similarly, a major source of executive peril has been the recent SEC victories in the *Texas Gulf Sulphur* and *BarChris* cases[6] and the *Merrill Lynch* proceedings.[7] This concern with potential antitrust and securities liability may be characterized as only one aspect of broader anxiety over the increasingly strict judicial interpretation of the standards of executive liability.[8] This worry is multiplied when one considers the unprecedented increase in the number of suits filed against executives.[9]

Faced with these growing risks of executive liability, more and more corporations have drafted bylaws providing for indemnification to the greatest extent allowable under the applicable state law. This desire to isolate corporate management from personal liability, however, raises serious public policy issues. Complete protection against any liability is against the basic tenet of our judicial system—that no man may place himself beyond the law. Thus, legislatures have attempted to provide safeguards against the potential misuse of the power to indemnify within a framework which will also insure adequate protection for those who serve as directors. Most statutes fail to erect a structure in which both the directors and the investing public are satisfactorily protected, and only recently have

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5. *See, e.g.*, Green, *Executives in Court*, Wall Street Journal, June 29, 1966, at 1, col. 6. For a description of the trial in which the GE-Westinghouse executives were fined from $1000 to $12,500, see N.Y. Times, Feb. 7, 1961, at 1, col. 4, *cited in* G. WASHINGTON & J. BISHOP, *supra* note 3, at 1 & n.1.

6. SEC. v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968); Escott v. BarChris Constr. Co., 283 F. Supp. 643 (S.D.N.Y. 1968).

7. In the Matter of Merrill, Lynch, Pierce, Fenner & Smith, Inc., CCH FED. SEC. L. REP. ¶ 77, 629 (1968). *See* Carley, *Insuring Executives*, Wall Street Journal, Aug. 29, 1968, at 1, col. 1.

8. The increased potentiality of liability due to the strictness of judicial interpretation is evidenced by the changing standards of conduct in 16(b) and 10b-5 actions under the Securities Exchange Act of 1934 and in proxy contests. Additionally, more and more "outside" directors are being held liable for failure to supervise the activities of others, even though they obviously do not have the time to keep in close contact as "inside" directors do. *See* note 86 *infra* and accompanying text.

9. This increase has been explained as a consequence of two closely related factors the increase in the number and knowledge of stockholders and the contingent fee system. Green, *supra* note 5, at 8, col. 2. Other reasons suggested for the increase in suits include the fact that more information upon which one may base a suit is available due to the disclosure requirements of the SEC and that statutory standards are becoming stricter. *See* Mace, *Directors and Officers Liability Insurance*, 85 BANKING L.J. 39 (1968).

legislatures become attuned to the need for new legislation, particularly with respect to indemnity in connection with settlements and with suits decided otherwise than on the merits. This awareness has produced a greatly improved law of indemnification, although no fully satisfactory solution has been formulated to date.

The ultimate aim of this article is to draft a statute which can cope with the conflicting policies. Initially, however, one must focus upon the historical development of the problem from early common law to the most recent statutory provisions, for it is essential to meaningful evaluation of the proposed statute that one understand the history of the problem. Although the analysis of most statutes is limited to the critical question of what limits are imposed upon the power of the corporation to indemnify its personnel, a detailed comparative analysis is presented in discussing the two most thoughtful provisions enacted to date—the 1963 New York Statute[10] and the 1967 Delaware Statute.[11] In addition, consideration will be given to nonstatutory means of resolving the indemnification problem, such as the use of corporate-paid indemnity insurance.

II. THE COMMON LAW

A. *Pre-Statutory Common Law*

An examination of the case law which preceded the first statutory reaction to the problem will be helpful for several reasons. First, such authority explains in large part why statutes developed as they did. Second, such authority is still viable and persuasive in jurisdictions with no statutory provision and even in jurisdictions with an indemnification provision where the provision is "non-exclusive" and thus permits extra-statutory indemnification. Furthermore, by studying the policy limits placed on indemnity at common law, one may more accurately forecast the limits which a court today would impose upon the power of statutory indemnification.

Where a director or officer had been unsuccessful in defending an action in the right of the corporation[12] and had been adjudged guilty of negligence or misconduct in the performance of his duties, courts held with uniformity that there could be no reimbursement. These courts reasoned that there was no justification for the corporation

10. N.Y. BUS. CORP. LAW §§ 721-26 (1963).

11. DEL. CODE ANN. tit. 8, § 145 (Supp. 1967).

12. Apparently no problem arose with indemnification in suits not in the right of the corporation, for each case examined involved a derivative suit.

paying the expenses of a guilty director who was not acting for the benefit of the corporation.[13] But where a director or officer had successfully defended against the suit, confusion reigned. One court simply held that where no guilt was found, it was not "improper or unjust" that the corporation should reimburse the successful person.[14] Other judges, however, looked for concrete benefit to the corporation and placed the burden upon the director or officer to show that some benefit occurred[15] or that some interest of the corporation had been threatened.[16] Finally, some courts have refused to reimburse the successful director or officer on the theory that the director or officer as a corporate agent was acting illegally or outside the scope of his authority.[17]

The confusion reached its peak with the case of *New York Dock Company v. McCollum*,[18] which denied indemnification to several directors who had been vindicated in a derivative suit.[19] The court reasoned that there could be no recovery where there was no benefit to the corporation, and as a result, innocent directors were forced to pay over $86,000 in attorneys' fees. Even more shocking to the corporate world must have been the apparent opinion of the referee that situations in which the corporation would reap a benefit would rarely occur, since it would be almost impossible for a company to benefit from defeating a suit brought in its own right.[20]

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13. *See, e.g.*, Wickersham v. Crittenden, 106 Cal. 329, 39 P. 603 (1895) (no corporate benefit where for individual use only); Hollander v. Breeze Corp., 131 N.J. Eq. 585, 26 A.2d 507 (Ch. 1941) (no benefit in personal defense); Apfel v. Auditore, 223 App. Div. 457, 228 N.Y.S. 489 (1928) (corporation not a party in interest). For other cases, see Washington, *supra* note 2, at 433 n.7.

14. Figge v. Bergenthal, 130 Wis. 594, 109 N.W. 581 (1906) (allowed the use of corporate funds to pay the attorneys' fees of a director innocent of fraud).

15. *See, e.g.*, Griesse v. Lang, 37 Ohio App. 553, 175 N.E. 222 (1931); Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922). This analysis is not very helpful since rarely would the defense provide the corporation with an affirmative benefit. Bishop, *supra* note 3, at 1061. *But see* note 20 *infra* and accompanying text.

16. Esposito v. Riverside Sand & Gravel Co., 287 Mass. 185, 191 N.E. 363 (1934); Godley v. Crandell & Godley Co., 181 App. Div. 75, 168 N.Y.S. 251 (1917).

17. DuPuy v. Crucible Steel Co., 288 F. 583 (W.D. Pa. 1923) (no recovery despite the good faith and innocence of corporate agent where criminal charge not denied in statement of claim). *Cf.* Adams v. North Range Iron Co., 191 Minn. 55, 253 N.W. 3 (1934); Hoch v. Duluth Brewing & Malting Co., 173 Minn. 374, 217 N.W. 503 (1928). Note that the converse of the *DuPuy* agency principle should also be true; that is, if an agent is called upon by the principal to do an act not manifestly illegal and he has no knowledge of its wrong, the principal should indemnify the agent. *But see* DuPuy v. Crucible Steel Co., 288 F. at 585.

18. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

19. The suit never reached trial at all since one of the charges in the complaint was dismissed initially and the other dismissed for failure of proof. *Id.* at 107, 16 N.Y.S.2d at 846.

20. *Id.* at 111, 16 N.Y.S.2d at 849. However, there is a subtle benefit which exists, since

As a result of this indication, demands rose for legislation to remedy the result and soon thereafter the first statutory provisions on indemnification were enacted.

B. *Post-Statutory Common Law*

Since the *McCollum* case and the resulting statutory reaction, the trend in those jurisdictions still relying upon the common law[21] has been away from the *McCollum* benefit rule and in favor of reimbursing the innocent director.[22] In fact, one could conclude from studying the law in these jurisdictions that even if no statutes had been enacted to remedy the injustice and confusion of the *McCollum* decision, the law would have developed in a similar manner. For example, two years after *McCollum*, a New Jersey court in *Solimine v. Hollender*,[23] despite finding that a corporate benefit did exist,[24] held that such a benefit was not essential where directors had prevailed in a stockholder's suit and allowed recovery of litigation expenses on the basis of the sound policy of "inducing responsible businessmen to accept the post of director."[25] However, the court did emphasize that there could be no reimbursement prior to the director's vindication, thus making ultimate acquittal the test with the corporation maintaining a completely neutral role until that time.[26] Similarly

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indemnification benefits the corporation by inducing the best men to serve as directors and officers. *See* Bishop, *supra* note 3, 20 BUS. LAW. at 839.

21. There are seven states which have no statutory provisions for indemnification. These states are Alabama, Idaho, Illinois, Louisiana, New Hampshire, Oklahoma and Vermont.

22. The changing attitude of the courts was recognized by the court in Mooney v. Willys-Overland Motors, 204 F.2d 888 (3d Cir. 1953), which commented: "We note merely that although the earlier cases dealing with the subject are divided, a more favorable attitude among judges and other writers has been developing in recent years." It is perhaps no accident that this favorable attitude has coincided with the increasingly strict interpretation of executive liability standards. See note 8 *supra* and accompanying text.

23. 129 N.J. Eq. 264, 19 A.2d 344 (1941). Since this case, New Jersey has enacted an indemnification statute, but the case is frequently cited by common law jurisdictions to support the granting of indemnification. *See, e.g., In re* E. C. Warner Co., 232 Minn. 207, 45 N.W.2d 388 (1950).

24. The benefit was based upon the fact that "in defending themselves they demonstrated to the investing public the honesty of the corporate management and thus they did not alone serve their own interests but also a duty which they owed to the beneficiaries of the trust—the stockholders." Solimine v. Hollender, 129 N.J. Eq. 264, 271, 19 A.2d 344, 347 (1941).

25. Other policy grounds mentioned by the court included the fact that indemnification enabled a director of limited means to engage counsel and that indemnification was likely to discourage stockholder litigation of the strike variety. *Id.* at 272, 19 A.2d at 348.

26. *Id.* at 266, 19 A.2d at 345. As support for this proposition, the court quotes: "There is a vast difference between letting the director fight the battle at his own expense with reimbursement if he is vindicated—and using the power of the corporation to aid in the fight

about ten years later, another court echoed the *Solimine* theory that the ultimate result of the litigation was controlling and that where the director was successful on the merits, reimbursement was clearly necessary due to the "sound public policy favorable to the development of sound corporate management as a prerequisite for responsible corporate action."[27] Continued development of a law favorable to the director is evident in a recent case which indicated that the corporation no longer must maintain its neutral position and can make advances where "the interests of the corporation, considered apart from the respective interests of the individual defendants therein, were so injuriously threatened or involved as to justify it in retaining and paying counsel to protect its interests."[28] Thus, although there is no meaningful case development in jurisdictions relying upon common law indemnification, it is submitted that the results in those jurisdictions would be strikingly parallel to those in jurisdictions with a statutory provision. Certainly the *McCollum* benefit theory has been abandoned, and decisions appear to rest upon the same public policy considerations evident in many statutory provisions.

III. Statutory Reaction

The *McCollum* decision led directly to the passage of statutes in many states. These early statutes may be divided into two basic groups, though within each group there may appear slight variations in approach.[29] The first group includes those statutes which grant the

before it is shown whether or not he is a faithful servant who deserves indemnity. . . . The rule under discussion is designed to produce fair play—to prevent the plaintiff from being overwhelmed by the company's financial power before the real defendants have shown their guilt or innocence." Washington, *supra* note 2, at 438. *But see* International Bhd. of Teamsters v. Hoffa, 242 F. Supp. 246, 253 (D.D.C. 1965), which suggests that it is equally as clear that if the corporation's own interests lie on either side, it must aggressively defend such interests.

27. *In re* E. C. Warner, 232 Minn. 207, 214-15, 45 N.W.2d 388, 393 (1950).

28. International Bhd. of Teamsters v. Hoffa, 242 F. Supp. 246, 253 n.46 (D.D.C. 1965), *citing* Kirby v. Schenck, 25 N.Y.S.2d 431, 433 (Sup. Ct. 1941).

29. Other authors have asserted that only two types exist: "Those which have the power to indemnify personnel for litigation expenses in certain situations and those which give a statutory right to indemnification in certain situations." Comment, *Corporations Indemnification of Management for Litigation Expenses*, 52 MICH. L. REV. 1023, 1030-31 (1954); Bishop, *supra* note 3, at 1069. Additionally these authors make the confusing suggestion that some states such as New York have both types of statutes. It is submitted that a more useful analysis would divide the approaches on the basis of the absence or presence of non-exclusive language. Furthermore, those statutes such as New York's may be better understood as a unique hybrid of the exclusive and non-exclusive dichotomy and should be examined apart from those statutes which are wholly exclusive or non-exclusive.

corporation the power to indemnify certain personnel against expenses incurred in suits[30] except where such persons are adjudged "liable for negligence or misconduct in the performance of duty."[31] All these statutes include, however, non-exclusive language indicating that notwithstanding such limitations, the corporation may by appropriate action indemnify its personnel to any extent it wishes. The second group, with far fewer statutes, includes those which either lack non-exclusive language or which are expressly made exclusive, thus limiting indemnification to the situations described in the statute.[32] The most important distinction between the two groups is the existence or omission of this non-exclusive language, for if a statute includes such language, the restrictions in the statute apparently may be exceeded by appropriate corporate or stockholder action.

Clearly one must study the good and bad points of these older statutes and their variants before considering in detail the two most recently developed approaches. However, a detailed discussion of the older statutes' mechanics would be repetitively burdensome for the reader,[33] since many of the mechanics are included in the two recent statutes which are analyzed in detail in Part V. Thus, the following discussion is limited to the most troublesome area within the older statutes—the non-exclusive language and the maximum extent to which a company may indemnify its personnel under such language.

A. The 1953 Delaware Statute

The starting point for any discussion of statutory indemnification must be the 1953 Delaware statute, since its language has been adopted by the majority of all states having such provisions.[34] This

30. A major flaw in these statutes is that there is no distinction between derivative actions and actions not in the right of the corporation. *See* notes 97 & 98 *infra* and accompanying text.

31. These statutes were patterned after the 1953 Delaware statute and the 1960 Model Business Corporation Act which was copied substantially from the Delaware act. *See* DEL. CODE. ANN. tit. 8, § 122(10) (1953); 1 MODEL BUS. CORP. ACT ANN. § 4(o) (1960). For a complete list of statutes following the Delaware language, see note 34 *infra*.

32. Initially the 1947 California statute was the model used by states following this exclusive type statute which provided for narrow indemnification under court control. Very few states have adopted this approach. *See* note 58 *infra*. A few other states have borrowed from this approach but eliminated the court control by merely stating the grounds under which the corporation had the power to indemnify. *See* note 59 *infra*.

33. For an excellent summary of the varying characteristics of these early statutes, see 1 MODEL BUS. CORP. ACT ANN. § 4(o), ¶ 2.03, at 147-51 (1960).

34. Today 23 states out of 43 states having indemnification provisions are patterned for the most part after the 1953 Delaware statute and the 1960 Model Business Corporation Act. These states are Alaska, Colorado, Hawaii, Indiana, Iowa, Maine, Maryland, Massachusetts,

statute provided that every Delaware corporation shall have the power to:

> Indemnify any and all of its directors or officers . . . against expenses actually and necessarily incurred by them in connection with the defense of any action, suit or proceeding . . . except in relation to matters as to which any such director or officer . . . shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duty. Such indemnification shall not be deemed exclusive of any other rights to which those indemnified may be entitled, under any by-law, agreement, vote of stockholders or otherwise.[35]

The intention of the legislature was plainly to provide the corporation with the power to indemnify its directors or officers without the necessity of a by-law in every instance except where the insider had been "adjudged . . . liable for negligence or misconduct in the performance of duty." However, if the last sentence (the "non-exclusive" clause) is to be given any effect, it would seem that the legislature must also have intended to allow the corporation to provide for even broader indemnification. Yet despite this apparently clear authorization, it would be unrealistic to think any court would permit the corporation to roam unchecked in the indemnification field.[36]

Unfortunately there are few cases under this statute or a statute of a similar type which have involved an attempt to indemnify corporate insiders. *Mooney v. Willis-Overland Motors, Inc.*,[37] the first case to involve the statute, indicates that certain policy restrictions limit the extent to which a corporation may indemnify under a bylaw its directors or officers. This case involved an action to recover under

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Minnesota, Mississippi, Nebraska, Nevada, New Mexico, North Dakota, Oregon, Rhode Island, South Dakota, Texas, Utah, Washington, West Virginia, Wisconsin, and Wyoming. For citations of these statutes, see note 4 *supra*. With the exception of Iowa, Maryland, and Massachusetts, whose statutes depart from the literal language of the 1953 Delaware statute while achieving the same result, all the above states have adopted the Delaware language without any major change. For a discussion of a recently recommended change in the Maryland statute to provide for advance indemnity, see Sebring, *Recent Legislative Changes in the Law of Indemnification of Directors, Officers, and Others*, 23 BUS. LAW. 95, 107 (1967).

35. DEL. CODE ANN. tit 8, § 122(10) (1953).

36. *See generally* G. WASHINGTON & J. BISHOP, *supra* note 3. This book alone has probably shaped the thought in the indemnification area more than any other factor, and its main message is perhaps that the non-exclusive language cannot be taken literally and excessive abuse of it will be checked by public policy. In commenting upon this Delaware section, the authors stated: "[I]t is intrinsically unlikely that many courts will be predisposed to construe such a statute in a manner which would drastically alter the common law's equitable limitations upon the indemnification of insiders whose innocence is dubious, or not even dubious." *Id.* at 118.

37. 204 F.2d 888 (3d Cir. 1953).

a contract which provided that if the plaintiff terminated his employment as president of the corporation, the corporation would indemnify the plaintiff according to its bylaw for expenses in suits currently pending. The bylaw[38] was broader than the statute in that it permitted indemnification for the cost of unsuccessful defenses and reasonable settlements and excluded expenses only where the insider was adjudged by a court or independent counsel to be "derelict in the performance of his duty."[39]

In holding that the contract and bylaw were valid and in granting the plaintiff indemnification, the court commented:

> We think that Delaware Corporation Law § 2(10) and Willis' By-Law XXIII have met the requirements of public policy by the realistic limits they set upon the right of indemnification. We do not think that public policy requires that the Delaware statute be construed as controlling every conceivable situation which in one aspect may be called indemnification for litigation expenses, any more than the policy of ultra vires should be applied to invalidate those other payments under the contract which, except for the contract, would be gifts. Where there exists, as there does here, an independent ground for the payment of litigation expenses, we see no reason to make an overriding reference to the statute. . . . We see no danger here of encouraging non-meritorious claims for indemnification outside the by-law and the statute. An independent legal ground for such claims must be shown in every case.[40]

From this language it would seem that the corporation in forming its indemnity bylaw must meet the needs of public policy by setting "realistic limits" on the rights to indemnification.[41] The only hint presented to define those limits, however, is the broad reference to "non-meritorious" claims, indicating that a bylaw which encouraged such claims would exceed the permissible limits.

The few other cases which have involved the statutes provide little

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38. For the text of this bylaw, see 204 F.2d at 891 n.5.

39. "Derelict" for the purpose of this bylaw may be defined by the concluding proviso to mean "wilful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office." *See* G. WASHINGTON & J. BISHOP, *supra* note 3, at 118-19. If construed in this manner, it is obvious that the bylaw is broader. However, it is submitted that the two provisions could be read independently with the "derelict" standard being a somewhat lesser standard than the one in the concluding proviso, in which case the bylaw may not be as broad as suggested.

40. 204 F.2d at 896.

41. Professors Washington and Bishop have commented: "The reference to meeting the requirements of public policy by setting 'realistic limits' on the right to indemnification probably means that the court would have voided, as against public policy, an agreement to reimburse a director who had been adjudged liable to the corporation for negligence or misconduct. . . . [I]t would be unsafe to rely upon the opinion as authority for the proposition that indemnification may properly be granted in all situations which might seem to be covered by the Willys bylaw." G. WASHINGTON & J. BISHOP, *supra* note 3, at 120-21.

or no guidelines to aid in ascertaining the limits of Delaware's public policy with regard to indemnification. In *Essential Enterprises Corporation v. Automatic Steel Products, Inc.*,[42] directors who successfully contested the majority shareholders' attempt to oust them recovered indemnification from the corporation. This bylaw was identical to the Delaware statute except that it made indemnification mandatory. The Chancellor in relying upon the *Mooney* decision stated:

> I believe my construction of the statute and implementing by-law tends to promote the desirable end that corporate officials will resist what they consider to be illegal removal action, secure in the knowledge that their reasonable expenses will be borne by the corporation they have served *if they are vindicated.*[43]

Thus, despite no language in the bylaw limiting indemnification to vindicated directors, the court indicated that such a limitation would most likely be placed upon such a bylaw. Clearly, however, directors and officers may be indemnified in situations where they are not vindicated. For example, where no negligence to the corporation is involved, but only questionable misconduct to a third party, a strong case for indemnification may exist.

In *Essential Enterprises v. Dorsey Corporation*,[44] the court avoided the opportunity to decide whether the statute without a bylaw would have permitted indemnification of those directors or officers who had settled out of court. The court held the bylaw controlling, and it specifically excluded indemnification not only where the director was "finally adjudged" liable for dereliction of duty, but also where there was a "compromise of any such liability."[45] The court, avoiding the choice between a construction which did violence to the legislature's explicit wording and one which would permit the indemnification of probably guilty insiders, commented that "[a] corporation is free to invoke less than all the indemnification power granted it under this particular statute, thus the by-law governs here."[46] From this decision it is clear that the corporation can limit the right of indemnification granted by the statute to any extent, but it remains uncertain how far a corporation may go the other way in indemnifying its directors and officers.

One recent decision involving a Delaware corporation vividly

42. 164 A.2d 437 (Del. Ch. 1960).
43. *Id.* at 441-42 (emphasis added).
44. 182 A.2d 647 (Del. Ch. 1962).
45. *Id.* at 652.
46. *Id.* at 653.

demonstrates the probable reaction of courts to a bylaw which indemnified directors or officers in all circumstances. In *Teren v. Howard*,[47] shareholders were successful in a derivative action against several officers and directors for ordinary negligence and misconduct. When the action was started, the board of directors immediately passed a resolution indemnifying all directors and officers for everything. The court, however, refused to permit any indemnification, holding the offense to be within the "negligence or misconduct" provision which prohibited indemnification. The court made no mention of the "non-exclusive" clause and of the attempted resolution. Professor Bishop made the following comment on the absence of any language in the court's opinion dealing with the "non-exclusive" clause:

> It dealt with the non-exelusive clause of the Delaware statute, which on its face would seem to say that this resolution entitled them to indemnification, in an extremely simple way. It ignored it. My guess is that that is about what any court would do in such a situation. So I would not place great reliance on the seeming unlimited permissiveness of the statutes of the Delaware variety.[48]

One other interpretation of the "non-exclusive" clause is possible. The clause could be construed as being subject to the "negligence or misconduct" provision; in other words, the corporation could enact any bylaw except one which indemnified its directors or officers for negligence or misconduct. However, no case has construed the "non-exclusive" clause as being subject to the "negligence or misconduct" provision.

Decisions in other jurisdictions having similar statutes are scarce and of little aid in defining the bounds of public policy.[49] Nevertheless, it is clear that there are judicial limits on indemnity, no matter how liberal legislatures have been. One example of perhaps typical judicial reluctance to permit indemnification apparently authorized by statute may be seen in the recent case of *SEC v. Continental Growth Fund*.[50] There a director of a mutual trust fund registered under the Investment Company Act of 1940 and incorporated in Maryland

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47. 322 F.2d 949 (9th Cir. 1963).

48. Bishop, *supra* note 3, 20 BUS. LAW. at 842.

49. For an excellent and detailed analysis of what these bounds of public policy might be, see G. WASHINGTON & J. BISHOP, *supra* note 3, at 201-03. The outline they present is designed to present the outside limits on indemnity, yet even they admit that "conceivably, indemnification might go a little farther without shocking the court's conscience too severely." *Id.* at 203.

50. CCH FED. SEC. L. REP. ¶ 91,437 (S.D.N.Y. 1964). *See* Bishop, *Insurance Against Liabilities of Directors and Officers*, 22 RECORD OF N.Y.C.B.A. 342, 355 (1967).

sought reimbursement for expenses in an action in which he had been adjudged guilty of ordinary negligence in permitting the company to be looted by another director. The Maryland indemnification provision was cast in the same non-exclusive language as the Delaware statute,[51] and the company had a charter provision pursuant thereto entitling a director to indemnification except where "adjudged liable because of wilful misfeasance, bad faith, *gross negligence* or reckless disregard of duties involved in the conduct of his office."[52] Additionally, this charter provision specifically complied with the limits of permissible indemnification set out in section 17(h) of the Investment Company Act of 1940.[53] Nevertheless, the court denied reimbursement on the ground the the director's right to indemnification depended not on being adjudged "grossly negligent" as provided in the charter and in the Investment Act, but rather on his being adjudged guilty of "negligence or misconduct" as provided in the Maryland statute. To achieve this result, the court refused to include the charter provision within the non-exclusive language of the Maryland statute. The court reasoned that a *charter* provision was not specifically mentioned and could not be placed within the "or otherwise" part of the clause, since "[s]uch a catch-all shelter is hardly an adequate haven for the lax standards of indemnification voted by the directors in their own benefit."[54]

The *Continental Growth* case vividly demonstrates the extent to which a court will go to deprive what it considers to be an unworthy director of indemnification clearly authorized by a statutory provision. The decision surely must be as disturbing as *McCollum* for it reeks with uncertainty and the injustice of judicial abrogation of legislative intention.

From the preceding examination of case authority, it is evident that though enacted in a majority of states, the 1953 Delaware statute does not provide a satisfactory solution to the problems of the common law and in fact has created a greater sense of uncertainty, since courts brazenly disregard statutory language to deny indemnification in cases which under some common law authority would have been close.[55] One additional factor contributing to the

51. MD. ANN. CODE art. 23, § 64 (Supp. 1968).

52. CCH FED. SEC. L. REP. ¶ 91, 437, at 94, 722.

53. Investment Company Act of 1940, 54 Stat. 789 (1940), 15 U.S.C. § 80a-17(h) (1964).

54. CCH FED. SEC. L. REP. ¶ 91,437, at 94,723.

55. For example, if the *Continental Growth* situation had resulted from pure corporate indemnity outside of any by law or statute, it is doubtful that reimbursement would have been denied under the rationales of *Solimine* and the *Teamsters* cases. See notes 23 & 28 *supra*.

uncertain status of the law under such statutes is the scarcity of judicial authority. It is clear that several companies have adopted very permissive bylaws pursuant to the non-exclusive language, yet there have been no judicial decisions involving these bylaws.[56] Apparently if indemnity has been made under these bylaws, it most likely has not been made known to the stockholders where a challenge appeared likely or has been made with the full knowledge and approval of all the stockholders.

B. *Other Statutory Reaction*

In contrast to the pattern established by the 1953 Delaware statute and its imitators, the other group of statutes is marked by the absence of non-exclusive language, though within this group there are several different approaches.[57] Additionally, these statutes are more complex, representing a more realistic effort to meet the myriad of considerations in indemnification.

One approach within this group is patterned after the 1947 California statute.[58] These statutes are phrased in exclusive language and grant corporate personnel the right to indemnification, but only if the defendant is successful or has settled with court approval *and* only if the court finds that his action "fairly and equitably" merits indemnification.[59] By placing indemnification under court control, this type of statute attempts to avoid the uncertainty which exists with the

56. For example, National Steel Corporation, General American Investors Company, and Northern States Power Company have adopted permissive bylaws. G. WASHINGTON & J. BISHOP, *supra* note 3, at 181.

57. *See* note 29 *supra*.

58. CAL. CORP. CODE § 830 (Supp. 1968-69). Subsection (f) was added to section 830 in 1957 to provide separate standards for suits not in the right of the corporation.

59. ARK. STAT. ANN. § 64-309 (1966); CAL. CORP. CODE § 830 (Supp. 1968-69); N.C. GEN. STAT. §§ 55-19 to -21 (1965); S.C. CODE ANN. §§ 12-12.2(18), 12-18.18 (Supp. 1968). Specifically the language states that expenses can be assessed against the corporation by the court if *both*: "(1) The person sued is successful in whole or in part, or the proceeding against him is settled with the approval of the court. (2) The court finds that his conduct fairly and equitably merits the indemnity." North Carolina and California to permit indemnification outside of court approval but only in the case of suits not in the right of the corporation and the above standards apply to derivative suits. California also added in 1968 subsection (h) to § 830 to permit corporate-paid indemnity insurance against liability arising from either type of suit. This significant amendment eases the strict recovery burdens that exist under this statute for the director or officer. *See* CAL. CORP. CODE § 830(f) (Supp. 1968-69); N.C. GEN. STAT. § 55-20(3) (1965). South Carolina has broadened the standards in the derivative suit by phrasing the requirements in the alternative, thus effectively eliminating the first requirement. *See* S.C. CODE ANN. § 12.18.18 (Supp. 1968). *Cf.* CONN. GEN. STAT. ANN. § 33-320 (Supp. 1966), which is not specifically exclusive but which contains no non-exclusive language and follows the South Carolina pattern of phrasing the above requirements in the alternative.

non-exclusive language of the Delaware type statute. However, the same public policy problem remains in the requirement that the court find that the defendant's conduct "fairly and equitably" merits reimbursement. In a sense, this approach codifies what actually happened under the 1953 Delaware statute; that is, in both cases the court will assess the whole situation and grant indemnification only if it feels the case falls within the limits of public policy. Yet clearly it is a more thoughtful statute and makes two significant advances. First, it removes the potential abuse which existed where executives could determine their own limits and places the determination in a far better agency, the courts.[60] Second, it indicates that two situations may exist with respect to indemnification—the successful defense and the settlement—though it stops short of making the needed distinctions between the two. Thus, though not without faults, this approach does make meaningful steps toward a better solution.

Another statutory approach achieves exclusiveness not by express language but by omission of any non-exclusive language and the resulting presumption that the statute is conclusive. There are two variations of this approach. Some states remove the indemnification problem from corporate consideration by statutorily conveying a right of indemnification to corporate personnel not adjudged liable for negligence or misconduct in the performance of their duties. At the same time, these provisions grant the corporation great power by permitting reimbursement of compromise settlements if a neutral board of directors approves the settlement, having determined no negligence or misconduct.[61] Other states leave the power of indemnification with the corporation, but impress it with limitations

60. It may be urged that it is unwise to transfer the power of indemnification from the corporation to the legislature and the judiciary, since the non-exclusive language provides a flexibility needed to meet the particular needs of a particular corporation. However, it is submitted that indemnification is better suited for legislative and judicial control, since the non-exclusive language paves the way for nefarious indemnity which would clearly violate public policy if it were ever challenged. With definite standards, the limits of indemnification are better defined while court control provides it with flexibility to meet the hard cases. For a discussion of other advantages of exclusive language, see note 96 *infra* and accompanying text. Note that the 1968 California amendment regarding indemnity insurance may well provide a means of avoiding the legislative and judicial control contained in the previous act.

61. KY. REV. STAT. § 271.375 (1962); MONT. REV. CODES ANN. § 15-2204(o) (1967). *Cf.* MO. ANN. STAT. §§ 351.385(10), 351.355 (1966). Neither the Kentucky statute nor the Montana statute contains exclusive or non-exclusive language; therefore, each statute presumptively pre-empts the area.. While granting the director or officer the right to indemnification, the Missouri statute differs from the Kentucky-Montana pattern in that it is phrased in nonexclusive language and requires court approval for indemnity in the settlement situation.

substantially more severe and definite than those in the Delaware statute.[62] Although both types attempt to provide a thorough answer to the complexities of indemnification, much of their effort seems misguided. The first group of statutes unthinkingly opens the door to the most flagrant possibilities of abuse by permitting fellow directors to approve a compromise outside of judicial control, and this will undoubtedly precipitate the uncertainty which accompanies a court striking down an abuse as against public policy. The second type, though more precise, still does not treat the many complexities thoughtfully.[63]

One outstanding example of misguided legislation is the 1966 Arizona statute.[64] This provision, going the other direction from the 1953 Delaware statute by broadening the standards, permits the corporation to indemnify directors and officers to any extent if authorization exists in the articles or bylaws and if the board of directors determines in "good faith" that the defendant did not act with "*gross* negligence" or with "fraudulent or criminal intent."[65] In its attempt to favor management, the legislature has created a horror of potential misuse and perhaps as a result has necessitated a narrow construction by the judiciary to fit the statute within the bounds of public policy. Surely such legislation should be avoided and more thoughtful solutions found to balance the policy of favoring indemnification with that of protecting the corporate treasury from unjustified plunder.

The most thorough and complex statutes, each presenting an approach of its own, were adopted by New York in 1963[66] and by

62. FLA. STAT. ANN. § 608.13(14) (Supp. 1968); MICH. STAT. ANN. § 21.10(*l*) (1963). *Cf.* OHIO REV. CODE ANN. § 1701.13(E) (Baldwin Supp. 1967). Florida adopted the 1953 Delaware statute but deleted the non-exclusive language. Presumably it is exclusive and allows indemnity in each case except where adjudged guilty of negligence or misconduct. The Michigan statute contains the same language as the Florida statute except that to restrict indemnity in the settlement situation it includes in the excepted language matters settled by agreement predicated upon the existence of liability. Ohio's statute provides even stricter limitations upon the power of the corporation to reimburse its directors or officers but is phrased in nonexclusive language even though it departs substantially from the Delaware pattern.

63. Obvious faults lie in the Florida and Michigan statutes; for example, neither adequately provides for the compromise situation or for advance payments. Each of these early statutes suffers from a common error of treating the complicated subject of indemnification in too simple a statute.

64. ARIZ. REV. STAT. ANN. § 10-198 (Supp. 1968).

65. *Id.*

66. N.Y. BUS. CORP. LAW §§ 721-26. Tennessee has recently adopted legislation substantially based upon the New York indemnification provisions and is the only other state to adopt the New York approach. TENN. CODE ANN. §§ 48-407 to -411 (Supp. 1968). Other states

Delaware in 1967.[67] These statutes, being the best and most comprehensive solutions to date, will be analyzed in greater detail later in Part V, in an effort to extract the best characteristics of both for inclusion in a proposed model statute.

IV. NON-STATUTORY REACTION

A. *Liability Insurance*

Due to the uncertainty of both legislative and judicial reaction to the limits of proper indemnification, many corporations have concluded that a better means of protecting their directors and officers lies with liability insurance.[68] The typical insurance purchased is in reality a package deal of two policies.[69] The first, usually called the "Reimbursement" policy, provides that the insurer pay on behalf of the corporation those amounts it must pay due to a bylaw, a court order, or otherwise by law. The second, usually entitled the "Directors and Officers Liability" policy, permits the direct indemnification of those executives by the insurer in those situations where due to an omission in a bylaw or requirement of law the executives may not look to the corporation for indemnification.[70]

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have adopted limited parts of the New York law. *See, e.g.*, GA. CODE ANN. § 22-717(h) (1968); N.J. STAT. ANN. § 14A:3-5(7) (1969).

67. DEL. CODE ANN. tit. 8, § 145 (1967). Pennsylvania, Virginia, and Kansas are the only other states to have adopted the language of the new Delaware statute, which was copied from the new indemnity section of the Model Business Corporation Act. KAN. GEN. STAT. ANN. § 17-3010 (Supp. 1968); PA. STAT. ANN. tit. 15, § 410 (Supp. 1968); VA. CODE ANN. § 13.1-3.1 (Supp. 1968); ABA-ALI MODEL BUS. CORP. ACT § 4A (1967). Georgia and New Jersey have substantially adopted the new Model Act language but have added a few modifications. GA. CODE ANN. § -22-717 (1968); N.J. STAT. ANN. § 14A:3-5 (1969). *See* note 66 *supra*.

68. Insurance firms handling indemnity policies have reported a phenomenal increase in 1968 sales. For example, Employers' Group of Boston sold 40 policies totaling nearly 200 million dollars during the first half of 1968, as compared with only 22 policies totaling 110 million dollars in all 1967. Carley, *supra* note 7, at 1, col. 1. Some firms have adopted aggressive advertising policies which vividly project the expanded scope of potential directors and officers liability. *See, e.g.*, full page ad of American Home Assurance Company, Wall St. Journal, January 27, 1969, at 9. For a detailed examination of the advantages and disadvantages of liability insurance see, *e.g.*, Bishop, *supra* note 3, 22 BUS. LAW. 92 (1967); Brook, *Officers and Directors Liability Insurance*, 2 THE FORUM 228 (1967); Hinsey & De Lancey, *Directors and Officers Liability Insurance—An Approach to its Evaluation and a Checklist*, 23 BUS. LAW. 869 (1968); *Insurance Against Liability of Directors and Officers—A Forum*, *supra* note 3; Mace, *supra* note 8; Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648 (1967); Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716 (1967).

69. The standard form used is the Lloyd's of London policy. Note, *Liability Insurance for Corporate Executives*, *supra* note 66, at 649-50 n.11. For a detailed analysis of the protection provided by the Lloyd's policy, see Hinsey & De Lancey, *supra* note 68. Some American firms offering such coverage are the St. Paul Fire & Marine Insurance Company, the Travelers Insurance Company and the Kempers Insurance Group. Green, *supra* note 5, at 8, col. 2.

70. For a discussion of these types of policies, see Mace, *supra* note 11, at 48.

Most state statutes prohibit the corporation from indemnifying the director where he is adjudged guilty of negligence or misconduct, but very few regulate the purchase of liability insurance which under the "Directors and Officers Liability" policy could accomplish the same result.[71] In this connection a serious policy question has arisen, since due to the great expense of the premiums[72] many corporations underwrite the burden of the premium expense either by increasing executive compensation to cover the cost or by paying the premium itself.[73] It is argued that if the corporation could not directly indemnify the executive by a bylaw due to local law restrictions, it should not be allowed to circumvent the state law by purchasing liability insurance for the executive.[74] In an apparent effort to meet this objection, many companies allocate 90 per cent of the premium expense to the corporation as that attributable to the "Reimbursement" policy and 10 per cent to the executive as that attributable to the "Directors and Officers Liability" policy.[75] However, even the 90 per cent-10 per cent allocation is subject to suspicion, since many companies undoubtedly finance the 10 per cent through increased executive compensation.[76]

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71. Most policies exclude certain liabilities from coverage. However, Lloyd's policy would apparently permit a negligent director to recover since it specifically covers "wrongful acts" committed by the insureds in their roles as directors and officers. Intentional misconduct is for the most part excluded. Note, *Liability Insurance for Corporate Executives*, *supra* note 68, at 650.

72. The largest policy which provides 25 million dollars in coverage for the executives of General Motors Corporation costs about $450,000 for a three year period. Carley, *supra* note 7, at 1, col. 1. Premiums on smaller policies run between $2000 and $2500 per year for each $500,000 coverage. Green, *supra* note 5, at 8, col. 2.

73. Where the executive pays the complete premium, the legality question has been somewhat milder, focusing only upon the policy issue of whether such insurance undermines the liability the law seeks to impose and is thus void. Most commentators however view this problem to be of minimal significance. *See, e.g.*, Note, *Liability Insurance for Corporate Executives*, *supra* note 68, at 651-53.

74. Bishop, *supra* note 3, 22 BUS. LAW. 92 (1967); Bishop, *supra* note 3, 22 RECORD OF N.Y.C.B.A. at 355. *See also* Mace, *supra* note 11, at 50.

75. The 90%-10% allocation is the standard only due to practice and is unsupported by reliable data. The rationale for the use of these figures is well stated as follows: "This allocation is supported by the idea that the great majority of suits against directors and officers will be successfully defended and indemnification for expenses incurred in defending the action will be [legally] obtained from the corporation which, in turn, will seek reimbursement from the insurer under the 'Reimbursement' policy." Mace, *supra* note 8, at 50-51. Some corporations do in fact pay 100% of the premium; for example, the Comptroller of the Currency has ruled that national banks may do so. *Id.* at 51, *citing* NATIONAL BANK REV. 116 (Sept. 1965).

76. The greatest danger to the executive who accepts increased compensation designed to pay his 10% is a stockholder's derivative suit to require that person to pay his fair share

Although there have been no cases decided on the point, the validity of indemnity through insurance purchased by the corporation seems doubtful under the *Continental Growth* rationale,[77] which could easily be extended to the insurance situation which achieves the same result prohibited by that case. It is submitted, however,that to conclude that the purchase of insurance violates public policy because it achieves results which would be outside public policy if done by bylaw indemnification is to ignore the distinguishable qualities of insurance and indemnification.[78] Liability insurance for directors is very similar to other types of professional insurance[79] and can be justified as part of the executive's compensation protecting him against future liability which has not arisen. On the other hand, indemnification cannot be so considered, since payment is predicated on a determination of liability or on a settlement in which case the corporation, not some third party, must reimburse the executive.[80] In one instance, the corporation merely pays a premium, which may be analogized to the life insurance premium many corporations pay for their executives, while in the other case the corporation may have to reimburse the executive for amounts which were awarded the corporation due to an adjudged wrong of the executive. Thus, insurance should be viewed as executive compensation and should be permitted to be purchased by the corporation without resorting to the 90 per cent-10 per cent fiction.

Even if one assumes the validity of corporate payment, there are other problems which must be considered. For example, insurers anxious to avoid any litigation which might question the validity of liability insurance are very cautious as to whom such policies are

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of the premium costs. Moreover, the executive incurs the risk that the insurance company, which faced with a large loss, will refuse to pay upon the ground that such an increase in compensation to pay the premium voids the policy as a matter of public policy. *Id.* at 52. The latter risk seems minimal, since if an insurance company pursued such a defense, it is doubtful if it would be in business for very long thereafter.

77. *See* note 50 *supra* and accompanying text.

78. A similar analysis was made in Note, *Liability Insurance for Corporate Executives*, *supra* note 68, at 667.

79. One author has analogized the mistrust of directors' liability insurance to the reluctance with which attorney's malpractice insurance was initially viewed. Brook, *supra* note 68, at 228-29. The same analogy could reasonably be made with insurance for doctors and other professionals.

80. This distinction is crucial in the derivative suit, since the corporation would be reimbursing the executive for the very amount paid to the corporation as a result of the suit; whereas, in the insurance situation, the corporation would keep its recovery and a third party insurance company is the one who must reimburse the losing defendant.

offered and reject over one-half the applications due to poor risk.[81] Furthermore, a recent study of the advantages of coverage over the costs of such insurance indicates only minimal advantages exist in providing coverage beyond that which a corporation may give via indemnification.[82] Yet except for the company where chances are highly remote that any of its personnel will have need of indemnity, it is suggested that insurance should be purehased as supplementary protection to that provided by indemnification bylaws. Such insurance does offer the unique and important advantage of protecting the executive where indemnification is prohibited by local law as well as avoiding the uncertainty which surrounds the indemnification statutes. Furthermore, insuranee provides a more secure protection to the executive who may be concerned about falling out with management or about the corporation's inability to pay.[83] But such advantages could be nullified by a narrow view of the validity of corporate payment of insurance premiums. It is therefore essential that future statutes take their cue from the realistic approach of the 1967 Delaware statute[84] and specifically grant the corporation the power to purchase insurance.

B. Resignation of Directors

The rise in stockholder's suits and the increasing awareness of the liabilities which may result therefrom has had the disturbing effect of deterring many able men from service as corporate directors as well as causing the resignation of some. Many who resigned or who have been deterred feared that pressures of other affairs would prevent them from being adequately informed of the company's activities and thus would increase the possibility of their liability in a suit based upon acts of which they were unaware.[85] Several corporations have sought

81. The Wall Street Journal reports that "they turn down at least half the applications they get, because the companies, or the executives for whom the coverage is sought, don't appear to be good risks." Green, *supra* note 5, at 8, col. 2. Companies which are most likely to be turned down are in industries that are prime targets for antitrust or securities actions, such as steel. Carley, *supra* note 7, at 1, col. 1.

82. *Insurance Against Liability of Directors and Officers—A Forum*, *supra* note 3, at 368. For a helpful checklist to determine if liability insurance would be beneficial in a particular case, see Hinsey & De Lancey, *supra* note 68, at 879-83.

83. For a complete list of the unique advantages of liability insurance, see Brook, *supra* note 68, at 235-37.

84. DEL. CODE ANN. tit. 8, § 145(g) (1967). In 1968, California added a similar subsection to its statute authorizing corporate paid indemnity insurance. CAL. CORP. CODE § 830(h) (1968).

85. Green, *supra* note 5, at 8, col. 3. *See generally* Gartner, *"Thanks But . . .,"* Wall Street Journal, March 13, 1969, at 1, col. 6.

to protect such fringe directors by naming them "advisory" directors in hopes of distinguishing them from the "full" directors who are liable to suit.[86] Yet undoubtedly well-qualified executives have been influenced by the state of flux existing in the law of indemnification. The answer lies in well-reasoned legislation in which the judiciary will have sufficient confidence to respect the obvious meaning of the statute, thus eliminating the fear and uncertainty that now pervades the area.

V. THE BEST STATUTORY SOLUTIONS—A COMPARISON

The New York statutes, though copied only by a single state,[87] presents a far more realistic solution than any of its contemporaries, including the 1953 Delaware statute. The comprehensive nature of the New York law undoubtedly caused the drafters of the Model Business Corporation Act to reassess the adequacy of the original Model Act provision, which had been copied from the 1953 Delaware Code, and to conclude that a more thoughtful section was needed.[88] Their work resulted in adding to the Model Act in April of 1967 a new indemnification section to supplant the old one.[89] Immediately thereafter Delaware and five other states adopted language almost identical with that of the new Model Act section.[90] (For comparison, this group will be referred to hereinafter as the 1967 Delaware type statute.)

These two recent statutory provisions represent the most sophisticated and comprehensive legislation enacted to date, yet neither appears to provide a solution able to cope with the needs of

86. The Wall Street Journal reports Litton Industries as one company which has sought to protect outside directors by naming them "advisory" directors. *Id.* Professor Bishop has long advocated a dual standard of liability for the "inside" director and the "outside" director, which if adopted, would alleviate this problem. *See, e.g.*, Bishop, *supra* note 3, 22 BUS. LAW. 92, 102 n.37 (1967).

87. Tennessee recently adopted the New York language in its indemnification section. See note 64 *supra*. It is submitted that the reason many states have shied away from the New York approach is the fact that the statute is exclusive and severely limits the corporate power to indemnify, and thus many corporations undoubtedly have lobbied against the passage of such a statute. Some states, such as Kentucky, Michigan, and Missouri, do have similar provisions with respect to settlements but depart from the whole pattern.

88. Sebring, *supra* note 34, at 96.

89. Section 4A was approved on April 22, 1967, by the Committee on Corporate Laws of the Section of Corporate, Banking and Business Law of the American Bar Association. For the official reporting of the revised section, see Sebring, *supra* note 34, at 95.

90. DEL. CODE ANN. tit. 8, § 145 (1967); GA. CODE ANN. § 22-717 (1968); KAN. GEN. STAT. ANN. § 17-3010 (Supp. 1968); N.J. STAT. ANN. § 14A:3-5 (1969); PA. STAT. ANN. tit. 15, § 410 (Supp. 1968); VA. CODE ANN. § 13.1-3.1 (Supp. 1968).

the modern corporate executive. The following comparative analysis of the two approaches is designed to provide a fuller understanding of the characteristics of the proposed model statute which follows. To aid the reader in comparing these characteristics, a chart comparing the 1953 Delaware type statute followed by a majority of states, the 1967 Delaware type statute, the New York statute, and the proposed model statute has been prepared and is included in the article as Appendix A.

A. Exclusiveness

Despite the confusion and criticism which resulted from the non-exclusive language in the 1953 Delaware statute, the drafters included the same non-exclusive language in the 1967 Delaware type statute.[91] Mr. Orvel Sebring, Chairman of the ABA Committee which originally drafted this new provision, makes the following comment on the retention of the non-exclusive language:

> This provision . . . was intended to do what it says: to enable corporations to adopt additional indemnification provisions if deemed necessary. In view of the express wording of the statute, it is difficult to see why a court would not enforce a by-law provision, reasonable in its terms, which might go beyond the scope of Section 4A or Section 145.[92]

Although this explanation was justifiably applicable (though unworkable due to severe judicial reluctance) to the 1953 Delaware statute, it is suggested that it is unjustifiable when considered with the comprehensive nature of the 1967 Delaware type statute. As Mr. Sebring continues, the "statutory provisions alone, being self-executing, are sufficient,"[93] and one might add to his statement that they are sufficient without the aid of any non-exclusive clause. A further indication that the provisions are "complete" is his suggestion that any existing bylaw less liberal than the new provisions should be repealed.[94] Surely the same rationale would apply to a more liberal bylaw which would come much closer to violating legislative intent and judicial public policy. Indeed so comprehensive is the nature of this statute that it would be difficult to exceed its scope without breaking the bounds of judicial public policy which, despite the non-

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91. DEL. CODE ANN. tit. 8, § 145(f) (1967).

92. Sebring, *supra* note 34, at 105.

93. *Id.* at 106.

94. *Id.* This concern apparently arises from cases which have held that bylaws which are more restrictive than statutory standards are controlling. *See, e.g.*, Essential Enterprises v. Dorsey Corp., 182 A.2d 647 (Del. Ch. 1962).

exclusive language, would undoubtedly be controlling. Thus, it is submitted that the non-exclusive clause adds nothing to the well-designed, comprehensive statute and in fact minimizes its effectiveness by injecting an element of uncertainty as to how far the courts will permit the corporation to go under it.

In contrast to the Delaware type statutes, the New York statute is completely exclusive, forbidding any indemnification inconsistent with its terms.[95] In addition to providing greater certainty as to the limits of permissible indemnification, the exclusive approach has several other significant advantages. First, it provides a certain amount of uniformity and predictability in the indemnification rights of corporate personnel. Any area so closely tied with public policy that courts are willing to override clear legislative intent should seek uniform application of the law. Surely a non-exclusive clause can never achieve that aim, as it encourages a diverse "bylaw by bylaw" application since each corporation is free to place in its bylaws any provision it wishes.[96]

Second, the exclusive language is a more effective means to implement public policy. The non-exclusive language lends itself to indemnification under bylaws which grossly violate the bounds of public policy but which may never be challenged due to stockholder apathy or lack of notice. On the other hand, the exclusive statute defines the limits of public policy in the statute itself and prohibits any indemnity inconsistent with those limits.

Third, the exclusive statute need not abrogate the corporate freedom which defenders of the non-exclusive statute say can exist only if the corporation can indemnify outside the provisions of the statute. If the exclusive statute has been broadly drafted, then any provision outside its limits would be prohibited by public policy. Additionally, the corporation should still have the freedom to choose, since the statute should merely grant the power to indemnify within its limits and should not be mandatory as a whole.

Thus it is suggested, as it is provided in the proposed statute, that the exclusive language be used. It should be noted, however, that where such language is used, it is essential that the other provisions be carefully drawn to the outer limits of public policy. It is only in that

95. N.Y. BUS. CORP. LAW § 721 (1963).

96. Even Mr. Sebring who advocates the use of non-exclusive language strongly agreed with the need for a more uniform approach and has commented: "A more uniform approach is desirable, which is not possible under a system through which indemnification is provided on a corporation-by-corporation by-law basis." Sebring, *supra* note 34, at 99.

manner that the policy favoring the protection of the corporate executive can be adequately balanced with the policy prohibiting unjustifiable corporate expenditure.

B. Type of Actions Covered

The majority of statutes do not distinguish between the derivative suit and suits not in the right of the corporation—whether civil, criminal or administrative—and prescribes the same standard of conduct for both types.[97] Clearly, however, different policy considerations are involved and should be recognized, as has been done in both the New York statute and the 1967 Delaware type statute.[98] Even at common law, courts recognized that a lesser standard should be applied to suits not in the right of the corporation on the theory that the relationship then becomes ruled by the law of agency that the principal must indemnify its agent for losses which are a direct consequence of the agency.[99] Accordingly it makes good sense to have a different standard. The derivative suit involves a breach of fiduciary duty to the corporation itself, and as such, reimbursement of amounts paid for its benefit should be strictly controlled.[100] However, in a third party suit, such as a criminal or civil antitrust action, the corporate executive may have been acting with the best intentions to further the corporate interest and should therefore be indemnified more readily than where he has breached his fiduciary duty. The proposed model statute therefore has separate provisions for the derivative suit and the suit not in the right of the corporation.

C. Standard of Conduct

1. *Suits Not in the Right of the Corporation.*—Although most early statutes were aimed toward indemnity in the derivative suit, the rapid rise in potential suits by outsiders in the form of antitrust or

97. Connecticut was perhaps the first state to make this distinction. CONN. GEN. STAT. ANN. § 33-320 (1961).

98. *Compare* DEL. CODE ANN. tit. 8, §§ 145(a)-(b) (1967), *with* N.Y. BUS. CORP. LAW §§ 722, 723 (1963).

99. Du Puy v. Crucible Steel Co., 288 F. 583 (W.D. Pa. 1923); Hoch v. Duluth Brewing & Malting Co., 173 Minn. 374, 217 N.W. 503 (1928). For a discussion of this agency theory and these cases, see G. WASHINGTON & J. BISHOP, *supra* note 3, at 106-08.

100. This need for strict control was partially recognized when the Model Act in 1959 amended its original section copied from the 1953 Delaware section by adding the words "to the corporation" to the excepted language, but still no different standard was established for the derivative suit.

securities suits has focused attention upon the need for a lesser standard in situations involving actions not in the right of the corporation. Without question the successful director or officer should be indemnified and both statutes have so provided,[101] but with respect to the executive who is less successful or who has compromised, each statute differs slightly. Under the 1967 Delaware type statute, the less successful person may be indemnified against all amounts paid, including judgments as well as expenses, only if he:

> acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable excuse to believe his conduct was unlawful.[102]

Such indemnification may be made by a majority vote of a quorum of disinterested directors if it exists, by independent legal counsel, or by the stockholders.[103] This standard was adopted from the similar New York language but adds the "not opposed to" wording to cover the case where a director or officer engages in a completely personal transaction in which he believes the corporation has no interest.[104] The New York statute, however, provides greater protection, in that if the corporation refuses to indemnify the executive, as where the executive has lost favor with management, he may apply to the court for indemnification which may be awarded despite the adverse corporate action.[105]

The standard used by both statutes recognizes the policy distinctions from the derivative suit, yet there still are some trouble spots for the "honest but dumb" director. The standard may cut him out, since it requires that he act in a manner he "reasonably" believes to be in the best interests of the corporation. The reasonableness requirement has an objective flavor, and to inject a more subjective standard for the innocent director the proposed statute requires only that he "honestly" believe his actions to be in the corporation's best interests. Similarly, reimbursement may be prohibited because,

101. DEL. CODE ANN. tit. 8, § 145(c) (1967); N.Y. BUS. CORP. LAW § 724(a) (1963).

102. DEL. CODE ANN. tit. 8, § 145(b) (1967).

103. DEL. CODE ANN. tit. 8, § 145(d) (1967); N.Y. BUS. CORP. LAW § 724(b) (1963). The proposed model provision has added the Executive Committee since in many corporations it is the managing hody.

104. One writer states that these words were specifically added "to cover the possibility of a case brought because of the status of the person concerned (i.e., a director or officer, etc.) based on acts in an individual capacity such as were involved in the *Texas Gulf Sulphur* case." Sebring, *supra* note 34, at 102.

105. N.Y. BUS. CORP. LAW § 725 (1963).

although an executive may be able to show that his conduct was in good faith and in the best interest of the corporation, he may have had "reasonable cause to believe" his conduct was unlawful.[106] Thus, to avoid such a contingency as well as to recognize the need for liberality in an exclusive statute, the proposed model statute adopts a broader standard and permits indemnification if there is a finding in any criminal action or proceeding by the court or by appropriate corporate action that the individual "fairly and equitably merits indemnification."[107]

2. *The Derivative Suit.*—As with the non-derivative suit, the problem arises only with the unsuccessful director or officer, since the successful one is and should be indemnified.[108] But as to the less successful person, the statutes impose far stricter standards of conduct and limit indemnification to expenses. Moreover, unlike the non-derivative action, separate standards tightly control settlements.

The New York statute has the simpler, though more prohibitive, standard, permitting reimbursement of expenses in all cases except where the director or officer has been "adjudged to have breached his duty to the corporation."[109] The 1967 Delaware type statute, on the other hand, applies initially the same subjective good faith standard as in the non-derivative suit and then excepts situations where the director or officer has been "adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation" unless a court determines despite such an adjudication that he is "fairly and reasonably" entitled to indemnification.[110] Both use the same procedure for judging the executive's conduct as in the non-derivative suit, except that Delaware by including the "unless" clause gives some sanction to court control though there is still no procedure by which an executive not so adjudged can apply for judicial indemnification.

The conflicting policies are clear, yet they defy easy solution. All would agree that there should be no indemnity where a director or officer has so violently breached his fiduciary duty as to be guilty of

106. One author has in fact concluded that given modern antitrust concepts it would be very difficult to convince a court that a defendant director or officer "had no reasonable cause to believe that his conduct was unlawful." *See* Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875, 907.

107. This language has been borrowed from the California indemnity provision. CAL. CORP. CODE § 830(a) (2) (1947).

108. See note 101 *supra* and accompanying text.

109. N.Y. BUS. CORP. LAW § 722(a) (1963).

110. DEL. CODE ANN. tit. 8, § 145(b) (1967).

actual dishonesty, willful misconduct, or gross negligence. But the use of mere negligence or misconduct as the standard raises disturbing questions. For example, Professor Bishop has urged that such terms are not restrictive enough and that therefore some executives have been spared loss when their conduct would have prohibited indemnification under an objective public policy.[111] Yet, on the other side, these terms embrace such an endless variety of harmful activity that their use often results in an improper denial of indemnification. There is no room to distinguish deliberate misconduct from that done with good intentions. Nor may negligence which results from a violation of a well-established duty be distinguished from that in violation of a newly announced duty with an uncertain scope.[112] Nor is there opportunity to impose a different standard on the advisory fringe director, as distinguished from the inside director.[113] The only means of providing the flexibility needed to cope with these differing situations is to establish a broader standard and to place the determination of whether the standard has been met under judicial control. Surely this determination in a derivative suit can be made more appropriately by a disinterested judiciary than by directors who will be compassionate in judging their fellow director. The 1967 Delaware type statute moves in this direction but requires a judgment of negligence or misconduct before judicial determination comes into play. Thus, it is submitted that the wiser course is to opt for the broader standard of the New York statute and to place its determination in the hands of the judiciary. This creates a more restrictive standard, while at the same time providing the flexibility necessary to handle the hard case.

Additionally, there may be cases where money judgments against

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111. *See generally Insurance Against Liabilities of Directors and Officers—A Forum*, *supra* note 3, at 354.

112. Professor Folk emphasizes this point well in the following comment: "[A] new rule of fiduciary duty can be evolved more readily and declared more boldly if the court can, in an appropriate case, grant indemnity in whole or in part for conduct concededly unethical but not legally wrong at the time, and thereby avoid a heavy judgment retrospectively imposed upon an individual for the first time. This aids the court caught between the Scylla of holding no breach of duty under existing law, and the Charybdis of exacting a possible crushing personal liability for disregarding an ethical concept which was not then but should now be a legal standard." Folk, *supra* note 106, at 910-11. *Cf.* British Companies Act, 11 & 12 Geo. 6, ch. 38, §§ 136, 448 (1) (1948), which provides for placing the burden of expense upon the corporation in such a case.

113. Bishop, *supra* note 3, 22 BUS. LAW 92 (1967). Mr. Sebring notes that such a distinction should exist but fails to explain how the Model Act has provided for it. Sebring, *supra* note 34, at 104.

the director or officer should not be borne by him but by the corporation, as where he acted on legal advice given by corporate counsel. Thus, the proposed model statute permits the reimbursement of judgments and amounts paid in settlement as well as the expenses involved. The potential for abuse is limited since the extent to which indemnification can be awarded is controlled by judicial discretion. In such a case, there is no reason to limit recovery to expenses as does the 1967 Delaware type statute.

D. *Mandatory Indemnification*

Both statutes require indemnification where in either a non-derivative or a derivative suit the defendant was successful "on the merits or otherwise,"[114] though New York does require him to have been "wholly successful."[115]

The policies favoring mandatory indemnification are twofold. First, where a defendant has been vindicated, he is presumed free from fault, and thus indemnity will violate no public policy. Second, compulsory indemnification protects the person who has won the suit but lost the battle due to his being in disfavor with management who would otherwise refuse to indemnify him. True, he could apply to court under the proposed statute and eventually be reimbursed, but since under the premise of the first policy there is no public policy question involved, it is better to provide for extra-judicial means. Although mandatory indemnification for the successful director is supported by persuasive policies, it is suggested that contrary to the policy of the Delaware and the New York statutes, it does matter whether the director was successful on the merits or otherwise. It is not always true that the director who wins "otherwise" deserves indemnification, since the director who wins by default judgment or other technicality may in fact be as guilty of breach of fiduciary duty as the director who loses on the merits.[116] Thus, mandatory indemnification should be limited to those persons successful on the merits, leaving those otherwise sucessful, whose conduct may raise

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114. DEL. CODE ANN. tit. 8, § 145(c) (1967); N.Y. BUS. CORP. LAW § 724(a) (1963).

115. N.Y. BUS. CORP. LAW § 724(a) (1963). The word "wholly" could easily be discarded as surplusage.

116. One court has indicated approval of such a construction and has held a defendant to be adjudged guilty for indemnity purposes though the suit was dismissed. Diamond v. Diamond, 307 N.Y. 263, 120 N.E.2d 819 (1954).

public policy issues, to rely upon proper corporate or judicial action.[117]

E. Judicial Discretion

Since many of the suggestions discussed rely heavily upon the use of judicial discretion, it seems beneficial to focus briefly upon the reasons behind its use. First, access to the judiciary for reimbursement protects the director or officer who has been unjustifiably refused recovery by his fellow directors or stockholders. Second, judicial determination helps prevent the hard case where, although a person has breached the prescribed standard, he fairly and reasonably deserves indemnification. Third, the use of the judiciary to make such determinations insures fairness and equality that a similar determination by sympathetic directors could not guarantee. Finally by allowing ad hoc determinations, the use of judicial discretion enables the law of corporate indemnity to adapt more easily to the changing needs of modern society. Thus, one may conclude that the greatest advantage of the use of judicial discretion is that it lends a flexibility to indemnification statutes which under the old model were rigidly attached to a single standard.

F. Types of Personnel Covered

New York and a majority of the older statutes limit their coverage to "directors and officers," leaving other employees to their uncertain common law rights.[118] Delaware, however, has expanded the coverage to include a "director, officer, employee or agent" of the corporation, thus subjecting the employee and agent to the same statutory standards as the director or officer.[119] The problem may appear largely semantic, since anyone who is not a director or officer is not likely to be involved in a non-derivative or derivative suit, yet it becomes very real where an executive is both an officer and an employee.[120] In such a situation, it is argued that as an employee he

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117. Clearly this needed check does not impose a harsh burden upon those who win on a technicality since if their conduct deserves indemnity, board approval will be automatic in both the derivative and non-derivative situation. Furthermore, if the board for personal reasons refuses to grant indemnity, the party always has another route through the courts.

118. N.Y. BUS. CORP. LAW § 721 (1963). The 1953 Delaware provision also limited its scope to "directors and officers."

119. DEL. CODE ANN. tit. 8, §§ 145(a)-(b) (1967).

120. Professors Washington and Bishop ask the following questions: "Finally, what happens if, as is often the case, a particular executive is *both* an officer and an employee, e.g., vice president and general manager of the Widget Division? Can he, in his employee capacity,

could contract for broader rights than are available under the statutory provisions. It seems doubtful in light of the common law that such "broader rights" would be permitted to exceed the limits of public policy. However, to avoid the uncertainty that extra-statutory coverage would raise, the wiser course seems to be the inclusive Delaware coverage. There is no apparent reason why the employee or agent should not be held to the statutory standards, especially since chances are slim that they will ever be faced with the problem.

The Delaware statute also includes anyone "serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise,"[121] while New York permits indemnity in this subsidiary director situation only in the non-derivative suit.[122] Such a distinction seems untenable, since the subsidiary director involved in a derivative suit should be judged by the same standards as the parent director. Thus, the proposed model statute follows the inclusive Delaware language in both the derivative and non-derivative situations.[123]

G. Expenses

The term "expenses," the only sum awarded under the 1953 Delaware type statute, has been ambiguously construed. Some took the broad view that the term included judgments, fines and attorneys' fees, while others limited its meaning to fees and costs.[124] The 1967 Delaware type statute and the New York statute correct this ambiguity by precise language and rest the extent of indemnity upon the type of action involved. Under the New York statute recovery in a

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contract for a broader right of indemnification than that spelled out in the statute? If he cannot, and *if* the courts regard the statute as leaving to the employees and agents full freedom to contract for indemnification, here may be a reason for eschewing the prestigious but otherwise empty title of vice president." G. WASHINGTON & J. BISHOP, *supra* note 3, at 155-56.

121. DEL. CODE ANN. tit. 8, §§ 145(a)-(b) (1967).

122. N.Y. BUS. CORP. LAW § 723(a) (1963). The language of the New York statute in the non-derivative situation is less specific than its counterpart in the Delaware statute, since it includes any director or officer who has "served in any capacity at the request of the corporation."

123. An additional provision must be made for the person who has retired or died prior to indemnification. The right to indemnity should survive either his death or retirement, but most statutes overlook the need to protect this right for his estate or for himself on retirement. The proposed statute protects the retired person by the use of the "is or was" language of the 1967 Delaware provision and the estate of the dead person by including "heirs, executors or administrators" in the scope of coverage.

124. *Compare* G. WASHINGTON & J. BISHOP, *supra* note 3, at 128, *with* Folk, *supra* note 106, at 905.

derivative suit includes "reasonable expenses, including attorneys' fees, actually and necessarily incurred by him," while recovery in a non-derivative suit includes "any judgment, fines, amounts paid in settlement and reasonable expenses, including attorneys' fees, actually and necessarily incurred."[125] Delaware adopted the same language, with the exception of substituting the word "reasonably" for "necessarily" and omitting the word "reasonable" preceding expenses.[126] The less stringent standard was adopted due to the difficulty of proving that expenses were "necessary"[127] and is clearly an improvement.

The proposed model statute departs from the New York-Delaware pattern and allows full recovery in the derivative suit including amounts paid in settlement. There are strong contrary policy arguments, however, which must be met. Most authorities suggest that to permit such indemnity in the derivative suit produces a "circuity of payments" and nullifies the preventive force of the derivative suit.[128] This result would be quite true if the model statute did not require judicial authorization of any indemnity in derivative suits. Thus, the derivative suit retains its force since the judiciary will be likely to grant full recovery only in those exceptional cases where the expenses should be justly borne by the corporation. Moreover, by allowing payment of settlement amounts with court approval, the corporation may in fact save money due to the absence of litigation costs.[129]

H. Settlements

The majority of the older statutes did not include a separate provision for the settlement situation, but relied upon a broad interpretation of the term "expenses" to include settlement payments in indemnification.[130] However, equating the settlement situation with

125. N.Y. BUS. CORP. LAW §§ 722(a), 723(a) (1963).

126. DEL. CODE ANN. tit. 8, §§ 145(a)-(b) (1967).

127. Connecticut was the first state to make this change and it has been suggested that the reason was the extreme difficulty in proving that particular past expenses were necessary. Manning, *The 1961 Amendments to the Connecticut Corporation Acts*, 35 CONN. B.J. 460, 466 (1961). *See also*, Folk, *supra* note 106, at 905 n.181.

128. Bishop, *supra* note 3, 20 BUS. LAW. at 843 (1965); Sebring, *supra* note 34, at 103.

129. *Contra* Sebring, *supra* note 34, at 103.

130. This attitude may be best exhibited by the following comment of the drafters of the Model Business Corporation Act: "The reference in the Model Act to 'expenses actually and reasonably incurred' should be held to cover settlement payments if the corporation has been advised by counsel that the suit was without substantial merit and that the settlement payments did not exceed the probable expenses of litigation." 1 MODEL BUS. CORP. ACT ANN. ¶ 4.03, 160 (1960).

the judicial trial case ignores the totally different policy considerations involved. On one hand there is the strong policy favoring settlements as a means of avoiding court congestion and protracted litigation, while on the other hand there is the policy against encouraging strike suits brought solely for their harrassment value.[131] The latter would be violated by awarding indemnity for all settlements since this would undoubtedly encourage directors not to vindicate their actions against groundless claims. Moreover, general indemnification in the settlement situation would frustrate the standards of the statute since any person who thought he might be adjudged liable for breach of duty to the corporation would seek a settlement as quickly as he could thus maximizing the possibility of his indemnification. For these reasons, a few statutes, including both the New York and the 1967 Delaware type statutes, have special provisions for indemnity in settlement situations.[132] Both the New York and Delaware statutes adopt a strict view, prohibiting the indemnification of amounts paid in settling a derivative suit even if approved by a court, while allowing recovery of expenses incurred in settling a derivative suit if the requisite standard of conduct was met and, in the case of New York, if approved by a court.[133] In the non-derivative suit, however, the policies against indemnity are not as strong and full recovery is permitted by both statutes.[134] Limiting recovery to expenses appears unjustified where strict judicial control is imposed. Thus, the proposed model statute, while more lenient in allowing recovery of amounts paid in settlement as well as expenses, is stricter by requiring a judicial determination that one "fairly and reasonably" merits indemnity to the extent sought. In this manner, both policies are served, since settlements where justified are encouraged, while judicial controls guard against misuse of the settlement route.

I. Advance Payments

None of the earlier statutes provided for payments of expenses prior to final termination of the suit, and therefore many successful

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131. For an analysis of these conflicting policies behind settlements, see Note, *Attorney's Fees: Where Shall the Ultimate Burden Lie?* 20 VAND. L. REV. 1216 (1967).

132. DEL. CODE ANN. tit. 8, §§ 145(a)-(b) (1967); N.Y. BUS. CORP. LAW §§ 722(b), 723(a) (1963).

133. DEL. CODE ANN. tit. 8, § 145 (b) (1967); N.Y. BUS. CORP. LAW § 722(b) (1963). The Tennessee Legislature in adopting the New York language intentionally omitted this prohibition, though the printed editions of the new Act have incorrectly included it. TENN. CODE ANN. § 48.407(2) (Special Supp. 1968).

134. DEL. CODE ANN. tit. 8, § 145(a) (1967); N.Y. BUS. CORP. LAW § 723(a) (1963).

defendants found their assets stripped by the expenses of lengthy litigation, even though they later were reimbursed. The need for such a provision is crucial, since a defendant forced to rely upon personal funds may be prevented by expenses from presenting the best case to vindicate his action. Yet there must certainly be means of controlling the use of advance payments. Both the New York statute and the 1967 Delaware type statute allow advances but require approval by a disinterested board, or if none, by independent counsel, or by stockholders.[135] Moreover, the defendant must repay to the corporation any amounts to which he is not entitled.[136] Although there is no concrete evidence indicating how well these controls work, this statutory pattern appears well-reasoned and in harmony with sound policy. Thus, the proposed model statute has adopted that pattern, except that interest is added to the amounts repaid to avoid any unjustified interest-free loan and that approval may be made by the Executive Committee, which is the controlling body in many corporations today.

J. Insurance

As discussed in Part IV, liability insurance has become an increasingly popular and effective means of supplementing bylaw indemnification despite the doubt which exists as to the extent to which a corporation may purchase such insurance. Most statutes, including the New York statute, are not helpful since no reference is made to insurance. Those who would deny the corporation the power to purchase insurance argue that the purchase of insurance permits the corporation to circumvent indemnification bylaw restrictions since the final results are similar,[137] but as was asserted earlier, this reasoning ignores the special nature of insurance. Thus, in accordance with the earlier conclusion that the purchase of insurance is sound policy, the model provision follows the 1967 Delaware type provision,[138] which grants the corporation the power to purchase such insurance.

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135. DEL. CODE ANN. tit. 8, § 145(e) (1967); N.Y. BUS. CORP. LAW §§ 724(c), 725(c) (1963).

136. DEL. CODE ANN. tit. 8, § 145(e) (1967); N.Y. BUS. CORP. LAW § 726(a) (1963).

137. For these views, see note 74 *supra* and accompanying text.

138. DEL. CODE ANN. tit. 8, § 145(g) (1967).

K. Notice to Stockholders

One reason that has been suggested for the lack of judicial authority on the proper limits of indemnification is the fact that many cases of improper reimbursement have gone unchallenged merely due to lack of stoekholder notice. This result must be avoided, yet very few statutes require any kind of notice,[139] and surprisingly the otherwise comprehensive 1967 Delaware type statute fails to include this important means of protecting the corporate interest. Even the SEC disclosure requirements do not adequately provide notice, since their effect is limited to the situation existing at the time when the indemnification bylaw was adopted.[140] New York, however, does require notice of the persons paid, the amount paid and the nature of the litigation at the time paid.[141] Such a provision is necessary to provide full protection to the corporate coffers and therefore has been adopted for inclusion in the proposed model statute.

VI. THE PROPOSED MODEL STATUTE

The following statute has been drafted to reflect the conclusions reached in Part V. It is not intended to be an end in itself, but is intended to stimulate ideas which may develop into a statute better adapted to modern corporate conditions. There must not be, as occured with the 1953 Delaware statute, a blind apathetic acceptance of the recent Delaware and Model Business Corporation Act provisions, and the search for a better solution must continue. With these thoughts in mind, the following statute is submitted for examination.

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139. California, one of the first states to have a provision for notice to the stockholders, required a court order to call the notice provision into effect. CAL. CORP. CODE § 830(c) (1947).

140. Professors Washington and Bishop suggest that the SEC could do much more than it does to implement public policy as to indemnification and conclude as follows: "In short, although the SEC almost certainly has power under the 1933 and 1934 Acts, particularly Section 7 of the former and Sections 13 and 14 of the latter, to require that corporations subject to these Acts routinely inform their stockholders of actual indemnification of insiders, it has thus far made little use of this power. Stockholders have, of course, other methods of getting information as to the activities of management, but probably none so effective as the disclosure process of the federal securities acts." G. WASHINGTON & J. BISHOP, *supra* note 3, at 243-44.

141. N.Y. BUS. CORP. LAW § 726(c) (1963). Georgia adopted this provision in its new indemnity section, though it followed the 1967 Delaware language in every other respect. GA. CODE ANN. § 22-717(h) (1968).

Model Statute

Indemnification of Corporate Personnel

(a) No provision made to indemnify a director, officer, employee or agent (and the heirs, executors or administrators of such person) of the corporation for expenditures connected with the defense of any civil, administrative or criminal action, suit or proceeding, or in connection with any appeal relating thereto, whether contained in the charter, the bylaws, a resolution of the stockholders or directors, a contract, an agreement, or otherwise, shall be valid unless consistent with this section.

(b) A corporation shall have the power to indemnify any person (and the heirs, executors or administrators of such person) who is made or is threatened to be made a party to any action, suit or proceeding, or to any appeal relating thereto, other than by or in the right of the corporation, whether civil, criminal or administrative, by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against judgments, fines, amounts paid in settlement, and expenses (including attorneys' fees) actually and reasonably incurred as a result of such action, suit, proceeding or appeal if such person acted in good faith for a purpose which he honestly believed to be in or not opposed to the best interest of the corporation, and, in any criminal action or proceeding, is determined to fairly and equitably merit indemnification. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, does not fairly and equitably merit indemnification.

(c) A corporation shall have the power to indemnify any person (and the heirs, executors or administrators of such person) who is made or is threatened to be made a party to any action or suit, or to any appeal relating thereto, by or in the right of the corporation to procure a judgment in its favor by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against judgments, fines, amounts paid in settlement, and expenses (including attorneys' fees) actually and reasonably incurred by him in connection with such action, suit, or appeal if he acted in good faith for a purpose which he honestly believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person has been adjudged to have breached his duty to the corporation unless and only to the extent that tbe court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which such court shall deem proper.

(d) To the extent that a director, officer, employee or agent of a corporation has been successful on the merits in defense of any action, suit or proceeding referred to in subsections (b) and (c), or in defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith. Where such a person is successful otherwise than on the merits, unless ordered by a court under subsection (f), he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith only if the board of directors or executive committee determines his conduct fairly and equitably merits indemnification.

(e) Except as provided in subsection (d), any indemnification under subsections (b) and (c), unless ordered by a court under subsection (f), shall be made by the corporation only as authorized in the specific case upon a determination that indemnification of the person is proper in the circumstances because he has met the applicable standard of conduct set forth in subsections (b) and (c). Such determination shall be made (1) by the board of directors or by the executive committee by a majority vote of a quorum consisting of directors or members of the executive committee who were not parties to such action, suit or proceeding, or (2) if such a quorum is not obtainable, by independent legal counsel in a written opinion, or (3) by the stockholders.

(f) Notwithstanding the failure of a corporation to provide indemnification, and despite any contrary resolution of the board or executive committee or of the stockholders in the specific case under subsections (d) and (e), indemnification may be awarded by a court to the extent authorized under subsections (b), (c) and (d). Application therefor may be made in every case, either:

(1) In the civil suit or proceeding in which the expenses were incurred or other amounts were paid, or

(2) To a court in a separate proceeding, in which case the application shall set forth the disposition of any previous application made to any court for the same or similar relief and also reasonable cause for the failure to make application for such relief in the suit or proceeding in which the expenses were incurred or other amounts were paid.

The application shall be made in such manner and form as may be required by the applicable rules of court or, in the absence thereof, by direction of a court to which it is made. Such application shall be upon notice to the corporation. The court may also direct that notice be given at the expense of the corporation to the stockholders and such other persons as it may designate and in such manner as it may require.

(g) Expenses, including attorneys' fees, incurred in defending any action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding as authorized in the subsection (e). When indemnification is sought by judicial action under subsection (f), the court may require advance payment of reasonable expenses, including attorneys' fees, during the pendancy of the litigation as are necessary in connection with the proceeding, if the court shall find that genuine issues of fact or law are or have been raised by the person seeking indemnification under subsection (f). In either case, before a person may receive advance payment, he must file with the secretary of the corporation a notarized written statement agreeing to repay such amounts, plus a reasonable amount of interest as determined by the board of directors or by the executive committee, if such person is ultimately found not to be entitled to indemnification, or if the expenses advanced exceed the indemnification to which he is entitled.

(h) A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section.

(i) If, under this section, any expenses or other amounts are paid by way of indemnification otherwise than by court order or action by the stockholders, the corporation shall, not later than the next annual meeting of stockholders unless such meeting is held within three months from the date of such payment, and in any event, within fifteen months from the date of such payment, send by first class mail to its stockholders of record at the time entitled to vote for the election of directors a statement specifying the persons paid, the amount paid, and the nature and status at the time of such payment of the litigation or threatened litigation.

		Majority of States (1953 Delaware Statute)	1967 Delaware Statute (Model Act)	1963 New York Statute	Drafted Proposed Statute
Exclusive		No	No	Yes	Yes
Non-Derivative-Derivative Distinction		No	Yes	Yes	Yes
Standard of Conduct Derivative		"Adjudged liable for negligence or misconduct in performance of duty."	Requires action to be in good faith and in best interest of corporation and no judgment of negligence or misconduct in the performance of his duty.	"Adjudged to have breached his duty to the corporation."	Requires action to be in good faith and in best interest of corporation and no judgment that he breached his duty to the corporation.
Standard of Conduct Non-Derivative		Same as Derivative for majority of states.	Requires action to be in good faith and in best interest of corporation and if a criminal action no cause to believe his conduct was unlawful.	Same as Standard of Conduct for 1967 Delaware statute.	Requires action to be in good faith and in best interest of corporation and if criminal action he fairly and equitably merits indemnity.
Mandatory Indemnification		No	Yes	Yes	Yes
Scope of Coverage		Limited to directors or officers of the corporation on a subsidiaries thereof. No provision for death or retirement.	Covers directors, officers, employees and agents of the corporation and subsidiary organizations thereof. Provides for death or retirement.	Limited to directors or officers of the corporation and subsidiary organizations. Provides for death or retirement.	Same as scope of coverage for 1967 Delaware statute.
Judicial Control		None in statute	Little control except in derivative suit where court may allow indemnity despite adjudication of liability.	Large control in that court may allow indemnity to any extent.	Same as 1963 New York judicial control.
Scope of Indemnity	Derivative Suits	"Expenses actually and necessarily incurred."	Expenses actually and reasonably incurred.	Reasonable expenses actually and necessarily incurred.	Same as Delaware non-derivative scope of indemnity.
	Non-Derivative Suits	Same as Derivative	Expenses, judgments, fines and amounts paid in settlement actually and reasonably incurred.	Judgments, fines, amounts paid in settlement and reasonable expense actually and necessarily incurred.	
Settlements	Derivative Suits	No provision	Recovery of settlement expenses only.	Recovery of settlement expenses only with court approval.	Recovery of amounts paid in settlement and expenses of settlement with court approval.
	Non-Derivative Suits		Recovery of amounts paid in settlement and expenses of settlement.	Same as non-derivative suits of Delaware (1967).	
Advance Payments		No	Yes	Yes	Yes
Liability Insurance		No	Yes	No	Yes
Notice to Stockholders		No	No	Yes	Yes