Rights of Defendant Directors, Officers and Employees to Reimbursement for Defense of Stockholders' Derivative Action

Gerald Reff
from the indemnitor's liability insurer. The reasoning of *La Gumina v. Citizens Casualty Co.*,\(^\text{16}\) and of the New York cases construing former Section 109, would lead to the conclusion that the indemnity creditor would be denied recourse against the indemnity debtor's liability insurer.

Thus it is seen that since the less restrictive phrasing of Section 167 did not lead to less restrictive interpretation, there was a need for a more specific statutory amendment. Subsection seven gives to the assignee, the contribution creditor, and the indemnitee creditor the same right of action as is given to the injured party or his personal representative.

KENNETH FOX.

**Rights of Defendant Directors, Officers and Employees to Reimbursement for Defense of Stockholders' Derivative Action.**—The New York Legislature at its last session enacted Article 6a of the General Corporation Law.\(^\text{1}\) The primary purpose of this article is an attempt to eliminate the "benefit rule" as established by the courts in declaring the common law and in interpreting former Section 61a of the General Corporation Law.\(^\text{2}\)

At common law, the court, in *New York Dock Co., Inc. v. McCollum*,\(^\text{3}\) required a defendant director to show that some direct benefit had accrued to the corporation before he would be allowed reimbursement for his successful defense of a stockholders' derivative action. However, that this was paradoxical\(^\text{4}\) was apparent and even recognized by the *McCollum* case which established the "benefit rule", since it is obvious that a corporation stands to gain only if the plaintiff stockholder is successful.

Soon after the *McCollum* case, and probably as a result, the legislature enacted former Section 61a of the General Corporation Law, presumably to remedy the effect of the *McCollum* case. However, in subsequently interpreting the two main divisions of Section

---

\(^{16}\) *Supra* note 11.

\(^{1}\) N. Y. Laws 1945, c. 869, effective April 1945.

\(^{2}\) N. Y. Laws 1941, c. 350, §1, effective April 1941, repealed L. 1945, c. 869, §2.


In this case, former Court of Appeals Judge Crouch, sitting as official referee, concluded that there is no legal or equitable right to reimbursement for a director's successful defense of a stockholders' derivative action except where a director can show that: "in conducting his own defense successfully, he has conserved some substantial interest of the corporation which otherwise might not have been conserved or has brought some definite benefit to the corporation which otherwise might have been missed"; Bailey v. Bush Terminal, 293 N. Y. 735, 56 N. E. (2d) 739 (1944). *Contra:* Solimine v. Hollander *et al.*, 129 N. J. Eq. 264, 19A (2d) 344 (1941).

\(^{4}\) In the words of former Court of Appeals Judge Crouch: "Just how such a state of facts can come about, however, is not very clear to the referee."
61a, the courts seemed to frustrate the apparent intent of the legislature. The first division of the statute was construed as giving the defendant a strict and absolute right to reimbursement, while retaining in the second part the “benefit rule” by construing it as leaving the question of reimbursement to the discretion of the courts. The latter decided that reimbursement should not be allowed unless a direct benefit accrued to the corporation. Thus, despite the use of the word “shall” in both portions of the statute, the courts, by their construction of the second half, as giving them discretion in granting the allowance, make the usually mandatory word “shall” come to mean “must” in the first part, and “may” in the second. This was the state of the law until Article 6a of the General Corporation Law was enacted by the last session of the legislature.

This new article declared: “any person made a party to any action, suit, or proceeding by reason of the fact that he, his testator or intestate, is or was a director, officer, or employee of a corporation shall be entitled to have his reasonable expenses . . . assessed against the corporation . . . upon court order . . .” and states that pay-

---

5 “In any action, suit, or proceeding against one or more officers or directors . . . of a corporation . . . the reasonable expenses, including attorney’s fees . . . incurred in connection with the successful prosecution or defense of such action, suit, or proceeding shall be assessed upon the corporation . . .”


7 “If the party or parties shall be successful in part only, or if such action, suit, or proceeding shall be settled with the approval of the court . . . the reasonable expenses, including attorney’s fee . . . shall be assessed upon the corporation in such amount as such court shall determine and find to be reasonable in the circumstances.”

8 Drivas v. Lekas, 182 Misc. 567, 48 N. Y. S. (2d) 785 (Sup. Ct. 1944); Neuberger v. Barrett, 180 Misc. 222, 39 N. Y. S. (2d) 575 (Sup. Ct. 1942), cited supra note 6. In this case, the court held: “The Legislature in enacting Section 61a made a distinction between ‘successful prosecution or defense’ of a derivative stockholders’ suit, and a settlement of such suits. In the former, it apparently wished to make certain that the conclusion reached in the McCollum case was changed, and therefore it decided that reasonable expenses be paid where the directors have been judicially exonerated from liability. But with respect to a settlement, the provision of the statute is that the expenses ‘shall be assessed upon the corporation in such amount as such court shall determine and find to be reasonable in the circumstances . . . .’” (Italics by court.) “The differences between the two cases . . . make it discretionary with the court as to whether any counsel fees shall be granted in the case of a settlement . . . .” Since, in this case, the defendant had brought no benefit to the corporation, the court could find nothing upon which to exercise discretion.

9 30 CORN. L. Q. 252.

10 N. Y. GEN. CORP. LAW § 64 makes the following exception: “except in relation to matters as to which it shall be adjudged . . . that such officer, director, or employee is liable for negligence or misconduct in the performance of his duties.”
CURRENT LEGISLATION

The court shall grant such application in such amount as it shall find to be reasonable and shall make an order directing the corporation to pay to the applicant the amount awarded. . . .” 11 In reading the two sections together, we can conclude that the legislature, attempting to change the “benefit rule” as construed under Section 61a, intended the defendant to have an absolute right to reimbursement for his success in whole or in part or for settlement suits, without his having to show any benefit to the corporation, leaving but the amount to the discretion of the court. This is the only logical construction of the statute. The only other interpretation would be that the courts have discretion as to whether reimbursement should be allowed, in which case, the statute would be rendered ineffective and merely declarative of common law as established by the McCollum case, for, as we have seen, where the courts have had such discretion, they required the defendant to show a direct benefit to the corporation.

The new law, in addition to attempting to change the “benefit rule”, has set up a procedure for obtaining assessment or payment of expenses and attorneys’ fees. Applications may be made either in the action, suit, or proceeding in which the expenses were incurred, or in a separate action in the Supreme Court. However, if a separate suit is brought, the application must show reasonable grounds why application was not made in the suit in which the expenses were incurred. The application must also show the disposition of any previous application. 12 The law further provides that an application shall be made in the manner and form that the applicable rules of the court require, or if there are no such rules, then by the direction of the court. Finally, the law requires notice to be given to the corporation, but grants the court discretion as to whether or not the notice shall be given at the expense of the corporation. 13

Thus the new law remedies the defects of the old Sections 27a 14 and 61a, which by their failure to set up procedures for payment or assessment of expenses, raised questions of constitutionality because, as a general rule, 15 a statute which omits requirements of notice violates the “due process” clause of the Constitution. 16 The new law, as an exercise of the reserve power of the state to alter or amend corporate charters, is undeniably constitutional.

---

15 State ex rel. v. District Court of Second Judicial Dist. et al., 33 Mont. 529, 85 P. 367 (1906); Hayman v. Morris, 179 Misc. 265, 37 N. Y. S. (2d) 884 (Sup. Ct. 1942), cited supra note 6.
16 U. S. Const. Amend. XIV, § 1.
Article 6a makes a further correction in former Sections 27a and 61a by omitting the word "plaintiff" throughout. The old sections granted the right of reimbursement to plaintiff as well as defendant. This provision was unnecessary in view of the fact that at common law the right of a successful plaintiff stockholder is always recognized if he has shown a benefit to the corporation, which is of course merely the nominal defendant in suits of this kind and therefore must stand to gain if the plaintiff is successful.

Furthermore, the new law broadens the scope of permitted indemnity by adding employees to the list of parties who may be authorized to obtain reimbursement from the corporation, and makes certain that the executor or personal representative of a deceased defendant may claim reimbursement for expenses incurred by the deceased in the defense of an action.

In addition, the new law is made applicable to foreign corporations "doing business" in this state. The provision was probably unnecessary, for undoubtedly the law would be so interpreted by the courts under the general rule that a foreign corporation not connected with interstate commerce should not have privileges not given to domestic corporations. A state statute will not be interpreted so as to give a non-resident or a foreign corporation greater privilege than is enjoyed by a resident or a domestic corporation. Furthermore, the powers, duties and liabilities of a corporation, whether they concern the internal affairs of the corporation or not, are regulated by the state in which it carries on its business and not by the laws of its domicile. As the state has the power to authorize an assessment on domestic corporations, it follows that it may do so on foreign corporations, for a corporation "doing business" in our State must be obedient to our laws.

Article 6a thus not only relieves directors of the hazards of litigation, formerly "one of the risks attendant on directorship," but also clarifies, remedies and broadens the scope of corporation law.

GERALD REFF.

---

17 Davidson v. Rodnon, 261 App. Div. 902, 25 N. Y. S. (2d) 167 (2d Dep't 1941); New York Dock Co., Inc. v. McCollum, cited supra note 1; Stevens on Corporations 673.
18 N. Y. Gen. Corp. Law § 64.
21 Former Court of Appeals Judge Crouch, sitting as official referee in the McCollum case.