Reimbursement of Corporate Directors and Officers for Successful Defense of a Shareholder's Derivative Action

Corporations are guided by boards of directors. These directors may also be officers. Most directors and officers are chosen because they meet the high qualifications required of men who are to direct and plan the future of the corporate business. Some are chosen because their names add prestige to the corporation or enable the corporation to more easily obtain credit. Often, a director receives only nominal compensation for his services as a director, although he usually gets enough to cover the expenses of attending a directors' meeting.[1]

A shareholder in the corporation may suspect or believe that the director has injured the corporation by some dereliction of duty whether through fraud, negligence, abuse of discretion or similar wrong. He may then proceed to institute suit against the derelict director on behalf of the corporation. The shareholder may be sincere in bringing his suit, or on the other hand, he may be a disgruntled minority shareholder interested only in harassing the corporation. In more extreme cases he may be interested only in filing his suit in the hope of making a private settlement for whatever he can get.

The director now finds himself in the position of having to defend himself against the shareholder's suit. In many cases the damages alleged run into hundreds of thousands of dollars.[2] The director may be a man of wealth or he may be of modest means, as is usually the case in most corporations. Nevertheless, he is compelled, at no small cost, to engage counsel for his defense whether the suit is genuine, for harassment or in the hope of a private settlement. In the latter two cases the suit is almost always groundless.

Let us assume that the suit is genuine and that the shareholder has obtained a judgment against the director. Under the theory of derivative suits, the shareholder is acting in behalf of the corporation and anything he recovers inures to the benefit of

---

[1] $285. per year is an estimate of what the average director receives. N. Y. Times, Dec. 10, 1939, Section 3, p. 1, col. 8, quoting National Industrial Conference Board findings. If the director is also an officer, his compensation will be considerably higher. Assuming that today the amount is twice as much, the compensation is still negligible.

[2] As to the size of recovery and its percent of the amount sought in New York derivative actions see, Wood, *Survey and Report Regarding Stockholders' Derivative Suits* (1944), p. 79 et seq.

the corporation.[3] The shareholder now claims reimbursement from the corporation for his expenses, including attorneys' fees, and the courts almost invariably grant it. This is on the theory that the litigating shareholder represents all the shareholders as agent and that since the corporation is benefited, it would be unjustly enriched if it did not bear the cost of the benefit.[4] Both the representative and the benefit factors must be present. If the shareholder is unsuccessful, there is no benefit to the corporation and he cannot recover his expenses.[5]

Conversely, what about the director? Can he collect anything from the corporation for his expenses incurred in defending the suit even though he has lost? The courts have generally denied reimbursement for litigation expenses when the director has been unsuccessful.[6] This result seems to be based on the premise that corporate funds must be used for corporate purposes. When the stockholder has been successful, he is the party that has served a corporate purpose and can be reimbursed. The director, however, has served no corporate purpose and, in being found derelict, has in fact, acted adversely to the corporation.[7]

However, a director is not to be completely denied when unsuccessful. If corporate interests are sufficiently threatened, courts will charge the corporation with the expenses incurred in connec-

---

[3] Horton v. Johnston, 166 Ala. 317, 51 So. 992 (1910); Anderson v. Derrick, 26 P. 2d 463 (Cal. 1933), *Aff'd on rehearing*, 220 Cal. 770, 32 P. 2d 1078 (1934); Roscower v. Bizzell, 199 N.C. 656, 155 S.E. 558 (1930).

[4] Lamar v. Hall, 129 Fed. 79, 82 (5th Cir. 1904); Hand v. Savannah & Charleston R. R., 21 S.C. 162, 178-179 (1884); Buell v. Kanawha Lumber Corp., 201 Fed. 762, 767-769 (E.D.S.C. 1912). It is socially necessary that the shareholder be enabled to recover, otherwise the effect would be that he would be unable to police the corporate management because his recovery would seldom exceed his costs. Simpson, *Fifty Years of American Equity* 50 HARV. L. REV. 171, 190-191 (1936). Douglas, *Directors Who Do Not Direct* 47 HARV. L. REV. 1305, 1307, 1329-1334 (1934).

[5] In some cases, even though the shareholder brought the suit to a successful conclusion, the fact that there was no pecuniary benefit to the corporation may still prevent his recovery of expenses. McArthur v. John McArthur Co., 39 Cal. App. 704, 179 Pac. 700 (1919); Hildreth v. Western Realty Co., 62 N.D. 233, 242 N.W. 679 (1932).

[6] Neuberger v. Barrett, 180 Misc. 222, 39 N. Y. S. 2d 575 (1942); Wickersham v. Crittenden, 106 Cal. 329, 39 Pac. 603 (1895); see Washington, *Litigation Expenses of Corporate Directors in Stockholders Suits*, 40 COL. L. REV. 431, 433, *n.* 7 (1940).

[7] See Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, *Cf.* Solemine v. Hollander, 129 N. J. Eq. 264, 19 A. 2d 344 (1941).

tion with such defense.[8] But directors are not reimbursed, whether successful or unsuccessful, if the subject matter of the suit involves non-corporate matters, such as a criminal action against the director for improperly making tax returns.[9] Likewise, reimbursement has been denied when the director has been charged with misfeasance in office and the suit discontinued without formal exoneration of the director.[10] In these areas the judge-made law is fairly well settled. The real problem before the corporation and the courts today concerns the reimbursement of the director when he has successfully defended the suit and has been completely absolved of any dereliction in duty. Should he be reimbursed for the expenses of litigation?

There are only a few cases that have dealt with this phase of the problem. However, their analyses of the problem indicate that there is anything but certainty as to just what the proper view should be. Some cases hold that unless the successful defense results in a benefit to the corporation, the director cannot be reimbursed for his expenses incurred during the litigation.[11] A few hold that policy and the duty of the principal to indemnify his employee or agent for expenses arising from the proper performance of the duties of his employment dictate that he be reimbursed notwithstanding a lack of benefit to the corporation.[12] The former view, however, represents the weight of authority of those few cases which do permit reimbursement. However, many corporations and some states are not sympathetic with this view of the courts. As a result, they have attempted to obviate its effect by the use of corporate agreements and statutory provisions. These make it possible for the director, who successfully defends, to claim reimbursement from the corporation whether or not there is a benefit upon the corporation. Questions immediately arise. Which view is more constructive and harmonious with contem-

[8] Albrecht Maguire & Co. v. General Plastics, 256 App. Div. 134, 9 N. Y. S. 2d 415 (1939), *Aff'd*, 280 N. Y. 840, 21 N.E. 2d 887 (1939); Esposito v. Riverside Sand & Gravel Co., 287 Mass. 185, 191 N.E. 363 (1934) (receivership); Godley v. Crandall & G. Co., 181 App. Div. 75, 168 N. Y. Supp. 251 (1917), *affirmed without opinion in* 227 N. Y. 656, 126 N.E. 908 (1920) (receivership).

[9] Du Puy v. Crucible Steel Co., 288 Fed. 583 (W. D. Pa. 1923) (successful directors); Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922).

[10] Wood v. Noma Electric Corp., 96 N. Y. L. J. 1121, Col. 7 (1936) (officially unreported).

[11] Rogers v. Hill, 34 F. Supp. 358, (D.C. 1940); Griesse v. Lang, 37 Ohio App. 553 (1931). For a more complete list, see 152 A. L. R. 924.

[12] Solemine v. Hollander, 129 N. J. Eq. 264, 19 A. 2d 344 (1941), 26 MINN. L. REV. 119 (1941); Figge v. Bergenthal, 130 Wis. 594, 109 N.W. 581, 110 N.W. 798.

porary society? Is it proper that a director or officer should be indemnified when it is established that he has not betrayed his post?

PROPRIETY OF REIMBURSING THE SUCCESSFUL DIRECTOR

We commence with the basic proposition that a corporation is operated for profit. Therefore, gifts of the corporate assets should not be allowed.[13] This is one of the favorite arguments of those who condemn indemnity to the director. They say that the reimbursement is an outright gift of the shareholders' money and should not be permitted. But to dogmatically label these payments as gifts ignores entirely the view that reimbursement could, and should, be considered as a legitimate business expense of the corporation. The axiom that corporate expenses must be made in furtherance of the corporate business has been expanded in the modern cases.[14] There are cases upholding the power of the corporation to spend money for improving the health of its employees,[15] for supplying them with adequate housing,[16] and for furnishing housing facilities in the town in which the corporation operates.[17] Still others permit expenditures for inducing prospective employees to accept employment, for entertainment, for payment of moving and traveling expenses. One case went so far as to hold the corporation liable on its guarantee of an obligation of a salesman incurred in the purchase of furniture for his home.[18] The justification for such payments is clearly that the corporation, in order to acquire and retain the benefit of the services of qualified employees, may incur the expenses in question.[19] Can it be denied that the acquisition of qualified directors is not a benefit to the corporation? It is submitted that the reimbursement of the director who successfully defends a shareholders' derivative suit can be properly considered as an expense of the corporation. From another viewpoint, social policy dictates that highly qualified men direct our corporations. This is especially so when economic power is highly concentrated in the directors of a few of the large corporations of today. When these directors make decisions, it often has a greater effect upon our domestic and foreign affairs than

13 Brinkerhoff Zinc Co. v. Boyd, 192 Mo. 597, 91 S.W. 523 (1906).

14 40 COL. L. REV. 1199 (1940), citing Note 31 COL. L. REV. 136 (1931).

15 People *ex rel.* Metropolitan Life Ins. Co. v. Hotchkiss, 136 App. Div. 150, 120 N. Y. Supp. 649 (1909).

16 Steinway v. Steinway & Sons, 17 Misc. 43, 40 N. Y. Supp. 718 (1896).

17 *Cf.* Corning Glass Works v. Lucas, 37 F. 2d 798 (D. C. Cir. 1929); 40 COL. L. REV. 1192, 1193 (1940).

18 Burg v. Twin City Four Wheel Drive Co., 170 Minn. 101, 103, 167 N.W. 300 (1918).

19 40 COL. L. REV. 1192, 1200 (1940).

many of the decisions of our high government officials. And these directors are not responsive to the people. This is all the more reason why the public should at least be assured the best men possible.

There are many other equally cogent reasons for reimbursing the director who successfully defends a derivative suit. Indemnity to a successful director would perhaps discourage actions of the strike variety. The existence of a policy of indemnifying a successful director would encourage directors to press for trial those actions in which they were reasonably confident of prevailing, since success would vindicate them morally, as well as free them from the burden of the litigation expense.[20] The increased hazard to the director brought about by profuse administrative regulations is still another reason. An example is the Securities Exchange Act, Sec. 11. Under this provision the director may be sued and held liable for mere negligence. It seems that it would be just as easy to justify reimbursement to a director when he is not at fault as it is to uphold indemnity under Workmen's Compensation laws where the laborer is quite often found to be at fault. The risk can easily be placed on the business.[21]

Arguments have been advanced in opposition to the payment by the corporation of the successful directors' expenses. But generally they are quite shallow and can easily be disposed of. A strong contention is that if the corporation pays when the shareholder wins and also if the director is successful, then every time there is a derivative suit, the corporation is certain to have to pay. The claim is that this will be an undue burden on the shareholders' capital tending toward the ruination of the corporation. But it must be remembered that when the shareholder is successful the corporation usually benefits pecuniarily. On the other hand, when the director is successful the costs should be considered as a legitimate expense. Furthermore, although there are many derivative suits the number against any one corporation is not too great.

Then, an attempt is made to compare the director with other fiduciaries. It is often held that the agent cannot look to the principal for his litigation expenses when he is sued by the principal himself, even if the agent wins the suit.[22] And again, officers of

---

[20] *Id* at 1205.

[21] Wood, in his survey, suggests that the cost of the successful directors' attorneys, etc., should be placed on the unsuccessful shareholder bringing the suit. WOOD, SURVEY AND REPORT REGARDING SHAREHOLDERS' DERIVATIVE SUITS 20. This disregards the policy favoring derivative actions in that the shareholder would have more to lose than he could hope to gain.

[22] Cory Bros. & Co. Ltd. v. United States, 51 F. 2d 1010, 1013 (2d Cir. 1931). *Accord*: Buckley v. City of New York, 170 Misc. 412, 415, 10 N. Y. S. 2d 650 (1939).

municipal corporations are usually not allowed to be reimbursed for successful defense of a suit relating to the performance of their official duties.[23] But what about trustees and receivers? The trustee is entitled to charge the estate with the expense of repelling an attempt to subject him to a surcharge, or a proceeding for his removal, brought by a beneficiary. The same holds true for the receiver.[24] No definite rule is consistently applied where an executor or administrator is involved, although the tendency has been to permit an allowance for attorneys' fees incurred in making a successful defense of their conduct or position.[25] The answer to this argument is that possibly good policy demands that all these fiduciaries be indemnified when they are successful. But in the final analysis the answer is that the director's position is *sui generis*. Of all the fiduciaries, his post is the most hazardous and usually the least rewarded. He is accountable to a constantly shifting group; each day there may be new stockholders entitled under the law to call him to account, perhaps including some who have acquired their share with the sole purpose of bringing him to the bar of justice.[26]

It is submitted that these circumstances require that the director be treated differently. When he successfully defends a shareholders' derivative suit, indemnity, in good conscience, should not be denied.

Granting that a director should be reimbursed, how should it be provided for and by whom?

Reimbursement by Corporate Agreement

In order to avoid the judicial denial of relief to a director who has successfully defended, many corporations have attempted to guarantee their directors this protection by agreements. These agreements, in effect, say that the corporation will save the director from any expenses in connection with successful defense of a derivative action. The use of the agreement, however, is not free from its accompanying problems. The first problem to be raised is that of the validity of this type of agreement. It is commonly challenged on the ground that the act is ultra vires if the corpora-

[23] Chapman v. New York, 168 N. Y. 80, 61 N.E. 108 (1901). *And See* 5 McQuillin, Municipal Corporations § 2327 (2d ed. 1928); 6 McQuillin, Municipal Corporations §§ 2532 and 2583 (rev. ed. 1937). The requirement that public funds be used for a public purpose is the usual basis.

[24] 2 Scott, Trusts § 188.4 (1939); Jessup v. Smith, 223 N.Y. 203, 19 N. E. 403 (1918). Missouri & K. I. Ry. Co. v. Edson, 224 Fed. 79 (8th Cir. 1915) (receiver).

[25] See 3 Woerner, Amer. Law of Administration, § 515, ff. (3d ed. 1923); 90 A. L. R. 101 (1934); 101 A.L.R. 806 (1936).

[26] 40 Col. L. Rev. 431, 448 (1940), and cases cited.

tion is not a professional surety. But if we carry through the idea that these payments are expenses of the business then there is less reason to deny this being an incidental part of the business. Nevertheless, there is some doubt that courts will accept these payments as expenses of the business or that they will not deem them ultra vires acts.

Then too, there is some uncertainty surrounding these agreements relevant to their violation of public policy. The claim is often made that such agreements tend to induce the directors to act negligently or recklessly when they know that they can be reimbursed. But the agreements contended for, however, would reimburse the director only when he is successful. If he were sure of indemnity when he was wrong, this argument would have some force. These are substantive considerations. There are even more problems from the procedural standpoint. How and by whom is the corporate action to be taken? Should it be by action of the board, by by-law amendment, charter amendment, or by shareholder action?

If we permit the board of directors to take action on the matter and vote the reimbursement to directors we face the problem of the directors dealing with themselves. It is a general rule of law that corporate directors are precluded from increasing or voting compensation to themselves as directors or officers for either past or future services.[27] But all kinds of uncertainties arise when you try to speculate as to whether or not a court will consider reimbursement compensation. Likewise, it is not clear-cut as to how the courts will react to the matter of disinterestedness required of voting directors when all the directors had been successful parties defendant to the same action.

Authorizing the payment by by-law amendment or by charter amendment is about as clouded with doubt and uncertainty as is payment authorized by the directors. It is usually much easier to amend the by-laws than the charter. True, in both cases it must be submitted to the shareholders. But often it is more difficult to secure amendment to the charter than to by-laws because the shareholders usually use more caution in connection with the basic charter instrument. Most corporations that have heretofore authorized these agreements have done so through the by-law.[28]

[27] Chamberlain v. Chamberlain, Care & Boyce, Inc., 124 Misc. 480, 209 N. Y. Supp. 258 (1925), *Aff'd without opinion*, 216 App. Div. 787, 214 N. Y. Supp. 815 (1926) ; 40 COL. L. REV. 1192, 1201 (1940).

[28] Notes 10, 28 & 29, 40 COL. L. REV. 1192 (1940). The following is a typical example of a by-law amendment:

"In addition to reimbursement for his reasonable expenses incurred in attending meetings or otherwise in connection with his attention to the affairs

At this juncture it might be well to mention that most voting on these proposals is done by proxies which have been solicited by the corporation management. It might be well to weigh this factor in connection with the over-all consideration of using corporate agreements as a means for reimbursement.

Assuming that the by-law procedure will be used most often, are there any disadvantages in its use? One strong defect, and it is one that is common to any corporate attempt at reimbursement, is that when each corporation is left to its own desire, there is too much chance that their acts will be hasty and shaped by considerations not in the proper interest. Difficulty might also arise with regard to directors who are also shareholders. Can they vote in a shareholders' meeting upon a proposal to reimburse themselves? Although most of the courts have recognized that the director upon entering the shareholders' meetings has a freedom of action divorced of any fiduciary relation,[29] still there is an element of chance that a court might see otherwise. All of this weighs against the by-law method of reimbursement and in favor of a method more certain.

Finally, should the reimbursement be made through a vote of the shareholders? This procedure, it will be observed, has serious disadvantages. Such a method would be very expensive if a meeting had to be called each time. But an even more potent objection is that an inconsistent policy might well result; indemnity being granted in some cases, while denied in others, although the directors are equally deserving in each case.

In the event any one of the above procedures is utilized, there are still other difficulties and uncertainties that beset the use of the corporate agreement method of reimbursing the director. The

---

of the corporation, each Director as such, and as a member of any committee of the board, shall be entitled to receive such remuneration as may be fixed from time to time by the Board of Directors; provided, however, that the aggregate of such remuneration of any director as a director and as a member of any committee of the Board, shall not exceed during any one calendar year the sum of $5,000. Each Director and officer shall also be indemnified by the corporation against expenses reasonably incurred by him in connection with any action, suit, or proceeding to which he may be made a party by reason of his being or having been a Director or officer of the corporation, except in relation to matters as to which he shall be finally adjudged in such action, suit, or proceeding to have been derelict in the performance of his duty as such Director or officer; and the foregoing right of indemnification shall not be exclusive of other rights to which he may be entitled as a matter of law." Proxy statement of Johns-Manville corporation dated March 2, 1940.

[29] Gambel v. Queens County Water Co. 123 N. Y. 91, 25 N.E. 201 (1890); Thurmond v. Paragon Colliery Co., 82 W. Va. 49, 95 S.E. 816 (1918); Latten, *The Minority Stockholder and Intra-Corporate Conflict* 17 IOWA L. REV. 313, 331-2 (1934).

actual drafting of the agreement must be done with care. There must be excluded from its scope any pending litigation, to the extent of that portion of the litigation expenses incurred prior to the adoption of the by-law. To include these pre-existing charges would invite an attack based upon the principle that the directors' past services having been compensated, the attempt to pay additional compensation would be a prohibited gift.[30] If courts would hold that these payments are expenses and not compensation, then the result might be different.

Also to be considered in drawing up the agreement is the amount of reimbursement and for what items. A standard of reasonable expenses is often used in corporate agreements. This is a fair standard because it preserves the element of discretion that is needed in some cases with respect to this factor. But one can easily see that if the items and amount are left to each corporation, an infinite number of variations are possible depending on the views of the particular corporation.

These are but a few of the difficulties that can be encountered if this problem is to be solved through the efforts of the individual corporations. Difficulties and uncertainties such as these have led the General Counsel's office of the Securities Exchange Commission to question the validity of these agreements.[31] The commission supervises the issuance of proxies by corporations having securities listed on a national securities exchange. In spite of its doubt as to legality, the commission has permitted the inclusion of these agreements in proxy statements if they follow a certain form.[32]

In Ohio, corporate agreements are used by corporations. Each corporation prepares its agreements as it sees fit and consequently there are many different types. There are no Ohio cases touching upon the validity of these corporate agreements. The only Ohio case dealing with this problem of reimbursement held that there must be a benefit upon the corporation or that the payment must

---

[30] 40 COL. L. REV. 1192, 1203 (1940); *Cf.* Young v. U. S. Mortgage & Trust Co., 214 N. Y. 279, 108 N.E. 418 (1915).

[31] 40 COL. L. REV. 1192, 1206 (1940).

[32] General Counsel's office has interposed no objection to the following: "Each director and officer (and his heirs, executors and administrators) shall be indemnified by the corporation against reasonable expenses incurred by him in connection with any action, suit or proceeding to which he may be made a party by reason of his being or having been a director or officer of the corporation, except in relation to matters as to which he shall finally be adjudged in such action, suit or proceeding to have been derelict in the performance of his duty as such director or officer; and the foregoing right of indemnification shall not be exclusive of other rights to which he may be entitled as a matter of law." *The S. E. C. and Directors' Indemnity: Recent Developments,* 40 COL. L. REV. 1206, 1207 (1940).

be authorized by the shareholders.[33] This seems to be broad enough to cover corporate agreements. However, it is too sweeping to effect a standard policy. The foregoing analysis now forces the conclusion that if we permit each corporation to provide for reimbursing its directors by agreement, the results will be unfavorable. Assuming that reimbursement is good policy, we find many corporations making no provisions whatever; many do adopt agreements but they are a hodge-podge, having no trace of standardization and all are subject to the defects and uncertainties considered above. It is submitted that this whole problem can perhaps best be solved by the legislature. But here again the path must be carefully trod because there have been enactments in this area in other states which have failed to measure up to expectations in the effectuation of the desired policy. We shall now consider, along with desired provisions, some of the missteps that should be avoided in solving the problem by statute.[34]

Reimbursement by Statute

Some of our states have become conscious of the uncertainty and doubts that emanate from reliance on corporate authority, by-law or charter provision for reimbursement. Accordingly, in order to dispel this uncertainty and establish a standard policy, they have enacted statutes that afford remedies in this situation. California,[35] Kentucky,[36] New York,[37] and Wisconsin[38] are included in those states which have taken this salutary step. But the enactments vary as to execution of the policy and in some cases leave much to be desired.

In the first place the statute should afford an exclusive remedy. It should not be merely an enabling act authorizing corporate agreements. It should make ineffective any by-law, charter provisions or case law on the subject. It should also apply to directors and officers of the corporation and at the same time to foreign as well as domestic corporations. Whether or not a man is an officer or director should make no difference in the light of the over-all policy needed and desired. Likewise, the soundness of the policy can best be promoted by making it applicable to all corporations. Furthermore, this constructive policy would be given more vitality if it were not restricted to shareholders' derivative suits. Even

[33] Griesse v. Lang, 37 Ohio App. 553, 175 N.E. 222 (1931).

[34] For a further discussion of the corporate agreement method of reimbursement see Bates & Zuckert, *Directors' Indemnity; Corporate Policy or Public Policy?*, 20 Harv. Bus. Rev. 244 1942).

[35] Cal. Stat., c. 934 (1943); Cal. Civ. Code § 375.

[36] Ky. Acts, c. 40, § 1 (1942); Ky. Rev. Stats. §§ 271 and 245 (1942).

[37] N. Y. Gen. Corp. Law, Sec. 27a, L. 1941, c. 209.

[38] Wis. Stat., c. 182, § 182.01 (9a) (1949).

though this discussion has been made with a derivative suit setting, it should be recognized that this type proceeding is not the only one confronting the director. The statutory remedy should apply not only to shareholders' derivative suits, but also to actions by the corporation, by a receivor or trustee of a corporation, by creditors, by any governmental body or by any person or corporation. This would place no limitation upon the class of complainants or the kind of proceedings to which indemnity applies. There seems to be no reason why indemnity should be confined to one type of proceeding.[39]

As was stated earlier, of the few courts which do permit reimbursement, the greater number require that a benefit be bestowed upon the corporation before reimbursement will be allowed the successful director. Any statute on this subject should anticipate this interpretation and make the language unambiguous by permitting indemnity notwithstanding any lack of benefit upon the corporation.

Then too, some extant enactments on the subject have been brought to test because they were made applicable to pending litigation. Generally, however, it has been held that such retrospective or retroactive legislation is not invalid.[40] Even though these provisions might be made severable if invalid, it might be wiser to make the act entirely prospective and thus avoid any difficulties attending retroactive legislation.

This type statute also has been questioned as to its constitutionality under the equal protection clause of the Fourteenth Amendment. Several legal writers have noted the possibility that a statute does discriminate against corporations when it directs that a corporation, which unsuccessfully sues its fiduciaries, must pay, not only court "costs," but also actual expenses, whereas an individual who unsuccessfully institutes a suit against his agent is penalized only the usual statutory costs (which bear no reference to actual expenses).[41] Possibly, corporations can be reasonably classed for this purpose.

It should also be considered that a fair act should have reciprocity in favor of the corporation. When the director or officer is adjudged guilty of breach of trust he should be made to reim-

---

[39] Ballantine, *California's 1943 Statute as to Directors' Litigation Expenses: An Exclusive Remedy for Indemnification of Directors, Officers and Employees,* 31 CALIF L. REV. 515, 517 (1943).

[40] Application of Bailey, 178 Misc. 1045, 37 N. Y. S. 2d 275, 279, 281 (1942); Ann., *Validity of Retrospective Legislation Awarding Attorneys' Fees* (1934) 90 A. L. R. 530, 537.

[41] Hornstein, *Directors' Expenses in Stockholders' Suits,* 43 COL. L. Rev. 301, 309 (1943).

burse the corporation for its cost in obtaining redress. This cost not infrequently amounts to almost as much as the recovery.

The heart of a statute on this subject is the reimbursement itself. Who should determine the directors' expenses and attorneys' fees? How much should they be, and for what? What should be the procedure for awarding compensation to counsel for defendant directors? The statutes have varied on this provision and in some cases the results have been unsatisfactory. No statute should provide that a director or officer will be mandatorily reimbursed, unless adjudged liable for "actual negligence or misconduct" in the performance of his duties. This is too broad. It permits the director to obtain indemnity when he escapes liability on grounds other than freedom from negligence or misconduct, such as procedural defects, Statutes of Limitations, dismissal or delay in suit. The defendant director should be found innocent on the merits before he should be entitled to any indemnity as a matter of right.

Also connected with the problem of reimbursement is the related problem of who should decide when it should be given, and how much. Any statute that leaves these questions to the discretion of the board of directors or to the shareholders has not attained the maximum degree of fairness that is possible. Provisions inserted to guarantee impartial voting by directors or stockholders are utterly impractical and cannot be enforced.[42] Then too, quite often, the directors and stockholders do not possess the essential factors of first-hand knowledge of services actually rendered in order to determine the amount that should be awarded counsel for a director.

It is submitted that the proper party to resolve the questions relevant to indemnity is the court that tries the suit. The judge is in a position fairly to determine the merits of the cause and the value of the attorneys' services rendered therein. More often than not, the association of the members of a board of directors with a fellow director is too intimate to permit an unbiased consideration of his claim for reimbursement, even where the board is possessed of the facts necessary to a just decision.[43] The judge should have the discretion to withhold indemnity should he determine that the conduct of the party is such as not to fairly and equitably merit such indemnity. In this manner, a director might still receive indemnity should a suit be dismissed before it has gone to trial on the merits. This method of using the court to determine the value of legal services in a case before it has been utilized in other proceedings. It has been used in suits for violations of the Copy-

[42] Ballantine, *supra* note 39, at 529.

[43] Comment, *Right to Attorneys' Fees in Shareholders' Derivative Suits*, 30 CALIF. L. REV. 667, 675 (1942).

right Law[44] or the Securities Act of 1933,[45] and under the Bankruptcy Act.[46]

Having placed the duty of awarding compensation upon the court, there remains the matter of procedure. It would seem to save time and cost if application to the court for compensation were made in the suit against the director, preferably before judgment for the director. The application should be filed by the attorney defending the director. His compensation could then be made a part of the judgment. The judge is generally in a position to have first hand knowledge of the services that have been rendered in the proceeding before him. Coupled with this application for compensation there should be notice served upon the corporation or its representative and upon the plaintiff and other parties in the action or proceeding. Determining the amount of compensation is often difficult since the court does not have any amount of recovery to rely on when the director is successful. Applications for reimbursement would require close supervision by the court since counsel for the corporation may not be too disposed to keep down reimbursement to an attorney for a director who passes upon the continuance of the employment of the corporation counsel.

Another major concern in drafting the statute herein contemplated relates to the possibility that the director may be successful only in part, or perhaps voluntarily settles the case. Not infrequently, due to forms of pleading, the director is able to be partially successful in his defense. It would seem that the ideal statute would authorize indemnity for partial success but leave it entirely to the discretion of the judge sitting at the trial. Compensation should always be reasonable and if, upon the equities, the judge finds that the partially successful director should be compensated, he should be free to do so.

The question becomes more involved with respect to a voluntary settlement by the director. It is possible to rely entirely upon the discretion of the judge and permit indemnity if the settlement is made before a court. However, it seems rather inconsistent to allow a party to voluntarily settle a claim against himself and then, in turn, seek reimbursement from the party to whom he paid the settlement.

These provisions here touched upon are by no means exhaustive. They are intended to point up that even though the statute is the proper method for dealing with this problem, it too may precipitate the evils, doubts, and uncertainties, that we found frequently accompany indemnity methods discussed earlier. It is obvious

[44] 35 STAT. 1084 (1909), 17 U. S. C. § 40 (1941).
[45] 48 STAT. 907 (1934), as amended, 15 U. S. C. § 77 k (e) (1941).
[46] 52 STAT. 900-901 (1938), 11 U. S. C. §§ 641-643, 647, 650 (1941).

that the maximum effectuation of the desired policy with a reasonable degree of fairness will only be obtained after careful study of the deficiencies of the methods of attempted correction. The knowledge thus obtained must be skillfully transmuted into a statute approaching the pinnacle of drafting finesse if that policy is to materialize as an enactment beneficial to society.

SUMMARY

The advent of the corporation on the economic horizon to, in many cases, positions of great power has revolutionized our economic structure to such an extent that each individual is intimately affected by their decisions, policies and activities. An increase in the power of the corporation means an increase in the responsibilities of the directors and officers who direct and manage them. We must keep pace with these advances, and, as long as they do affect our lives we should not hesitate to make certain that they are in the hands of our most capable men, men who are conscious of their trust and who will not jeopardize the welfare of society as a whole for the sake of the selfish interests of a few. One step or aid to the procurement of these high caliber men is the creation of safeguards around the periphery of directorship or management. Remove those barriers that prompt many able men to shy away. Today, the increasing possibility of being forced to defend a derivative action with its attendant cost is a thorn that penetrates to the very core. A guarantee of reimbursement will aid in dispelling these fears and attract the qualities of leadership the offices demand.

We have seen that the guarantee of reimbursement is too uncertain and haphazard if left to the caprice of the individual corporations. Likewise, the courts have seemingly failed to recognize the need as it exists today. Corporation agreements are a step in the right direction but they lack standardization and fail to solve the problem in many cases.

In the final analysis, the problem should be left to the wisdom of the legislatures if uniformity is to be obtained. They are in the best position to promote the best interests of society. California's legislative body has accepted the challenge and come forth with what would appear to be one of the finest acts on this subject.[47]

Corporate agreements are utilized in Ohio. One Ohio case[48] indicates the court view on the matter. Ohio has no statute on directors' reimbursement. It is suggested that the Ohio General Assembly would be doing the populace of the state and nation a service were it to consider and act upon the question of reimbursing directors and officers for successful defense of a derivative suit.

Cornelius W. Dillon

[47] Note 35, *supra.*

[48] Note 33, *supra.*