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Corporations--Adverse Judgment Not Required to Deny Director Reimbursement for Litigation Expenses (Diamond v. Diamond, 307 N.Y. 263 (1954))

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one case,²⁷ the court went so far as to hold the bank liable to the beneficiary of trust funds deposited with it, merely because the bank was found to have had constructive knowledge of misappropriation by the wife of the trustee. Moreover, the banks themselves consider that they have a greater responsibility to protect their depositors than do other business concerns, particularly where, as in the principal case, the depositor is also a borrower from the bank.²⁸ This may result from a recognition of the bank's special status, which has been described as semi-public²⁹ or quasi-public,³⁰ and affected with a public interest.³¹

Perhaps some of the difficulty involved in determining whether an action against a bank is in contract or in tort has been due to an inability to categorize or name the action. Regardless of the label,³² however, it appears that the gravamen of such an action is a breach of a duty of care imposed by the banker-depositor relationship. Therefore, the conclusion reached by the minority, that a good cause of action in tort could here be pleaded, seems to be the correct one.



CORPORATIONS — ADVERSE JUDGMENT NOT REQUIRED TO DENY DIRECTOR REIMBURSEMENT FOR LITIGATION EXPENSES. — A stockholder's derivative action was brought by one of the two stockholders of a corporation against the other, as director, for corporate misconduct. The complaint was dismissed on a finding that the plaintiff participated in and ratified the misconduct of the defendant. On mo-

399 (1891); *Commisso v. National City Bank*, 174 Misc. 409, 413, 21 N.Y.S.2d 187, 191 (Sup. Ct. 1939), *aff'd mem.*, 259 App. Div. 891, 20 N.Y.S.2d 1007 (2d Dep't), *motion for leave to appeal denied*, 284 N.Y. 817, 29 N.E.2d 396 (1940).

²⁷ *Lee v. Corn Exchange Bank Trust Co.*, 270 App. Div. 2, 58 N.Y.S.2d 290 (2d Dep't 1945), *aff'd mem.*, 295 N.Y. 945, 68 N.E.2d 43 (1946).

²⁸ See CHAPIN, CREDIT AND COLLECTION PRINCIPLES AND PRACTICE 282-284 (5th ed. 1947) (This is evident from the banking practice of attempting to restrict the dissemination of credit information; credit men from mercantile houses, on the other hand, are much less reserved in dispensing credit information regarding those with whom they do business.).

²⁹ *Id.* at 283.

³⁰ See, e.g., *German Baptist Orphans' Home v. Union Banking Co.*, 13 F. Supp. 814, 816 (W.D. Mich. 1935); *Citizens' Bank & Trust Co. v. Mabry*, 102 Fla. 1084, 136 So. 714, 716 (1931); *Priest v. Whitney Loan & Trust Co.*, 219 Iowa 1281, 261 N.W. 374, 377 (1935).

³¹ See, e.g., *In re Thornton*, 7 F. Supp. 613, 614 (D. Colo. 1934); *Dyer v. Broadway Central Bank*, 225 App. Div. 366, 367, 233 N.Y. Supp. 96, 97 (1st Dep't 1929), *rev'd on other grounds*, 252 N.Y. 430, 169 N.E. 635 (1930); *Hoff v. First State Bank*, 174 Minn. 36, 218 N.W. 238, 241 (1928).

³² "There is no necessity whatever that a tort must have a name." PROSSER, TORTS 4-5 (1941).

tion for assessment of expenses against the corporation, pursuant to Section 64 of the General Corporation Law, the trial court awarded the defendant \$30,000. The Appellate Division affirmed. The Court of Appeals reversed the allowance for expenses and *held* that it was not necessary that a judgment be rendered against the defendant before the court could properly refuse litigation expenses. *Diamond v. Diamond*, 307 N.Y. 263, 120 N.E.2d 819 (1954).

At common law, a successful plaintiff in a corporate action or stockholder's derivative action was usually entitled to recover reasonable counsel fees and expenses,¹ the amount of which was computed by the trial judge. A rule developed whereby the judge would look to the benefit derived by the corporation as a result of the action and determine the recovery accordingly.² If the corporation received no benefit from the action the courts would refuse to grant expenses.³ On the other hand, if the corporation received a large pecuniary judgment,⁴ or if it was saved from a substantial loss,⁵ then the court would be liberal in assessing the allowance. This rule became known as the "benefit" rule.⁶

The same reasoning was applied to the allowance of counsel fees and expenses to directors who successfully defended an action in a derivative suit. In *New York Dock Co. v. McCollum*,⁷ in which former Court of Appeals Judge Leonard Crouch acted as official referee, it was held that successful defendant-directors were not entitled to reimbursement for expenses on the ground that the corporation had received no benefit from the defense. The referee admitted the

¹ See *Bysheim v. Miranda*, 45 N.Y.S.2d 473, 475 (Sup. Ct. 1943); see 1945 LEG. DOC. NO. 65(E), REPORT, N.Y. LAW REVISION COMMISSION 131, 140-141 (1945).

² *Hutchinson Box Board & Paper Co. v. Van Horn*, 299 Fed. 424 (8th Cir. 1924); *Murphy v. North American Light & Power Co.*, 33 F. Supp. 567 (S.D. N.Y. 1940); *Neuberger v. Barrett*, 180 Misc. 222, 39 N.Y.S.2d 575 (Sup. Ct. 1942). Some courts require that the benefit to the corporation result in a "fund" from which an allocation of expenses can be made. This is a too limited view. See *Bysheim v. Miranda*, *supra* note 1; *Neuberger v. Barrett*, *supra*.

³ *Bank of America Nat. Trust & Savings Ass'n v. West End Chemical Co.*, 37 Cal. App.2d 685, 100 P.2d 318 (1940) (action for declaratory relief); *Hildreth v. Western Realty Co.*, 62 N.D. 233, 242 N.W. 679 (1932).

⁴ See, e.g., *Winkelman v. General Motors Corp.*, 48 F. Supp. 504, 514 (S.D. N.Y. 1942), *aff'd sub nom. Singer v. General Motors Corp.*, 136 F.2d 905 (2d Cir. 1943) (Attorneys' fees totalled over one-half million dollars in a case where the corporation benefited by a \$4,500,000 cash settlement.); *Neuberger v. Barrett*, *supra* note 2 (Corporation received a settlement of \$653,744 and the court awarded the plaintiffs \$200,000.).

⁵ See, e.g., *Bysheim v. Miranda*, *supra* note 1 (The corporation was required to pay \$500,000 in a settlement for a claim of \$2,300,000. The court allowed expenses to the plaintiffs inasmuch as the corporation received a substantial benefit.); see also Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COL. L. REV. 784, 799 n.100 (1939).

⁶ See Legis., 20 ST. JOHN'S L. REV. 67 (1945).

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

harshness of such a position but could think of no case wherein the corporation could be benefited by such a defense. Other jurisdictions refused to follow this reasoning.⁸

It is not difficult to appreciate the injustice and evils resulting from such a decision. The directors, because of the lack of personal funds, were denied adequate counsel in defending such actions.⁹ Fear of personal liability in defending costly actions discouraged capable individuals from becoming directors.¹⁰

As a result of the *McCullum* case, the legislature enacted provisions authorizing reimbursement of litigation expenses for directors. Two separate provisions were enacted.¹¹ Section 27-a of the General Corporation Law authorized indemnity by contract embodied in the certificate of incorporation, the by-laws or by resolution, the only limitation being that the directors have not been adjudged liable for negligence or misconduct. Section 61-a of the same law did not require any such express contract right; rather it permitted a successful defendant-director to petition the courts directly for the awarding of "special costs," the qualification here being that he be "successful in whole or in part." If it had been the intention of the legislature to completely abolish the "benefit" theory it was not entirely successful. Courts still applied it in matters concerning settlements.¹²

In 1945, the Law Revision Commission re-appraised these two sections, pointed out inconsistencies and made recommendations to clarify and expand the previous provisions.¹³ In the same year, the legislature followed the recommendations of the Commission; it amended and renumbered Section 27-a, repealed Section 61-a and enacted Sections 63-68 of the General Corporation Law.¹⁴ It was under these sections that the old common-law "benefit" rule received its death blow,¹⁵ as Section 67 specifically provided for settlements.

The courts thereafter abandoned the "benefit" rule and interpreted the laws as requiring a mandatory allocation to successful defendants, with but one exception, *i.e.*, that the directors not be adjudged negligent or guilty of misconduct.

In *Dornan v. Humphrey*,¹⁶ the stockholder's action was dismissed on a plea of statute of limitations. The trial court refused

⁸ *Solimine v. Hollander*, 129 N.J. Eq. 264, 19 A.2d 344 (Ch. 1941). See PRASHKER, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 804 (2d ed. 1949).

⁹ See *Solimine v. Hollander*, *supra* note 8, 19 A.2d at 348.

¹⁰ *Ibid.*

¹¹ Laws of N.Y. 1941, c. 209; Laws of N.Y. 1941, c. 350, § 1.

¹² See, *e.g.*, *Neuberger v. Barrett*, 180 Misc. 222, 227-228, 39 N.Y.S.2d 575, 580 (Sup. Ct. 1942).

¹³ See 1945 LEG. DOC. NO. 65(E), REPORT, N.Y. LAW REVISION COMMISSION 131 (1945).

¹⁴ Laws of N.Y. 1945, c. 869, §§ 1, 2, 4.

¹⁵ See *Legis.*, 20 ST. JOHN'S L. REV. 67, 69 (1945).

¹⁶ 100 N.Y.S.2d 684 (Sup. Ct. 1950).

to grant expenses on the ground that there had been no trial of the issues. The Appellate Division reversed,¹⁷ holding that the defendant was successful, and, as the case did not come under the above noted exception, recovery was mandatory. Similarly, the court in *Tichner v. Andrews*¹⁸ held that the directors were entitled to recover expenses in an action which was dismissed because of the failure of the plaintiff to post security under Section 61-b of the General Corporation Law.

The Court of Appeals has expressed reluctance to give this mandatory rule a liberal interpretation, declaring that because the statute is in derogation of the common law it must be strictly construed. This attitude was first expressed in the case of *Matter of Schwarz v. General Aniline & Film Corp.*¹⁹ wherein a defendant-director sought reimbursement from the corporation after pleading *nolo contendere* to a charge of violating the anti-trust laws. The lower courts refused to allow any recovery in this action on the basis that such a plea constituted a sufficient adjudication of misconduct and was therefore within the exception.²⁰ The Court of Appeals affirmed but on other grounds. Rather than apply the exception the court looked at the legislative intent, and held that the section was never intended to encompass criminal actions.

The instant case presented a similar problem. The lower courts felt compelled to allow the defendant to recover as there was no question that the action was "successful" within the meaning of Section 67;²¹ nor was the defendant "adjudged" guilty of misconduct.²² The Court of Appeals, however, as in the *Schwarz* case, looked to the legislative intent and, by applying a strict interpretation to the use of the word "adjudged," determined that the statute did not require a judgment to be rendered against the defendant.²³

It is to be noted that the holding in the instant case is in no way in conflict with prior decisions. There are no new exceptions created to the mandatory rule nor are there new restrictions imposed. The decision does, however, broaden the scope of the recognized exception.

¹⁷ 278 App. Div. 1010, 106 N.Y.S.2d 142 (4th Dep't 1951), *modified*, 279 App. Div. 1040, 112 N.Y.S.2d 585 (4th Dep't 1952).

¹⁸ 193 Misc. 1050, 85 N.Y.S.2d 760 (Sup. Ct. 1949).

¹⁹ 305 N.Y. 395, 113 N.E.2d 533 (1953), 28 ST. JOHN'S L. REV. 115.

²⁰ 198 Misc. 1046, 102 N.Y.S.2d 325 (Sup. Ct. 1951), *aff'd mem.*, 279 App. Div. 996, 112 N.Y.S.2d 146 (1st Dep't 1952).

²¹ In *Dornan v. Humphrey*, the court construed the word "successful," as used in Section 67, as not requiring the defendants to be exonerated of claims of negligence or misconduct; rather, the test was whether or not a judgment was rendered in his favor, either by a trial of the issues or by a dismissal of the complaint. 278 App. Div. 1010, 106 N.Y.S.2d 142 (4th Dep't 1951), *modified*, 279 App. Div. 1040, 112 N.Y.S.2d 585 (4th Dep't 1952).

²² *Diamond v. Diamond*, 200 Misc. 1074, 108 N.Y.S.2d 864 (Sup. Ct. 1951), *aff'd mem.*, 281 App. Div. 1015, 121 N.Y.S.2d 280 (1st Dep't 1953).

²³ *Diamond v. Diamond*, 307 N.Y. 263, 120 N.E.2d 819 (1954).

In this case the extension was unquestionably justified. The basis for this decision may be best determined by the language used by the Court, when it states "[s]o unconscionable a result, so unfortunate a preference of one wrongdoer over another, should not be countenanced if there be any escape therefrom."²⁴ The Court, with this in mind, seized upon the word "adjudged," and, by strict construction, held that the defendant was sufficiently adjudged a wrongdoer.

The instant case points out the inadequacy of the existing statute. There is no question that the defendant-director should not have been entitled to litigation expenses, but it was only through a strained interpretation that the court could arrive at a just result. While the decision might be regarded by some as a wedge in the door of the "mandatory" rule, the statute will continue to work an injustice in a great many cases. It seems most unjust that an erring director should be entitled to expenses from the corporation which he has harmed, merely because a stockholder fails to meet the requirements of Section 61-b of the General Corporation Law, or because the statute of limitations has run.

Legislation should be enacted providing that the court be empowered to inquire into the facts, and where it is clear that such directors have been guilty of misconduct, that they be precluded from recovering counsel fees. The California statute²⁵ might well serve as a model for such legislation. Care should be taken, however, not to make the rule so stringent that the evils existing under the "benefit" rule would once more return.²⁶



CORPORATIONS — REMOVAL OF DIRECTORS AS INHERENT RIGHT OF STOCKHOLDERS.—A proceeding under Article 78 of the New York Civil Practice Act was brought for an order in the nature of mandamus¹ to compel the defendant, president of a corporation, to call a stockholders' meeting. Among other reasons, petitioners sought the meeting to enable the shareholders to vote upon a proposal to hear charges against some of the directors and, if cause were shown,

²⁴ *Id.* at 266, 120 N.E.2d at 820.

²⁵ CAL. CORP. CODE § 830 (Deering, 1953). This Section provides that in addition to being successful in whole or in part, the court must find that his conduct fairly and equitably merits such indemnity.

²⁶ See notes 9 and 10 *supra*.

¹ New York, in 1937, abolished the proceeding of mandamus. See PRASHKER, *NEW YORK PRACTICE* 825 (3d ed. 1954). Today, an action which would have been brought by this proceeding is governed by Article 78 of the New York Civil Practice Act.