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CORPORATE INDEMNIFICATION OF DIRECTORS AND OFFICERS: TIME FOR A REAPPRAISAL

K.G. Jan Pillai*
Craig Tractenberg**

Corporations and their regulators have considered at great length the propriety of indemnifying corporate executives for liability and litigation expenses.¹ The economic and policy implications of indemnification have assumed such importance in recent years, though, as to merit reexamination of the permissible limits of the practice. In 1980 alone, one of every ten *Fortune*-listed companies² confronted litigation seeking personal liability against either a director or an officer,³ with a substantial number of claims being brought by stockholders alleging mismanagement or other breaches of fiduciary duty.⁴ As corporate execu-

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1. See Bates & Zuckert, *Directors' Indemnity: Corporate Policy or Public Policy?*, 20 HARV. BUS. REV. 244 (1942). Professor Joseph W. Bishop, Jr., has been at the forefront of the entire corporate indemnification issue and has authored many instructive works on the subject. See G. WASHINGTON & J. BISHOP, *INDEMNIFYING THE CORPORATE EXECUTIVE* (1963); Bishop, *Current Status of Corporate Directors' Right to Indemnification*, 69 HARV. L. REV. 1057 (1956); Bishop, *New Cure For an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW 92 (1966); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968); Klink, Chalif, Bishop & Arsht, *Liabilities Which Can Be Covered Under State Statutes and Corporate By-Laws*, 27 BUS. LAW, Feb. 1972 Special Issue, at 109; Bishop, *Protecting Corporate Executives Against Liability and Expense Under the Federal Securities Law: Potential Liability*, in *PROTECTING THE CORPORATE OFFICER AND DIRECTOR FROM LIABILITY* 155 (PLI Course Handbook Series No. 25, 1969).

2. *Fortune*-listed companies are the 1300 domestic companies listed annually in *Fortune* Magazine; they comprise the 1000 largest industrials plus the 50 largest each among banks and diversified financial, life insurance, retail, transportation, and utility companies.

3. THE WYATT CO., THE 1980 WYATT DIRECTORS AND OFFICERS LIABILITY AND FIDUCIARY LIABILITY SURVEY 6 [hereinafter cited as 1980 WYATT SURVEY]. The Wyatt Company surveyed 2247 United States corporations, 53% of them *Fortune*-listed, through a confidential questionnaire which asked about losses arising from director and officer liability, the prevalence of insurance and claims, and their costs. References to "a single claim" means each class action suit or each group of similar claimants bringing an action as a result of a single alleged occurrence.

4. *Id.* at 16. Of the 1980 claims, 40.3% were brought by stockholders.

tives become more vulnerable to litigation initiated by forces within the corporation, their desire increases for protective devices, such as indemnification, which effectively can insulate them from personal liability.⁵

In 1980, American corporations paid over fifty-two million dollars in director and officer insurance premiums.⁶ The prevalence of this insurance is understandable in light of the magnitude and incidence of the risks involved. More than one quarter of major publicly held domestic companies have had at least one claim against their executives between 1971 and 1980.⁷ In 1980, the average total claim cost⁸ resulting from indemnification was estimated to be almost one million dollars.⁹ Of this amount, the average defense cost was nearly \$320,000 — an increase of approximately seventy-five percent over 1974 defense costs.¹⁰

The potentially crushing personal liability which may arise from these lawsuits¹¹ creates a dilemma for the corporation: balancing the need for punishing the willing wrongdoer against the need to protect dynamic fiduciaries involved in good-faith efforts to increase profits. Corporate indemnification of executive risk and exposure thus becomes a matter of great public concern in seeking that middle ground where capable managers, subject to inordinate personal risk, are encouraged to serve, yet discour-

5. See Rout, *Job of Corporate Director Becomes More Susceptible to Legal Assault*, Wall St. J., March 3, 1981, at 33, col. 4.

6. 1980 WYATT SURVEY, *supra* note 3, table 28, at 73-75. See also Greenberg & Dean, *Protecting the Corporate Executives: Director and Officer Liability Insurance Re-evaluated*, 58 MARQ. L. REV. 555, 556 n.3 (1975).

Corporations prefer to purchase insurance and pay premiums, notwithstanding that claims covered by insurance legally could be reimbursed by the corporation out of its own loss reserves. 1980 WYATT SURVEY, *supra* note 3, at 23-24. For the 19 companies responding to the survey that had assets aggregating over \$2 billion and had policy limitations of \$50 million, the average premium paid in 1980 was \$168,012. *Id.* Of the 51% of *Fortune*-listed companies participating in the survey, 93% purchase D & O policies to protect their executives. In 1980, 95.6% of New York Stock Exchange companies purchased D & O insurance, compared to 70.4% in 1973. Similarly, D & O insurance coverage for American Stock Exchange companies increased to 89.3% in 1980, from 47% in 1973. *Id.* at 41.

7. 1980 WYATT SURVEY, *supra* note 3, at 7. About one in every 20 large companies (assets between \$400 million and \$1 billion) had at least one claim in any given year between 1971 and 1980. *Id.* at 9.

8. The average total claim cost consists of the average annual loss to the corporation plus the expense of legal defenses, *i.e.*, the total amount of all losses and all legal defenses divided by the number of claims reported in the survey. *Id.* at 26.

9. *Id.* at 27.

10. *Id.* at 12. The average total cost of successful claims was a staggering \$1,196,000, of which \$877,361 represents the average recovery by each claimant.

11. For comprehensive works on the subject of substantive liabilities of directors and officers, see M. FEUER, *PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS* (2d ed. 1974); W. KNEPPER, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* (2d ed. 1973).

aged from violating their positions of trust.

This Article evaluates the benefits and burdens of shifting litigation risk from management to the enterprise. The Article begins by considering the nature of the legal risks confronting the corporate executive, and the principles of common law that developed to counter those risks. The Article proceeds to assess the two statutory responses to threats of personal liability against the corporate executive: indemnification statutes, and director and officer insurance. Finally, after comparing the effective absolute immunity available to corporate executives with the qualified immunity enjoyed by high-level government officials, the Article concludes that indemnification practices have overinsulated the corporate officer from personal liability.

I. LEGAL RISKS INHERENT IN CORPORATE MANAGEMENT

Determining the appropriate allocation of the financial burdens of indemnification should begin by identifying the sources of potential litigation and the scope of executive liability. Suits against corporate management commonly are grouped into three distinct categories:¹² derivative suits, third-party suits, and status suits. Derivative suits typically are brought on behalf of the corporation, third-party suits arise from executive conduct directly affecting third parties, and status suits originate from the breach of statutory duties imposed by virtue of executive status.

A. *The Derivative Action*

The most common legal risks facing the corporate executive arise from shareholder derivative actions.¹³ These actions are based upon an asserted wrong to the corporation, with the plaintiff seeking money damages or other relief for the benefit of the corporation.¹⁴ Corporate executives, absent indemnification, bear the brunt of the successful derivative action. A director or officer

12. See Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92 (1966).

13. See generally 2 G. WASHINGTON & V.H. ROTHSCHILD, *COMPENSATING THE CORPORATE EXECUTIVE* 875-930 (3d ed. 1962).

14. Typically, plaintiffs in derivative actions are shareholders of the injured corporation. *But see* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), wherein plaintiffs were not shareholders of the insolvent corporations but had standing to sue on behalf of an undercapitalized corporation for the benefit of the creditors of the insolvent corporation.

may be the target of a suit if he seizes a corporate opportunity,¹⁵ engages in self-dealing with regard to compensation,¹⁶ reaps unreasonable reimbursement or payment of proxy expenses,¹⁷ or becomes entangled in stock repurchases by an issuing corporation.¹⁸ Derivative suits have been used successfully to attack decisions of disinterested directors who engage in needless financing,¹⁹ effect a merger in derogation of the statutory rights of dissenting shareholders,²⁰ or adopt policies inconsistent with antitrust and trade regulation legislation.²¹ Merely refraining from conscious wrongdoing may not always suffice to insulate management from "honest negligence";²² even the most conscientious director or officer may be found liable for conduct reasonably regarded by him as ethical and prudent, especially where confusion exists among jurisdictions regarding the formulation of the business judgment rule, an affirmative defense to the derivative action.²³

15. See, e.g., *Ragnar Benson, Inc. v. Kassab*, 325 F.2d 591 (3d Cir. 1963); *Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir.), cert. denied, 294 U.S. 708 (1934); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939). See also *Central Ry. Signal Co. v. Longden*, 194 F.2d 310 (7th Cir. 1952); *Craig v. Graphic Arts Studio, Inc.*, 39 Del. Ch. 447, 166 A.2d 444 (1960).

16. See, e.g., *Glenmore Distilleries Co. v. Seidman*, 267 F. Supp. 915 (E.D.N.Y. 1967); *Dwyer v. Tracey*, 118 F. Supp. 289 (N.D. Ill. 1954); *Heller v. Boylan*, 29 N.Y.S.2d 653 (Sup. Ct.), aff'd mem., 263 A.D. 815, 32 N.Y.S.2d 131 (1941); *Indurated Concrete Corp. v. Abbott*, 195 Md. 496, 74 A.2d 17 (1950); *Stoiber v. Miller Brewing Co.*, 257 Wis. 13, 42 N.W.2d 144 (1950).

17. See, e.g., *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 291 (1955); *Neuwirth v. Feeley*, 148 N.Y.S.2d 678 (Sup. Ct. 1955), aff'd, 1 A.D.2d 879, 150 N.Y.S.2d 773 (1956). See also *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912); *Kent v. Quicksilver Mining Co.*, 78 N.Y. 159 (1879).

18. See *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962). In regard to abusive stock repurchases, see SEC Securities Act of 1933 Release No. 6108, 18 SEC. DOCKET 67 (1979).

19. E.g., *Otis & Co. v. Pennsylvania R.R.*, 57 F. Supp. 680 (E.D. Pa. 1944) (failure to seek competitive bids for financing resulting in waste).

20. E.g., *Gilbert v. Burnside*, 197 N.Y.S.2d 623 (Sup. Ct. 1959), rev'd, 13 A.D.2d 982, 216 N.Y.S.2d 430 (1961), aff'd per curiam, 11 N.Y.2d 960, 183 N.E.2d 325 (1962).

21. E.g., *Graham v. Allis-Chalmers Mfg. Co.*, 40 Del. Ch. 335, 182 A.2d 328 (1962). For the background of this case, see J. BROOKS, *BUSINESS ADVENTURES* 199-223 (1969). See also *Fanchon & Marco, Inc. v. Paramount Pictures, Inc.*, 202 F.2d 731 (2d Cir. 1953).

22. *Bishop*, supra note 12, at 93.

23. Plaintiff shareholders may be barred from suing derivatively if refusal of the prerequisite shareholder demand on directors was made in the exercise of their sound business judgment. *Ash v. International Business Machs., Inc.*, 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966); *Swanson v. Traer*, 249 F.2d 854 (7th Cir. 1957); *Issner v. Aldrich*, 254 F. Supp. 696 (D. Del. 1966); *Findley v. Garrett*, 109 Cal. App. 2d 166, 240 P.2d 421 (1952); *Brooks v. Brooks Pontiac, Inc.*, 143 Mont. 256, 389 P.2d 185 (1964); *Rice v. Wheeling Dollar Sav. & Trust Co.*, 130 N.E.2d 442 (Ohio C.P. 1954); cf. *Groel v. United Elec. Co.*, 70 N.J. Eq. 616, 61 A. 1061 (1905) (business judgment is not a bar where a "grave doubt" exists as to fairmindedness of the judgment). As to jurisdictional confusion concerning the degree of care to be exercised by a fiduciary, see H. HENN, *LAW*

The major objection to indemnifying the corporate executive found liable in a derivative suit is that reimbursement violates the utility of this cause of action. Indemnification in this setting causes the corporation to repay the executive precisely the amount received as a result of the derivative action.²⁴ There may be less objection, however, to indemnification of settlement payments in derivative suits because the corporation can derive tangible benefits from prompt resolution of the action. If the corporation wants to encourage rapid disposition of particularly refractory litigation, reimbursement of settlement payments may well be to its advantage.²⁵

B. *The Third-Party Action*

In contrast to the derivative action, executives may be threatened with litigation brought on the basis of contract or legislation rather than on behalf of the corporation itself.²⁶ Such third-party actions often are difficult to distinguish from derivative suits. They arise, for instance, upon breach of the shareholders' membership contract. A third party might also seek payment of lawfully declared²⁷ and mandatory dividends,²⁸ enforced inspection of corporate records,²⁹ protection of preemptive rights or other dilution of shareholders' proportional interests,³⁰ prohibition of wrongful redemptions,³¹ or relief in proxy contests.³² Along with creditors and competitors of the corpora-

OF CORPORATIONS § 242 (2d ed. 1976). The standard lies between the severe standard of a common law trustee (the prudent man in the conduct of his own affairs), see *Hun v. Cary*, 82 N.Y. 65, 71 (1880), and a less exacting standard, see *Briggs v. Spaulding*, 141 U.S. 132 (1891); see Comment, *Public Policy and Director's Liability Insurance*, 67 COLUM. L. REV. 716, 720 (1967).

24. See Bishop, *Indemnification of Corporate Directors, Officers and Employees*, 20 BUS. LAW. 833, 841 (1965).

25. See Johnston, *Corporate Indemnification and Liability Insurance*, 33 BUS. LAW. 1993, 2009 (1978).

26. See H. HENN, *supra* note 23, at § 360.

27. *E.g.*, *Knapp v. Bankers Sec. Corp.*, 17 F.R.D. 245 (E.D. Pa. 1954), *aff'd*, 230 F.2d 717 (3d Cir. 1956); *Godley v. Crandall & Godley Co.*, 212 N.Y. 121, 105 N.E. 818 (1914); *In re Booth*, 139 Misc. 253, 248 N.Y.S. 264 (Sup. Ct. 1931).

28. *E.g.*, *Boardman v. Lake Shore & M.S. Ry.*, 84 N.Y. 157 (1881); *Koppel v. Middle States Petroleum Corp.*, 272 A.D. 790, 69 N.Y.S.2d 784 (1947).

29. *E.g.*, *In re Hauser v. Hopewell Products, Inc.*, 10 A.D.2d 876, 201 N.Y.S.2d 252 (1960); *Hagy v. Premier Mfg. Corp.*, 404 Pa. 330, 172 A.2d 283 (1961).

30. *E.g.*, *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Horwitz v. Balaban*, 112 F. Supp. 99 (S.D.N.Y. 1949); *Sheppard v. Wilcox*, 210 Cal. App. 2d 53, 26 Cal. Rptr. 412 (1963).

31. *E.g.*, *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Lehrman v. Godchaux Sugars, Inc.*, 207 Misc. 314, 138 N.Y.S.2d 163 (Sup. Ct. 1955).

32. *E.g.*, *Campell v. Loew's Inc.*, 36 Del. Ch. 563, 134 A.2d 852 (1957).

tion, the government frequently initiates third-party actions, such as criminal antitrust proceedings,³³ and suits involving tax³⁴ and securities regulations.³⁵ Commentators foresee development of additional causes of action grounded particularly upon infringement of civil rights and the failure of corporations to comply with federal standards governing safety and hiring practices.³⁶ Actions to enjoin a proposed merger or consolidation, sale of assets, or dissolution have been permitted as either derivative or third-party actions. Actions to compel dissolution, however, hardly benefit the dissolving business entity and therefore are classified as third-party actions.³⁷

Indemnification for the defense of a third-party action seems eminently justifiable. The great potential for strike suits³⁸ creates a legitimate need to protect both individual executives and the corporate image. Also, third-party actions commonly involve no breach of duties owed to the corporation, making indemnification more palatable than it might be in a derivative suit.

C. *The Status Suit*

The corporate executive confronts a third category of litigation risk imposed by virtue of his status.³⁹ Federal securities laws create such status obligations by requiring special conduct of corporate fiduciaries towards third parties. Perhaps the best example of status liability is that imposed by section 16(b) of the Securities Exchange Act of 1934.⁴⁰

Section 16(b) provides that a corporate issuer of securities may recapture any profits⁴¹ — arising within six months after the sale or purchase of those securities — that are realized by an officer, director, or ten-percent-beneficial owner of the corporation. Whether these profits are engendered by inside informa-

33. *E.g.*, Schwarz v. General Aniline & Film Corp., 279 A.D. 996, 112 N.Y.S.2d 146 (1952), *aff'd*, 305 N.Y. 395, 113 N.E.2d 533 (1953).

34. *E.g.*, United States v. Fox, 95 F. Supp. 315 (E.D. Pa. 1951); Du Puy v. Crucible Steel Co., 288 F. 583 (W.D. Pa. 1923).

35. See Bishop, *supra* note 12, at 95.

36. See Greenberg & Dean, *supra* note 6, at 558.

37. See H. HENN, *supra* note 23, at § 361.

38. A "strike suit" is brought solely for the purpose of harassing management, in the hope of a direct payoff to the stockholder plaintiff. Bishop, *supra* note 12, at 94.

39. *Id.* at 95.

40. 15 U.S.C. § 78p(b) (1976).

41. Profits are maximized by matching the lowest priced purchases against the highest priced sales. See Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951) (judgment against defendant for reconstructed profit despite actual loss of \$300,000).

tion is immaterial;⁴² section 16(b) has been termed a "Russian Roulette" provision, for it often applies to reproachless situations.⁴³

Status liability results also from implied civil actions under Securities Act of 1934 section 10(b), and rule 10b-5.⁴⁴ These provisions impose special duties on insiders to disclose material inside information, or to abstain from market disruption, for the purpose of prohibiting fraud, deceit, or the use of a manipulative device in connection with the sale or purchase of securities.⁴⁵ Liability under section 11 of the Securities Act of 1933⁴⁶ may be imposed where a director fails to make an adequate "due diligence" search before the requisite signing of a registration statement to be filed with the Securities and Exchange Commission in connection with a public offering of securities.⁴⁷

The federal securities laws likely did not contemplate creation of status liability in excessive amounts. Corporate executives, however, quickly realized the potential for substantial legal expenses arising from suits brought under the various federal statutes. Thus, in an effort to minimize the impact of status suits, as well as to avoid crushing liability arising from derivative and third-party actions, corporate executives sought common law rules favoring indemnification.

II. INDEMNIFICATION AT COMMON LAW

Principles of agency constituted the most appropriate vehicle at common law for granting the corporate executive relief from liability. These common law principles, however, while entitling

42. *Maqida v. Continental Can Co.*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956).

43. *See Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970) (holding Martin Marietta Corp. liable as an inside director of Sperry Rand Corp.).

44. 15 U.S.C. § 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1981). The scope of rule 10b-5 has been narrowed by judicial interpretation. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

45. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *Kuehnert v. Texstar Corp.*, 286 F. Supp. 340 (S.D. Tex. 1968).

46. 15 U.S.C. § 77k (1976).

47. *See Escott v. Bar Chris Constr., Inc.*, 283 F. Supp. 643 (S.D.N.Y. 1968) (holding a signatory to a false registration statement personally liable for losses suffered by debenture holders, notwithstanding that he had not been a director for 48 hours prior to the filing).

an agent to exoneration⁴⁸ from the principal for damages incurred in the performance of authorized duties, did not permit indemnification of expenses incurred in all types of corporate litigation.⁴⁹ The common law rule was particularly inadequate in failing to provide reimbursement to the agent who successfully defended a suit brought by the principal itself.⁵⁰ Thus, the law of agency stands reticent regarding the most recurring problem posed by derivative actions: whether, and under what circumstances, there can be indemnification of the executive acting as agent who presents a successful defense against the corporation as principal.

In derivative actions decided under common law principles, courts uniformly have denied reimbursement to unsuccessful corporate defendants.⁵¹ Since the earliest cases, however, actions involving *successful* defendants have proved more problematic. Because the successful defense of a derivative action rarely, if ever, will directly benefit the defeated corporation, the early courts struggled with the conflict between the equitable notion of reimbursement and the axiom that corporate funds should be expended only if tangible benefits would accrue to the corporation. As a result, some courts granted indemnification;⁵² others denied it, absent unanimous shareholder approval, unless the corporate directors seeking indemnification could show "some

48. For the purposes of discussion, no legal distinction of exoneration is made between direct corporate payments to defense counsel and reimbursement of executives for out-of-pocket payments.

49. See *Bibb v. Allen*, 149 U.S. 481, 498 (1893); *Differential Steel Car Co. v. Macdonald*, 180 F.2d 260, 270 (6th Cir. 1950); *Sunset-Sternau Food Co. v. Bonzi*, 60 Cal. 2d 834, 389 P.2d 133, 36 Cal. Rptr. 741 (Cal. 1964); RESTATEMENT (SECOND) OF AGENCY § 439(c) (1957); Johnston, *supra* note 25.

50. See *Cory Bros. & Co. v. United States*, 51 F.2d 1010 (2d Cir. 1931); *Buckley v. City of New York*, 170 Misc. 412, 415, 10 N.Y.S.2d 650 (Sup. Ct. 1939), *aff'd*, 264 A.D. 116, 34 N.Y.S.2d 577, *aff'd*, 289 N.Y. 742, 46 N.E.2d 352 (1942); RESTATEMENT (SECOND) OF AGENCY § 438, comment 1 (1958); G. WASHINGTON & J. BISHOP, *supra* note 1, at 95 & n.63.

51. See, e.g., *McCourt v. Singers-Bigger*, 145 F. 103 (8th Cir. 1906); *Wickersham v. Crittenden*, 106 Cal. 329, 39 P. 603 (1895); *Chabot & Richard Co. v. Chabot*, 109 Me. 403, 84 A. 892 (1912).

52. See, e.g., *Figge v. Bergenthal*, 130 Wis. 594, 109 N.W. 581 (1906), where a director sought recovery, in his capacity as stockholder, from other members of the board for fraud and misapplication of corporate funds. Although not strictly speaking a derivative action, the suit nonetheless was brought for the benefit of the corporation. The court sustained, without discussion or citation of authority, the use of corporate funds to pay the expenses of directors during trial and before exoneration, reasoning that "if no case is made against defendants it is not improper or unjust that the corporation should pay for the defense of the action." *Id.* at 625, 109 N.W. at 592. *But cf.* *Jesse v. Four Wheel Drive Auto Co.*, 177 Wis. 627, 189 N.W. 276 (1922) (holding that corporate funds could not be used to defend directors in litigation involving their personal dealings with stockholders rather than their management of corporate affairs).

benefit to the corporation or that some interest of the corporation was threatened."⁵³

This confusion reached its peak in *New York Dry Dock Company, Inc. v. McCollum*,⁵⁴ a decision denying reimbursement for expenses incurred in the successful defense of a derivative action. The court found that the defendant directors had failed to carry their burden of establishing either that the suit had preserved a substantial corporate interest or had generated benefits for the corporation.⁵⁵ The *McCollum* decision, perceived as rejecting a common law right to reimbursement of expenses absent express legislative authorization,⁵⁶ caused panic in Albany and on Wall Street alike. Directorates scurried to amend corporate bylaws, execute employment contracts, and correspond with political representatives in an effort to circumvent the adverse consequences of the decision.⁵⁷

Since the *McCollum* episode, the trend has been to recognize the rights of an innocent director to indemnification.⁵⁸ For example, the New Jersey case of *Solimine v. Hollander*⁵⁹ granted

53. *Griesse v. Lang*, 37 Ohio App. 553, 558, 175 N.E. 222, 223 (1931); see *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). These courts apparently failed to recognize the wide range of benefits that might cause a corporation to indemnify its executives, especially the benefit of indemnification in inducing competent executives to accept corporate positions. See G. WASHINGTON & J. BISHOP, *supra* note 1, at 87; Frampton, *Indemnification of Insiders' Litigation Expenses*, 23 LAW & CONTEMP. PROB., 325, 327-28 (1958).

54. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939). The defendant's name is properly spelled "McCollom." G. WASHINGTON & J. BISHOP, *supra* note 1, at 87 n.39.

55. The suit, brought by the corporation against certain of its directors, was for a declaratory judgment to resist payment of their expenses. It was alleged that these directors had successfully defended a derivative suit brought against them and had successfully prevented the appointment of a receiver. The court held that the directors were not entitled to reimbursement, for the following reasons: no disinterested approval of the reimbursement was obtained; no implied contract of law required reimbursement; no corporate benefit was bestowed by the directors (referee found that dismissal of the petition for receivership was due to the sole efforts of corporate counsel); the settled state of the law rejected any policy arguments in favor of indemnification; and it would have been more appropriate to bring the reimbursement claim before the trial judge in the original suit, who would be "in a much better position than any judge to evaluate the alleged benefits to the corporation of the legal services rendered." 173 Misc. at 113; 16 N.Y.S.2d at 850; see G. WASHINGTON & J. BISHOP, *supra* note 1, at 87-90.

56. See *Bailey v. Bush Terminal Co.*, 46 N.Y.S.2d 877 (Sup. Ct.), *aff'd mem.*, 267 A.D. 899, 48 N.Y.S.2d 324 (1943), *aff'd mem.*, 293 N.Y. 735, 56 N.E.2d 739 (1944). Note that *Bailey* was decided subsequent to passage of the New York indemnification statutes, chs. 209, 350, 1941 N.Y. LAWS 164th Sess. (current version at N.Y. BUS. CORP. LAW §§ 722, 723 (McKinney 1963 & Supp. 1980-1981)).

57. The result, only two years later, was the nation's first indemnification statute, drafted specifically to displace the effects of *McCollum*. See G. WASHINGTON & J. BISHOP, *supra* note 1, at 87.

58. See *Mooney v. Willys-Overland Motors, Inc.*, 204 F.2d 888, 895-98 (3d Cir. 1953).

59. 129 N.J. Eq. 264, 19 A.2d 344 (1941).

indemnification on the theory that the defense and vindication of management itself constituted a benefit to the corporation, going so far as to repudiate the necessity to demonstrate corporate benefits where the director had been successful on the merits. The court said: "[T]he right to reimbursement is a circumstance that would actuate and induce responsible business men to accept the post of directors, the emoluments of which would otherwise never be commensurate with the risk of loss involved in paying out of their own pocket the costs involved in defending their conduct."⁶⁰

III. INDEMNIFICATION STATUTES

A. *The Early Statutes*

Despite the clearly discernible common law trend favoring indemnification, the vast majority of states still found it prudent to enact special statutes granting the right or power of indemnification.⁶¹ In response to the *McCullum* case,⁶² corporate executives induced legislative adoption of protective bylaw provisions and statutes⁶³ assuring indemnification. Thus, almost all American jurisdictions, beginning with New York in 1941⁶⁴ and followed by Delaware in 1943,⁶⁵ have enacted statutes authorizing and regulating indemnification of litigation expenses incurred by corporate executives.⁶⁶

The statutes, as originally enacted, contained a number of defects enabling untoward judicial interpretations. For instance, the old Delaware statute was flawed because merely permissive; it did not give the executive an enforceable right to be indemni-

60. *Id.* at 272, 19 A.2d at 348; accord, *In re E.C. Warner Co.*, 232 Minn. 207, 214-15, 45 N.W.2d 388, 393 (1950).

61. See Mattar & Hilson, *Exposure of Corporate Directors: An Overview of Indemnification and Liability Insurance*, 46 J. Risk & Ins. 411, 412 (1979).

62. See notes 54-57 and accompanying text *supra*.

63. See generally G. WASHINGTON & J. BISHOP, *supra* note 1, at 112-205.

64. Chs. 209, 350, 1941 N.Y. Laws 164th Sess. (current version at N.Y. BUS. CORP. LAW §§ 722, 723 (McKinney 1963 & Supp. 1980-1981)).

65. Ch. 125, 44 Del. Laws 109th Sess. (1943) (current version at DEL. CODE ANN. tit. 8, § 145(c) (1974)).

66. Apparently state regulation was prompted by indemnification bylaws that aimed to grant management total immunity from personal liability. The public policy justifying statutory regulation arose out of bylaws permitting executives adjudged guilty in derivative actions to be indemnified for the very funds they had extracted from the corporate fisc. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1079 (1968).

fied.⁶⁷ Furthermore, the statute failed to distinguish between derivative and third-party actions, thus seeming to forbid indemnification in a third-party action when the executive was adjudged liable for actions done with intent to further corporate interests. The statute did not specifically cover criminal, administrative, or investigative proceedings, nor did it embrace counsel expenses incurred in threatened litigation. Finally, the defect most troubling to executives in the old statutes, such as Delaware's, was the absence of an express provision dealing with compromise settlements.⁶⁸

B. *The Modern Statutes*

Through a series of amendments and revisions, state legislatures sought to clarify the original indemnification statutes in order to cure the apparent deficiencies. Following the revision of the Model Business Corporation Act of 1967,⁶⁹ the Delaware statute became a prototype for other states. An analysis of these statutes is needed for a clear understanding of the varying degrees of risks and liabilities to which corporate executives currently are exposed.

Modern indemnification statutes may be divided into two broad categories: mandatory and permissive. Mandatory statutes require indemnification by corporations upon satisfaction of certain statutory prerequisites. This mandatory approach represents an improvement over earlier formulations because it provides an enforceable right against the corporate entity. Permissive statutes, in contrast, grant the corporation an option to indemnify its executives when specified conditions are met. While permissive statutes enable a corporation to guarantee indemnification by incorporating appropriate indemnification clauses in bylaws, charters, or employment contracts, such an option places undue emphasis on drafting and creates potential conflicts should the provision overstep the bounds of corporate responsibility for indemnification.⁷⁰

67. See Johnston, *supra* note 25, at 1995.

68. See *Essential Enterprises Corp. v. Dorsey Corp.*, 40 Del. Ch. 343, 351, 182 A.2d 647, 652 (1962) (Chancellor was troubled by "the unhealthy consequence of placing a director in the position where he would be assured of indemnification if he settled but would run the risk of paying his own attorney if he unsuccessfully resisted the action"); Bishop, *supra* note 66, at 1082-83.

69. See ABA-ALI MODEL BUS. CORP. ACT. § 5 (1967).

70. Courts have demonstrated a willingness to invalidate directors' attempts to indemnify themselves pursuant to bylaw or charter provisions. See *Teren v. Howard*, 322

Both mandatory and permissive statutes may be further subdivided based upon whether they grant exclusive or nonexclusive methods of indemnification. An exclusive statute permits indemnification only as expressly provided in the statute. Under nonexclusive statutes, corporations may be creative in devising methods to protect their executives. The risk of personal liability for the executive, however, still exists under nonexclusive statutes, because the method devised could be rendered void if the corporate authorization exceeds the bounds of public policy.

Mandatory statutes, such as those in Delaware,⁷¹ New York,⁷² and Pennsylvania,⁷³ require indemnification of reasonable litigation expenses only if the director is "successful on the merits or otherwise."⁷⁴ To illustrate the scope of these mandatory provisions, the Delaware statute enables a corporation to indemnify in third-party litigation against expenses, judgments, fines, and amounts paid in settlement. The right to indemnification in the case of derivative actions, though, is limited to expenses, including attorneys' fees, provided the defendant is not found liable for negligence or misconduct.⁷⁵

The statutes clearly provide for indemnification when the executive has been "wholly" successful on the merits. Significant jurisdictional differences arise, however, when the executive does not obtain a "wholly" successful verdict.⁷⁶ The New York statute, for instance, requires that the executive be entirely vindicated to obtain indemnification.⁷⁷ Given that the New York statute is exclusive, a corporation likely could not even indemnify

F.2d 949 (9th Cir. 1963) (efforts of directors to indemnify themselves for expenses incurred in derivative litigation held invalid); *SEC v. Continental Growth Fund*, [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,437 (S.D.N.Y. 1964); *Essential Enterprises Corp. v. Dorsey Corp.*, 40 Del. Ch. 343, 182 A.2d 647 (1962) (board resolution held invalid as an effort to indemnify themselves for counsel fees incurred in a court-approved settlement).

71. DEL. CODE ANN. tit. 8, § 145(c) (1974).

72. N.Y. BUS. CORP. LAW § 724(a) (McKinney 1963).

73. PA. STAT. ANN. tit. 15, § 410(c) (Purdon Supp. 1981-1982).

74. The "successful on the merits" language requires that the executive seeking indemnification be found either not guilty in a criminal case or not liable in a civil case. See *Mattar & Hilson*, *supra* note 61, at 413. The "or otherwise" statutory language contemplates that indemnification may be available where the action was dismissed with prejudice, for whatever reason. *Id.* In contrast, California requires success on the merits for mandatory indemnification, CAL. CORP. CODE § 317(d) (West Supp. 1981); see *Heyler, Indemnification of Corporate Agents*, 23 U.C.L.A. L. REV. 1255 (1976), although non-meritorious termination would not preclude indemnification if the defendant fell within the permissive provisions of the statute. CAL. CORP. CODE § 317(c)(1) (West Supp. 1981).

75. If the defendant is adjudged liable for misconduct or negligence, the court has discretion to award indemnity for expenses. DEL. CODE ANN. tit. 8, § 145(b) (1974).

76. *Mattar & Hilson*, *supra* note 61, at 413.

77. See N.Y. BUS. CORP. LAW. §§ 724(a), 725(a) (McKinney 1963).

permissively in this instance.⁷⁸

This signifies an apparent disadvantage of the New York statute in comparison with those of other jurisdictions. Under the California, Delaware, and Pennsylvania enactments, for example, executives are entitled to indemnification "to the extent" of success. The Delaware statute explicitly provides for partial indemnity upon partial success,⁷⁹ even should the success not bear upon the merits of the case.⁸⁰

This disadvantage, however, may be more illusory than real. In *Merritt-Chapman & Scott Corp. v. Wolfson*,⁸¹ the Delaware Superior Court held that partial dismissal of charges of perjury, obstruction of justice, and fraud would not entitle the defendant executives to indemnification for legal fees. Despite the Delaware statutory provisions supporting indemnification in this context, the court concluded that it would be "anomalous indeed, and diametrically opposed to the spirit and purpose of the [indemnification] statute and sound public policy to extend the benefits of indemnification to these defendants under the facts and circumstances of this case."⁸² Thus, the common law principle that public policy bars enforcement of indemnification contracts where parties have engaged in fraudulent or willful misconduct serves as a gloss upon the limitations established explicitly by the indemnification statutes.⁸³

78. See Johnston, *supra* note 25, at 2000; Mattar & Hilson, *supra* note 61, at 414.

79. DEL. CODE ANN. tit. 8, § 145(c) (1974); see *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 141 (Del. Super. Ct. 1974).

80. See Mattar & Hilson, *supra* note 61, at 414. Under the California statute, in order to gain partial indemnification, the defendant must partially succeed on the merits. *Id.*

81. 264 A.2d 358 (Del. Super. Ct. 1970).

82. *Id.* at 360. In a subsequent phase of the same case, however, the court did allow partial indemnification for expenses arising from criminal charges that had been dismissed. 321 A.2d 138 (Del. Super. Ct. 1974).

Public policy always has been an overriding limitation on the interpretation and application of state indemnification statutes. In *Diamond v. Diamond*, 307 N.Y. 263, 120 N.E.2d 819 (1954), for instance, the New York Court of Appeals denied indemnification to a successful defendant in a stockholders' suit, dismissed on the basis of plaintiff's participation in an alleged conspiracy to waste corporate assets, where the defendant had been an equal participant in the scheme. Similarly, in *People v. Uran Mining Corp.*, 13 A.D.2d 419, 216 N.Y.S.2d 985 (1961), a director successful on the merits nonetheless was denied indemnification for the defense of a suit alleging fraudulent conduct in securities transactions, because the defendant had at least participated in the transactions and had breached his fiduciary responsibility of good faith.

83. See *Kansas City Operating Corp. v. Durwood*, 278 F.2d 354, 358 (8th Cir. 1960) (indemnitee found *in pari delicto* with the indemnitor); *Pruet v. Dugger-Holmes & Assocs.*, 162 So. 2d 613 (Ala. 1964); Johnston, *supra* note 25, at 2006-07.

C. *Statutory Recovery and the Requisite Standard of Conduct*

The corporate executive can incur substantial expenses, such as attorneys' fees, fines, and settlement costs, whenever named as a defendant in a derivative suit. The statutes permit the executive defendant in derivative suits, however, to seek recovery only of litigation expenses; indemnification of the judgment would merely circulate the indemnity amount back to the injured corporation in the form of damages without making the corporation whole.⁸⁴ Under the Delaware and Pennsylvania statutes, a court has discretion to indemnify an executive against expenses, including attorneys' fees, arising from the defense of a derivative suit, notwithstanding a finding of misconduct. The New York statute, in contrast, does not permit the court to grant indemnification if it finds that the executive engaged in misconduct.⁸⁵

The statutes enable permissive indemnification by the corporation in derivative actions under a strict standard of conduct, requiring the defendant to have acted in good faith and in the corporate interest.⁸⁶ While the business judgment rule will provide limited protection to executives for mere errors in judgment, it will not insulate from liability the executive who fails to exercise due diligence. The executive who fails to ascertain the facts necessary to enable reasoned decisionmaking falls short of the standard of conduct necessary for permissive indemnification.⁸⁷

The standard of care required for indemnification in third-party and status suits is generally more liberal because the defendant executive owes a duty not to the corporation, but rather to other aggrieved parties. Under the restrictive New York and California statutes, indemnification requires a good-faith, reasonable belief that the conduct was in the best interest of the corporation.⁸⁸ The broader language of the Delaware and Pennsylvania enactments permits indemnification when an officer has acted "in or not opposed to" the best interests of the corpora-

84. See Bishop, *supra* note 12, at 841.

85. N.Y. BUS. CORP. LAW § 722(a) (McKinney Supp. 1980-1981).

86. See CAL. CORP. CODE § 317(c) (West Supp. 1981); DEL. CODE ANN. tit. 8, § 145(a) (1974); PA. STAT. ANN. tit. 15, § 410(b) (Purdon Supp. 1981-1982).

87. See Mattar & Hilson, *supra* note 61, at 418.

88. N.Y. BUS. CORP. LAW § 723(a) (McKinney Supp. 1980-1981); CAL. CORP. CODE § 317(b) (West Supp. 1981).

tion,⁸⁹ thus more readily enabling indemnification where, for instance, liability is based on status.⁹⁰

In contrast to the derivative action, where only litigation expenses are recoverable, the statutes empower the unsuccessful executive in a third-party action to seek indemnification as well for judgments, amounts paid in settlement, and fines. The New York statute is exceptional in its treatment of expenses incurred from threatened litigation: the executive can be indemnified for these costs in third-party but not derivative suits.⁹¹ Most other statutes provide for the advancement of litigation expenses even in threatened derivative suits. While advancement of funds appears proper in third-party actions, though, the concept seems self-defeating when the corporation effectively subsidizes the defendant executive — its party opponent. This apparent circularity of funds is mitigated, however, by provisions that the advances are to be repaid upon a determination that the indemnification is improper.⁹²

The courts carefully evaluate the propriety of indemnification in status liability actions. Because status cases generally are brought pursuant to federal securities laws, these laws have played a major role in limiting indemnification.⁹³ In general, the stance of the Securities and Exchange Commission has been that indemnification would reduce the ability of the federal provisions to deter negligent or reckless misconduct in the issuance, purchase, or sale of securities.⁹⁴ This approach is exemplified in Securities Act rule 460, permitting the SEC to refuse acceleration of the effective date of registration statements required in public distributions, unless there has been a waiver of indemnification with respect to the proposed offering, or unless the parties obtain a judicial ruling that indemnification would not offend public policy.⁹⁵

89. DEL. CODE ANN., tit. 8, § 145(a) (1974); PA. STAT. ANN. tit. 15, § 410(a) (Purdon Supp. 1981-1982).

90. See Johnston, *supra* note 25, at 1997.

91. See N.Y. BUS. CORP. LAW §§ 722, 723 (McKinney 1963); Johnston, *supra* note 25, at 2001.

92. N.Y. BUS. CORP. LAW §§ 722(b)(1) & (2), 723(a) (McKinney 1963).

93. See *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969) (underwriter's actual knowledge of omission of material from prospectus prevented enforcement of indemnification provisions of the underwriting agreement), *cert. denied*, 397 U.S. 913 (1970); *In re Equity Funding Corp.*, 416 F. Supp. 132, 156 (C.D. Cal. 1975); *Odette v. Shearson Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975); *Gould v. American Hawaiian Steamship Co.*, 387 F. Supp. 163 (D. Del. 1974), *vacated on other grounds*, 535 F.2d 761 (3d Cir. 1976); 3 L. LOSS, SECURITIES REGULATION 1831 (2d ed. 1961).

94. See Johnston, *supra* note 25, at 2008.

95. 17 C.F.R. § 230.460 (1981). Rule 460 contains no prohibition, however, against

Whether SEC policy would invalidate broadly worded, permissive state indemnification statutes remains unresolved.⁹⁶ The Delaware statute, for instance, does not require that the executive seeking indemnity have acted in the corporate interest, and expressly contemplates indemnification where the executive is sued by reason of serving as a director or officer of another corporation.⁹⁷ SEC policy likely would dictate that the Delaware statute spans too broadly in both these regards.⁹⁸

The most satisfactory approach to assessing the propriety of indemnification would be through reference to the purposes of the federal statute involved. If the federal securities statutes aim primarily to compensate the defrauded investor, the interest in enabling defendant executives to present a strong defense would argue for permitting indemnification. On the other hand, indemnification should not be allowed if the statutes are mainly punitive; the faithless fiduciary would not be adequately punished if indemnified.⁹⁹

D. Determination of Whether the Standard of Conduct Has Been Met

An independent arbiter must make the determination whether the statutory standard of conduct required for indemnification has been satisfied. The Delaware and Pennsylvania statutes both provide for this determination to be made by a majority of disinterested directors constituting a quorum, the stockholders, or,

indemnification for the expenses of a successful defense. Johnston, *supra* note 25, at 2009 & n.55. See also *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975) (holding that federal public policy precludes indemnification for violations of Securities Act § 12(2), or for fraud violations creating liability under rule 10b-5); *Gould v. American Hawaiian Steamship Co.*, 387 F. Supp. 163 (D. Del. 1974) (indemnification of conduct negligent under Securities Exchange Act § 14 would be contrary to public policy of securities laws), *vacated on other grounds*, 535 F.2d 761 (3d Cir. 1976).

96. See *Mattar & Hilson*, *supra* note 61, at 416.

97. DEL. CODE ANN. tit. 8, § 145(a) (1974).

98. *Cf. Globus v. Law Research Service*, 418 F.2d 1276 (2d Cir. 1969) (indemnification agreement between issuer and underwriter, in light of actual knowledge of violation, is violative of public policy), *cert. denied*, 397 U.S. 913 (1970). The SEC has said that insurance against liabilities arising under the 1933 Act is not against public policy, regardless of who bears the cost. See *W. KNEPPER*, *supra* note 11, § 16.03, at 411 & n.34.

99. At least three cases have suggested that the federal securities laws are compensatory rather than punitive, an argument supporting indemnification of the executive defendant in status actions. See *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1285 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *Baumel v. Rosen*, 412 F.2d 571, 576 (4th Cir. 1969) (dictum), *cert. denied*, 396 U.S. 1037 (1970); *Green v. Wolf Corp.*, 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

under certain conditions, an independent legal counsel.¹⁰⁰ The California statute provides for approval of indemnification either by a majority of disinterested directors or by court order.¹⁰¹ The New York statute permits indemnification by court order, approval by a majority of a quorum of disinterested directors, or by independent legal counsel or shareholder vote if a quorum of directors is unavailable.¹⁰²

Various commentators have found these statutory methods of independent determination to be deficient.¹⁰³ They argue that reliance upon indemnification decisions by disinterested directors may be unrealistic, given the inherent difficulty involved in asking a director to sit in judgment regarding the actions of fellow directors.¹⁰⁴ The constant threat of liability for biased decisions,¹⁰⁵ however, as well as statutorily mandated judicial and shareholder oversight of directors' indemnification determinations, generally provide substantial safeguards against indemnification awards that unduly favor the guilty director and adversely affect the interests of the corporation.

The notion that outside counsel can provide an adequate check upon indemnification decisions also has been attacked, because counsel chosen by the board of directors likely will not be truly independent of the board. Past or expected future business relationships between the board of directors and chosen counsel cast doubt upon whether this approach could produce an impartial evaluation of the indemnification decision.¹⁰⁶

The New York provision that permits a trial court to make the indemnification decision seems to provide the best option. This approach should be adopted by more states, notwithstanding the possibility that it entails some usurpation of the power vested in the board of directors to make business decisions. Court approval of indemnification determinations, coming at the end of conventional litigation and involving adversary parties,

100. DEL. CODE ANN. tit. 8, § 145(d) (1974); PA. STAT. ANN. tit. 15, § 410(d) (Purdon Supp. 1981-1982).

101. CAL. CORP. CODE §§ 317(d), (e) (West Supp. 1981). California quite properly ensures some level of shareholder participation in the process by requiring notice to shareholders whenever indemnification exceeds \$10,000. CAL. CORP. CODE § 1501(b)(2) (West Supp. 1981).

102. N.Y. BUS. CORP. LAW §§ 724-725 (McKinney Supp. 1980-1981).

103. See Johnston, *supra* note 25, at 1998; Klink, Chalif, Bishop & Arsht, *supra* note 1, at 121, 125; Mattar & Hilson, *supra* note 61, at 420.

104. See Johnston, *supra* note 25, at 1998.

105. See Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (1942), *aff'd mem.* 267 A.D. 890, 47 N.Y.S.2d 589 (1944).

106. See Johnston, *supra* note 25, at 1998-99; Klink, Chalif, Bishop & Arsht, *supra* note 1, at 121.

ensures disinterested decisionmaking and presents the parties in interest with an adequate opportunity to be heard on the propriety of indemnification.

IV. DIRECTOR AND OFFICER LIABILITY INSURANCE

The perceived inadequacies of the state indemnification statutes in sensitive areas such as derivative suit recoveries and coverage for federal securities law violations have inspired legislatures to authorize the purchase of director and officer ("D & O") liability insurance.¹⁰⁷ At common law, a corporation's purchase of D & O insurance was considered *ultra vires* because perceived entirely as a benefit to the management, with no corresponding advantage to the corporation.¹⁰⁸ In authorizing the purchase of D & O insurance, the state legislatures overcame this common law objection by finding that this insurance benefits corporations as a means of attracting executive talent.

Most state statutes expressly empower a corporation to insure executives against liabilities, regardless of whether the corporation itself could indemnify those liabilities. Thus, the standard D & O policy might cover liability arising from damage awards, settlements, and all manner of litigation expenses. Indeed, state statutes provide specific authorization for insuring liabilities

107. Forty-two states have adopted such statutes. See ALA. CODE § 10-21-64a(g) (1975); ALASKA STAT. § 10.05.010(g) (Supp. 1981); ARIZ. REV. STAT. ANN. § 10-005.G (1977); ARK. STAT. § 64-309(G) (1980); CAL. CORP. CODE § 317(i) (West Supp. 1981); COLO. REV. STAT. § 7-3-101(1)(o)(VII) (Supp. 1980); CONN. GEN. STAT. ANN. § 33-320a(f) (West Supp. 1981); DEL. CODE ANN. tit. 8, § 145(g) (1974); FLA. STAT. ANN. § 607.014(8) (Harrison 1977); GA. CODE ANN. § 22-717(g) (1977); HAWAII REV. STAT. § 416-35(h) (Supp. 1980); IDAHO CODE § 30-1-5(g) (1980); ILL. ANN. STAT. ch. 32, ¶ 157.42-12(g) (Smith-Hurd Supp. 1981-1982); IND. CODE § 23-1-2-2(10) (1976); IOWA CODE ANN. § 496A.4.19.g (West Supp. 1981-1982); KAN. STAT. ANN. § 17-6305(g) (1974); KY. REV. STAT. § 271A.025(7) (1981); LA. REV. STAT. ANN. § 12:83.F (West 1969); ME. REV. STAT. ANN. tit. 13-A, § 719(6) (Supp. 1980); MD. CORP & ASS'NS ANN. § 2-418(k) (Supp. 1981); MASS. ANN. LAWS ch. 156B, § 67 (Michie/Law. Co-op 1979); MICH. COMP. LAWS ANN. § 450.1567 (1973); MINN. STAT. ANN. § 301.095, subd. 7 (West 1969); MO. ANN. STAT. § 351.355(7) (Vernon Supp. 1981); NEB. REV. STAT. § 21-2004(15)(i) (Supp. 1981); N.J. STAT. ANN. § 14A:3-5(9) (West Supp. 1981-1982); N.Y. BUS. CORP. LAW § 727 (McKinney Supp. 1980-1981); N.C. GEN. STAT. § 55-19(c) (1975); OHIO REV. CODE § 1701.13(E)(3) (Page 1978); OKLA. STAT. ANN. tit. 18, § 1.43a(g) (West Supp. 1980-1981); OR. REV. STAT. § 57.260(4) (1979); PA. STAT. ANN. tit. 15, § 1410.G (Purdon Supp. 1981-1982); R.I. GEN. LAWS § 7.1-1.4.1(g) (1969); S.C. CODE § 33-13-180(d) (1976); TENN. CODE ANN. § 48-406 (1979); TEX. BUS. CORP. ACT ANN. art. 2.02(16) (Vernon 1980); UTAH CODE ANN. § 16.10-4(o)(7) (1953); VA. CODE § 13.1-3.1(g) (Supp. 1981); WASH. REV. CODE ANN. § 23A.08.025(11) (Supp. 1981); W. VA. CODE § 31-1-9(g) (1975); WIS. STAT. ANN. § 180.05(7) (West Supp. 1981-1982); WYO. STAT. § 17-1-105.1(f) (Supp. 1981).

108. Mattar & Hilson, *supra* note 61, at 420.

arising from status actions.¹⁰⁹ Although the broad scope of D & O policies has been severely criticized as insuring every species of fiduciary misconduct, D & O policy exclusions — including claims arising from defamation, insider self-dealing, unauthorized compensation, fraud, and failure to protect corporate assets¹¹⁰ — ameliorate the potential for abuse.

D & O insurance contracts generally consist of two parts. First, they include provisions for reimbursing the corporation for payments made to insured parties when the corporation is required or permitted to indemnify pursuant to statutory provisions.¹¹¹ Second, policies allow for direct indemnification by the insurance company in situations where the corporation lacks authority, under its bylaws or under state law, to indemnify the executive. The authorization to insure executive liability, however, is not absolute: the New York statute, for instance, bars any payment other than defense costs if a final adjudication establishes that the executive has engaged in active and deliberate dishonesty or has gained an advantage from the wrongdoing.¹¹² Moreover, most policies contain substantial deductible amounts and have co-insurance provisions requiring insureds to bear a percentage of any loss incurred.¹¹³ The co-insurance and deductible features of D & O policies further public policy by creating disincentives for wrongful conduct, but could be circumvented by a well-drafted bylaw permitting reimbursement by the corporation to the executive.¹¹⁴

A. D & O Insurance and Public Policy

A major policy objection arises in the face of extensive D & O liability insurance: executives may be effectively insulated from the deterrent effects of potential and actual litigation. Professor Bishop, recognizing the need for deterrence of corporate misbehavior, has argued that an insurance policy indemnifying an ex-

109. Greenberg & Dean, *supra* note 6, at 566-68; Mattar & Hilson, *supra* note 61, at 421.

110. See Greenberg & Dean, *supra* note 6, at 577-78.

111. The policy would not cover liabilities incurred by the corporation itself. See Johnston, *supra* note 25, at 2013.

112. N.Y. BUS. CORP. LAW § 727(b)(1) (McKinney Supp. 1980-1981). In addition, the statute specifically mandates that shareholders receive notice of information regarding the insurance, including the date of purchase, carrier, costs, and executive positions insured. *Id.* § 727(d).

113. 1980 WYATT SURVEY, *supra* note 3, at 54.

114. D & O policy limitations vary with the situation at risk, but in 1979 averaged about \$10 million for the *Fortune*-listed companies. *Id.* at 27.

executive for breaches of the duties of good faith and due care should be considered an inherently impermissible act — because it would be tantamount to an employment contract proclaiming that the executive owed no fiduciary duty to the corporation.¹¹⁵ D & O insurance policies have come under blistering attack for enabling a circumvention of state policy by indemnifying risks which state indemnification statutes would not permit corporations to indemnify absent insurance. At least one state legislature has found this reasoning persuasive; Minnesota has adopted a statute barring a corporation's purchase of insurance covering risks which the corporation may not otherwise indemnify.¹¹⁶ At bottom, this reflects the sentiment that management should not be permitted to avoid fiduciary responsibilities through insurance purchased by the corporation.

In defense of D & O policies, most exclude from coverage a substantial portion of those activities that the corporation could not indemnify on its own.¹¹⁷ While numerous D & O policies provide a measure of protection against judgments or settlements in derivative actions, for instance, most exclude from coverage the indemnification of fines or penalties, and claims arising from dishonest activities or illegal personal gains.¹¹⁸ Thus, to some extent, the D & O insurance carriers themselves have nullified the critics by requiring appropriate exclusions.¹¹⁹ Moreover, the legislative enactments under fire merely authorize corporations to pay premiums for D & O insurance — insurance carriers are not permitted to protect against risks in contravention of public policy.

Another public policy issue is whether intentional conduct should be indemnifiable.¹²⁰ Fundamental common law principles dictate that indemnifying against liability due to a willful wrong is void as against public policy.¹²¹ Certain commentators have asserted, however, that insurance coverage for intentional, will-

115. Bishop, *supra* note 66, at 1091.

116. MINN. STAT. ANN. § 301-095, subd. 7 (1969). An alternative approach to the response seen in Minnesota would be to require corporate executives to purchase their own insurance, mirroring the systems used in the medical and legal professions. Forcing executives to pay their own premiums would separate their personal interests from the business interests of the corporation. *But cf. Note, Indemnification of Directors*, 76 HARV. L. REV. 1429 (1963) (if individuals purchase insurance, there will be a loss of the economies of scale available when a corporation purchases insurance for many executives).

117. See text accompanying note 109 *supra*.

118. See Klink, Chalif, Bishop & Arsh, *supra* note 1, at 110.

119. See note 98 *supra*.

120. Scienter assumes increased significance since its recent establishment as an element in 10b-5 offenses. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

121. See Johnston, *supra*, note 25, at 2024; Note, *supra* note 116, at 648.

ful, fraudulent, or criminal conduct should be permitted where the deterrent effect of potential liability is minimal.¹²² Indeed, the common law supports this proposition to some extent, permitting indemnification of a corporate agent acting in the corporate interest without knowledge of illegality, even should the agent be found criminally liable for the conduct.¹²³ Additionally, there exists adequate support for the notion that attorneys' fees arising out of intentional or criminal conduct should be indemnifiable. In *Commissioner v. Tellier*,¹²⁴ the Supreme Court held that a broker — heavily fined for a deliberate violation of the federal securities laws — could deduct for tax purposes the costs of his unsuccessful defense as an "ordinary and necessary" business expense. The Court reasoned that the public interest in encouraging effective representation justified the allowance of the deduction for litigation expenses, notwithstanding strong federal interests in discouraging violations of the securities laws.¹²⁵ In at least some instances, therefore, *Tellier* should permit D & O insurance carriers to promote effective representation by indemnifying executives for defense expenses.¹²⁶

A further question is whether public policy should tolerate the indemnification of punitive damages. Admittedly, the deterrent force of punitive damages will be substantially diminished if the defendant executive can seek reimbursement from the insurance carrier. Yet, when compared with the threat of criminal liability for corporate wrongdoing, punitive damages have only marginal deterrent impact; if criminal penalties fail to deter executive wrongdoers, the imposition of punitive damages likely will not have significant incremental effect.¹²⁷ Indeed, various jurisdictions that permit indemnification of fines and penalties — sanctions closely akin to punitive damages — seemingly have found no public policy obstacle to reimbursement of punitive damages.¹²⁸

122. See Greenberg & Dean, *supra* note 6, at 583.

123. See Klink, Chalif, Bishop & Arsht, *supra* note 1, at 124.

124. 383 U.S. 687 (1966).

125. *Id.* at 694.

126. See Greenberg & Dean, *supra* note 6, at 584; Klink, Chalif, Bishop & Arsht, *supra* note 1, at 124.

127. Where the insurance policy does not explicitly exclude punitive damages from its coverage, there may be substantial judicial reluctance to interfere with the bargain struck between the insurer and the insured. See *Esmond v. Liscio*, 224 A.2d 793 (Pa. Super. 1966); *Mattar & Hilson*, *supra* note 61, at 422.

128. See DEL. CODE ANN. tit. 8, § 145(a) (1974); N.Y. BUS. CORP. LAW § 723 (McKinney Supp. 1980-1981) (expenses, judgments, fines); PA. STAT. ANN. tit. 15, § 410(a) (Purdon Supp. 1981-1982). Treble damages for civil antitrust violations are probably indemnifiable in whole or in part. See Greenberg & Dean, *supra* note 6, at 586.

V. THE EFFECT OF CORPORATE INDEMNIFICATION: RISK-SHIFTING OR IMMUNIZATION?

A. *The Compensation Fallacy*

Corporations and their executives frequently contend that shifting the risk of legal liability from corporate officers to the enterprise is a legitimate means of corporate compensation. The rationale has been that executives can be compensated through salary, bonus, or other emoluments, in whatever form.¹²⁹ From this perspective, indemnification represents merely another fringe benefit, to be grouped with executive expense accounts, profit-sharing plans, stock options, and deferred compensation plans.¹³⁰

But in fact, indemnity lacks the essential attributes of compensation. In contrast to the common law requirement that compensation be reasonably related to "past services rendered,"¹³¹

129. See G. WASHINGTON & J. BISHOP, *supra* note 1, at 5.

130. On expense accounts, see Rothschild & Soberheim, *Expense Accounts for Executives*, 67 YALE L.J. 1363 (1958).

Share options are granted to management as an incentive to increase efficiency, which is reflected in stock price appreciation, thereby rendering the option more valuable. See *Beard v. Elster*, 39 Del. Ch. 153, 160 A.2d 731 (Sup. Ct. 1960). Stock purchase plans offer shares at favorable prices to employees to encourage responsible conduct by increasing their ownership interests. See generally 2 G. WASHINGTON & V.H. ROTHSCHILD, *supra* note 13, at 613-33. Deferred compensation plans include pensions and annuities in which cash payments are made after peak income years for the purpose of preventing the sums from being taxed at the employees' current graduated rate. See generally E. WOOD & J. CERNY, *TAX ASPECTS OF DEFERRED COMPENSATION* 15-97 (2d ed. 1969). Fringe benefits may include life insurance, health and accident insurance, club membership, substantial discounts on corporate products, home-financing programs, moving expenses, medical examinations, educational opportunities, recreational facilities, guest homes, conventions, health resorts, limousines and chauffeurs, as well as yachts and crews. See generally *Larkin v. Commissioner*, 394 F.2d 494 (1st Cir. 1968); H. HENN, *supra* note 23, at § 254; 1 G. WASHINGTON & V.H. ROTHSCHILD, *supra* note 13, at 165-202.

131. See *McNulta v. Corn Belt Bank*, 164 Ill. 427, 45 N.E. 954 (1897); *Stratis v. Anderson*, 254 Mass. 536, 150 N.E. 832 (1926); *Miner v. Belle Isle Ice Co.*, 93 Mich. 97, 53 N.W. 218 (1892); *Seitz v. Union Brass & Metal Mfg. Co.*, 152 Minn. 460, 189 N.W. 586 (1922); *Adams v. Mid-West Chevrolet Corp.*, 198 Okla. 461, 179 P.2d 147 (1947).

Where compensation is excessive, the recipients, as well as the directors granting the windfall, are liable for the excess amounts, absent a meritorious defense of sound business judgment. See *Teren v. Howard*, 322 F.2d 949 (9th Cir. 1963); *Smith v. Dunlap*, 269 Ala. 97, 111 So. 2d 1 (1959); *Heller v. Boylan*, 29 N.Y.S.2d 653 (Sup. Ct.), *aff'd mem.*, 263 A.D. 815, 32 N.Y.S.2d 131 (1941), *motion for leave to appeal denied*, 263 A.D. 852, 32 N.Y.S.2d 1011 (1942). Moreover, compensation should be predetermined because retroactive compensation for past services is regarded as a grant without consideration, and thereby actionable by shareholders as a waste of corporate assets. See *Glenmore Distilleries v. Seidman*, 267 F. Supp. 915 (E.D.N.Y. 1967); *Hurt v. Cotton States Fertilizer Co.*, 159 F.2d 52 (5th Cir.), *cert. denied*, 331 U.S. 828 (1947); *Spaeth v. Journal Printing Co.*,

the legality of indemnification is determined by statutes, and the amount of indemnification is based upon actual costs incurred rather than upon a standard of reasonableness. Further, the executive function creating an indemnifiable liability need not have been performed for the benefit of the corporation — an essential prerequisite for any executive compensation.¹³² Additionally, in most situations where a corporation offers indemnification as an inducement to newly hired executives, the question does not even arise as to how the offered indemnification relates to past services rendered by the executive-beneficiary. Finally, indemnification differs from compensation because indemnities are not given at fixed intervals in agreed-upon amounts. In fact, there may be no occasion for indemnification in any given year, or indeed in the entire span, of the executive-beneficiary's tenure with the corporation.

The conclusion that indemnification cannot be equated with executive compensation draws support from the approach taken by state and federal statutes. State corporation laws do not classify indemnification as a form of compensation;¹³³ similarly, the Securities and Exchange Commission does not require the disclosure of indemnification payments in proxy statements, while making executive compensation a matter of mandatory disclosure.¹³⁴

139 F. Supp. 188, 16 Alaska 149 (D. Alaska 1956); *Heise v. Earnshaw Publications, Inc.*, 130 F. Supp. 38 (D. Mass. 1955); *Beacon Wool Corp. v. Johnson*, 331 Mass. 274, 119 N.E.2d 195 (1954); *Godley v. Crandall & Godley Co.*, 212 N.Y. 121, 105 N.E. 818 (1914). The rule preventing salary compensation for past services does have exceptions: where an implied contract exists, *Landstreet v. Meyer*, 201 Miss. 826, 29 So. 2d 653 (1947); where bonuses customarily are paid to executives at year's-end, *Wineburgh v. Seeman Bros.*, 21 N.Y.S.2d 180 (Sup. Ct. 1940); where the amount awarded is for the reasonable value of services rendered, *Wiseman v. Musgrave*, 309 Mich. 523, 16 N.W.2d 60 (1944); or where the compensation is ratified by the stockholders, *Chambers v. Beaver-Advance Corp.*, 392 Pa. 481, 140 A.2d 808 (1958); *cf. Russell v. Henry C. Patterson Co.*, 232 Pa. 113, 81 A. 136 (1911) (ratification was voidable because interested officers impermissibly had voted for ratification). Ratification of retroactive compensation is impermissible where the result or purpose would be to defraud the corporation, the minority shareholders, or other unprotected interests. *Hurt v. Cotton States Fertilizer Co.*, 159 F.2d 52 (5th Cir.), *cert. denied*, 331 U.S. 828 (1947). However, numerous cases hold that an officer or director may recover the reasonable value of extraordinary services rendered to a corporation upon an implied promise to pay for the services. *E.g.*, *Corinne Mill, Canal & Stock Co. v. Toponce*, 152 U.S. 405 (1894); *Fitzgerald & Mallory Constr. Co. v. Fitzgerald*, 137 U.S. 98 (1890); *Denman v. Richardson*, 292 F.2d 19 (9th Cir. 1923); *Navco Hardwood Co. v. Bass*, 214 Ala. 553, 108 So. 452 (1925); *Mortensen v. Ballard*, 218 Ark. 459, 236 S.W.2d 1006 (1951). *See generally* 19 Am. Jur. 2d *Corporations* § 1401 (1965).

132. *See New York Dry Dock Co. v. McCollum*, 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939); *Godley v. Crandall & Godley Co.*, 212 N.Y. 121, 105 N.E. 818 (1914).

133. *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT § 33 (1967); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1980-1981).

134. Proxy disclosure of executive compensation on Securities Exchange Act schedule

B. *Indemnification as Immunity*

The judicially developed doctrine of governmental immunity¹³⁵ is functionally equivalent to corporate indemnification. While governmental immunity insulates officials performing certain governmental functions from the threat of litigation, corporate indemnification likewise shields executives through the reimbursement of expenses.¹³⁶

The immunity granted to public officials thus bars the lawsuit at its inception; the court must inquire only whether the conduct at issue falls within the immunized categories of governmental functions. In contrast, the "functional immunity" provided by indemnification does not prevent the lawsuit, but rather neutralizes its consequences. The inquiry for the grantor of indemnity parallels the court's inquiry into governmental immunity: whether the executive wrongdoing comes within an indemnifiable category of corporate function.

Both indemnification and immunity spring forth from the identical fountain of necessity. The common law postulate that public servants require protection in order to engage in essential decisionmaking applies with full force to corporate executives, as evidenced by the frantic efforts of corporations to procure state indemnification statutes after the *McCullum* decision.¹³⁷ The need for indemnification to attract qualified managers to executive positions resembles, in certain respects, the need for governmental immunity with respect to officers who may not enjoy the alluring salaries and privileges provided their corporate counterparts. Given the commonality of the two doctrines, a comparison of the protection afforded by each suggests that the corporate executive has been overinsulated.

14A mandates only the listing of salary and benefits, contingent remuneration, and stock gains accrued by the exercise of options and appreciation rights. See *How Much Does the Boss Make?*, FORBES, June 8, 1981, at 114. The SEC does require indemnification disclosure on form 10-K, item 11, but only concerning the availability of the indemnity, not the amounts or the recipients.

135. See generally K. DAVIS, ADMINISTRATIVE LAW TEXT § 26 (1972 & Supp. 1980).

136. One very significant difference between governmental immunity and corporate indemnification arises from the perspective of the plaintiff: an injured party will receive compensation from the wrongdoing executive who later receives indemnification from the corporation, but there will be no compensation available should a government official be able to assert qualified immunity as a defense. This Article, however, focuses upon indemnity and immunity from the perspective of the protected officer or executive, rather than from the perspective of damage-seeking plaintiffs.

137. See notes 62-66 and accompanying text *supra*.

C. *The Waning Immunity of Public Officials*

The Supreme Court's approach in *Barr v. Matteo*¹³⁸ exemplifies the traditional common law rule that public officials acting in their traditional governmental capacities should be absolutely immune from personal liability. The acting director of a federal agency had been sued for malicious defamation allegedly committed in issuing a press release announcing the plaintiff's suspension for misconduct. A plurality¹³⁹ of the Court found the press release to be within the outer perimeters of the director's line of duty, and therefore accorded the defendant — an officer of high rank exercising a discretionary function — absolute immunity from tort liability for defamation.¹⁴⁰ The Court relied heavily upon the sentiment, expressed previously by Judge Learned Hand, that it would be "better to leave unredressed the wrongs done by dishonest officers than to subject those who try to do their duty to the constant dread of retaliation."¹⁴¹

Beginning with *Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics*,¹⁴² however, courts began shifting away from the absolute immunity rule. In *Bivens*, where federal narcotics agents were held liable for conducting a warrantless search in violation of the fourth amendment, the court held that federal officials committing constitutional torts would enjoy only a qualified immunity from suit, which would depend upon a defendant's good-faith belief in the lawfulness of the conduct.¹⁴³

138. 360 U.S. 564 (1959).

139. The 5-4 decision consisted of a plurality opinion by Mr. Justice Harlan, joined by three other Justices. Mr. Justice Black concurred in a separate opinion which emphasized the public interest in encouraging federal employees to express ideas concerning the proper operation of government.

140. 360 U.S. at 574-75; see *Spalding v. Vilas*, 161 U.S. 483 (1896). In *Spalding*, the Postmaster General was sued for circulating among postmasters a notice that defamed the plaintiff and interfered with his contractual relationships. The issue was raised whether the malicious motive of the officer would render that officer liable in damages for injury inflicted by his conduct that otherwise was within the scope of his authority. The Court concluded that the head of a department could not be held liable in a civil suit for damages on account of official communications made by him with respect to matters within his authority. The Postmaster General issuing the circulars "did not exceed his authority, nor pass the line of his duty. . . . The motive that impelled him to do that of which the plaintiff complains is therefore wholly immaterial." *Id.* at 499.

141. *Gregorie v. Biddle*, 177 F.2d 579, 581 (2d Cir. 1948).

142. 456 F.2d 1339 (2d Cir. 1972).

143. *Id.* at 1346; see *Tritsis v. Backer*, 501 F.2d 1021 (7th Cir. 1974) (Internal Revenue Service employees in the Bureau of Alcohol, Tobacco and Firearms charged with violations of the fourth, fifth, sixth, ninth, and tenth amendments granted qualified immunity); *State Marine Lines, Inc. v. Schultz*, 498 F.2d 1146 (4th Cir. 1974) (customs officers granted qualified immunity).

Further erosion of the principle of absolute immunity occurred in *Scheuer v. Rhodes*,¹⁴⁴ where the Governor of Ohio and officers of Kent State University were sued for damages under the Civil Rights Act.¹⁴⁵ The Court ruled that officers of the executive branch would be immune from suit only if they could demonstrate the existence of a reasonable good-faith belief in the propriety of their official conduct "formed at the time and in light of all the circumstances."¹⁴⁶

In *Butz v. Economou*,¹⁴⁷ the Court jettisoned the principle of absolute immunity, substituting a general rule of qualified immunity for high-level government executives. In a damage action brought against the Secretary of Agriculture for alleged violations of due process occurring during an administrative proceeding, the Court rejected the Secretary's contention that high-ranking officials needed absolute immunity in order to perform their official functions free from the fear of unending litigation. Rather, the Court concluded that only limited or qualified immunity was necessary to ensure the uninhibited exercise of governmental functions. Thus, the Court held that executive officials, in general, were entitled only to the qualified immunity set forth in *Scheurer*, and that "federal officials who seek absolute exemption from personal liability . . . [would] bear the burden of showing that public policy requires an exemption of that scope . . . [because] essential for the conduct of the public business."¹⁴⁸

This clear trend towards providing lesser protection from liability to employees operating at the highest levels of government raises the dilemma that the legitimate desire for subjecting government officials to tort liability may inhibit some conscientious public officers from making decisions that would be in the public interest. The ultimate resolution of this conflict in values likely will be to shift liability, at least to some extent, from public officials to governmental units, in much the same manner that liability of the corporate executive has been absorbed by the corporation through indemnification.¹⁴⁹

144. 416 U.S. 232 (1974).

145. 42 U.S.C. § 1983 (1976).

146. 416 U.S. at 247-48.

147. 438 U.S. 478 (1978).

148. *Id.* at 506-07.

149. See Jaffe, *Suits Against Governments and Officers: Damage Actions*, 77 HARV. L. REV. 209, 216-17 (1963) (arguing for indemnification of government officers acting reasonably or in good faith).

D. *Should Corporate Executives Enjoy Greater Immunity From Liability than Cabinet Officers of the Federal Government?*

The Supreme Court's decision in *Economou* provides a useful framework for assessing the concept of corporate indemnification. *Economou* suggests that a corporate executive should have some measure of immunity from liability, similar to that provided the government executive, to ensure effective decision-making. But in fact, indemnification insurance provides the corporate executive with substantially more protection from personal liability than the government official obtains through the narrow doctrine of qualified immunity.

In *Economou*, the Court made clear that the burden would rest upon the official seeking insulation from liability to show why public policy warranted more than a qualified immunity from suit.¹⁵⁰ Extending this reasoning to the corporate sphere, there seems little justification in public policy for providing the corporate executive with the functional equivalent of absolute immunity; indeed, considerations of policy suggest, if anything, that government officials should be provided a higher degree of protection from liability than their corporate counterparts. Government officials operating at the Cabinet level make far-reaching decisions that affect the health, safety, and security of millions of persons, while corporate executives normally face purely financial questions influencing a narrower range of interests. Moreover, the potential liability for faulty corporate decisions can more readily be foreseen and quantified than the liability for improper government decisions. In light of these differences, highly situated government officials seemingly deserve more, not less, protection from personal liability than do corporate executives.¹⁵¹

If, as *Economou* indicates, absolute immunity from personal liability is not indispensable to effective decisionmaking, the

150. See text accompanying note 148 *supra*.

151. A counterargument could be made here that government officials should have less protection from personal liability precisely because their decisions frequently will have broader impact. Thus, the argument runs, a greater scope of personal liability would induce greater caution among officials making these important decisions. In fact, however, increased personal liability in many instances does not lead to greater caution in decisionmaking, but rather merely disrupts government functions. See *Butz v. Economou*, 438 U.S. 478, 522 (1978) (Rehnquist, J., dissenting in part) (requiring Cabinet-level officials to defend actions on the merits represents a tremendous consumption of effort and is contrary to the best interests of the people).

question arises why corporate executives have obtained such favorable treatment. The burgeoning of corporate indemnification seems due in large part to the lack of public debate on the issue, which stems in turn from the paucity of available information regarding the financial and social costs of indemnification. Many state statutes whitewash the informational problems by permitting corporations to provide for corporate indemnification that exceeds any explicit statutory authorization, without requiring disclosure of the essence of indemnification agreements. The failure of states to mandate disclosure of these agreements creates a significant obstacle to shareholders seeking to challenge the propriety of indemnification in questionable transactions. Corporate executives have been ingenious in suppressing information concerning the extent to which they defend themselves, at the shareholder's expense, from the consequences of a breach of duty or even gross mismanagement of the corporation. Under the *Economou* rationale, corporations and their executives should bear the burden of demonstrating why a qualified immunity, analogous to federal executive immunity, does not adequately protect officers who in good faith pursue legitimate corporate interests.

CONCLUSION

The law of corporate indemnification has been transformed from its common law traditions into a doctrine which readily permits a corporation to protect executives who engage in self-serving conduct having no benefit to the corporation or its shareholders. Director and officer liability insurance has been widely used to circumvent even the least stringent limitations on indemnification imposed by state statutes and judicial decisions. Corporate officers enjoy effectively an absolute immunity from liability, while in contrast, government executives receive only a qualified immunity. Given that government executives make decisions more significant than their corporate counterparts, this disparity in immunity is counterintuitive and demonstrates the need to reduce the scope of corporate indemnification.

State and federal agencies responsible for regulating corporate conduct should take the initiative in compelling public disclosure of information concerning corporate indemnification. Publicly available information on indemnification practices will be the key to meaningful reform in this neglected but sensitive area of corporation law.

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