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Corporations - Officers and Directors - Indemnification of Expenses Incurred in Defense of Contract of Employment

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CORPORATIONS—OFFICERS AND DIRECTORS—INDEMNIFICATION OF EXPENSES INCURRED IN DEFENSE OF CONTRACT OF EMPLOYMENT—Plaintiff, Sorenson, contracted with defendant, Overland Corporation, to become one of its directors, and the contract was approved by Overland's stockholders. After he began to serve as a director, Sorenson was made a party defendant to a stockholder's derivative suit attacking the propriety of his contract of employment with Overland. The derivative suit terminated in favor of Sorenson and he then brought an action for reimbursement of the counsel fees incurred by him in defending the stockholder's action. Plaintiff's action was under a corporate by-law providing that the corporation shall indemnify directors and officers against expenses incurred by them in successfully defending any action in which they are involved by reason of "being or having been" a director or officer of that corporation.¹ On appeal from summary judgment for defendant, *held*, affirmed. The stockholder's suit was based on a matter which arose before plaintiff became a director and was not by reason of his "being or having been" a director. The contract was made by plaintiff in his individual capacity, not as a director, and did not come within the protection of the by-law. *Sorenson v. Overland Corp.*, (3d Cir. 1957) 242 F. (2d) 70.

The by-law under which plaintiff sought reimbursement is specifically authorized by Delaware statute.² An earlier decision interpreting the

¹ Article XXIII. "Indemnification of Directors and Officers. The corporation shall indemnify each director and officer of the corporation against all or any portion of any expenses reasonably incurred by him in connection with or arising out of any action, suit or proceeding in which he may be involved by reason of his being or having been an officer or director of the corporation. . . . The corporation shall not, however, indemnify such director or officer with respect to matters as to which he shall be finally adjudged in any such action, suit or proceeding to have been derelict in the performance of his duty as such director or officer. . . . The foregoing right of indemnification shall not be exclusive of other rights to which any director or officer may be entitled as a matter of law."

² Del. Code Ann. (1953) tit. 8, §122 (10). "Every corporation created under the provisions of this chapter shall have power to—(10) Indemnify any and all of its directors or officers or former directors or officers . . . against expenses actually and necessarily incurred by them in connection with the defense of any action, suit or proceeding in which they, or any of them, are made parties, or a party, by reason of being or having been directors or officers or a director or officer of the corporation . . . except in relation to matters as to which any such director or officer or former director or officer or person shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duty. Such indemnification shall not be deemed exclusive of any other rights to which those indemnified may be entitled under any by-law, agreement, vote of stockholders, or otherwise."

statute had indicated that this indemnity provision offered a rather broad basis of recovery.³ In the principal case, however, the court felt that there was no possibility of bringing the facts within the protection of the by-law,⁴ suggesting a more strict interpretation of the indemnity language.⁵ As a matter of interpreting the by-law's language, the correctness of the court's decision does not appear debatable. A contract made with the corporation by a prospective director simply does not arise by reason of his "being or having been" a director of that corporation. However, it would seem that legitimate litigation expenses of suits attacking contracts to become a director should be reimbursable to the innocent director in order to fulfill the policy which brought about the adoption of this type statute. The reasons for the existence of such indemnity statutes are (1) to induce responsible men to accept the post, (2) to encourage directors to resist unjust charges in confidence that, if innocent, they will be reimbursed for expenses of defense, and (3) to discourage derivative suits of the "strike"⁶ variety.⁷ A contract made with a corporation to become a director, while in a sense made in an individual capacity, certainly is a closely related and necessary part of being a director. If indemnity is not allowed to the innocent director sued on his employment contract, all the objectives of the statute are in some measure defeated. The director's contract of employment is an inviting area in which "strike" suits can be brought in the hope that the director will buy off unjust claims rather than bear the great expense of litigation;⁸ and the vulnerability to such suits attacking the terms of the employment contract will remain a possible deterrent to responsible men becoming directors. The problem is not confined to Delaware. About one third of the states have adopted indemnity

³ *Mooney v. Willys-Overland Motors, Inc.*, (3d Cir. 1953) 204 F. (2d) 888. The director involved was found innocent, in a stockholder's derivative action, of wasting corporate assets. In action by the director for reimbursement the court allowed full recovery of expenses under the Delaware statute although part of the expenses were attributable to defending charges against himself solely as a stockholder, he had never committed the acts charged, and he appeared voluntarily without service of process. The directors expenses were held to be reasonable within the indemnity statute and by-law. See 39 A. L. R. (2d) 566 (1954).

⁴ Principal case at 72.

⁵ *Schwarz v. General Aniline & Film Corp.*, 305 N.Y. 395, 113 N.E. (2d) 533 (1953), held that the New York indemnity statute was in derogation of the common law and should be strictly construed. There appear to be no cases indicating whether there was any common law right to indemnity in Delaware.

⁶ See Fuld, J., dissenting in *Gordon v. Elliman*, 306 N.Y. 456 at 479, 119 N.E. (2d) 331 (1954), for a description and denunciation of "strike suits."

⁷ In re E. C. Warner Co., 232 Minn. 207, 45 N.W. (2d) 388 (1950); *Solimine v. Hollander*, 129 N.J. Eq. 264, 19 A. (2d) 344 (1941). Bates and Zuckert, "Directors' Indemnity: Corporate Policy or Public Policy?" 20 HARV. BUS. REV. 244 (1942); Washington, "Litigation Expenses of Corporate Directors in Stockholders' Suits," 40 COL. L. REV. 431 (1940).

⁸ The expense of litigation in stockholders' suits against executives may amount to many thousands of dollars. See Hornstein, "Directors' Expenses in Stockholders' Suits," 43 COL. L. REV. 301 (1943).

statutes⁹ and under almost all of these statutes, recovery of expenses by the director, or others covered, is dependent upon his being involved in the action by reason of "being or having been" a director.¹⁰ While there appear to be no decisions involving a contract to become a director in any other state, it is to be expected that the decision of the principal case would affect any future interpretation of those statutes. To the individual considering corporate directorship, it will be important to know if and how he can protect himself, in view of this decision, against litigation expense on his contract of employment. Discounting amendment of the statute, the director may be able to find protection through amendment of the corporate by-laws or by use of an independent contract. Under the indemnity statutes having saving clauses similar to that in the Delaware statute¹¹ which provides that the indemnification offered by the statute "shall not be deemed exclusive of any other rights, to which those indemnified may be entitled under any by-law, agreement, vote of the stockholders or otherwise," there is little doubt that a provision for indemnity on the contract of employment could be inserted into the by-laws.¹² Even under statutes not containing a saving clause,¹³ an expansion to this extent might be valid. While by-laws

⁹ For a complete analysis of the differences in the indemnity statutes see 52 MICH. L. REV. 1023 (1954); 40 CALIF. L. REV. 104 (1952). Rather than giving the corporation permission to provide for indemnity of officers and directors as in Delaware, some statutes prescribe mandatory indemnification in certain cases. E.g., *California*, Cal. Corp. Code Ann. (Deering, 1953) §830; *Kentucky*, Ky. Rev. Stat. (1956) §271.375; *Missouri*, Mo. Stat. Ann. (Vernon, 1952) §351.355; *Montana*, Mont. Rev. Code Ann. (1947) §15-412; *New York*, 22 N.Y. Consol. Laws (McKinney, 1943; 1957 Cum. Supp.) §64; *Pennsylvania*, Pa. Stat. Ann. (Purdon, 1953) tit. 12, §1323.

¹⁰ E.g., *Connecticut*, Conn. Gen. Stat. (1949) §5129; *Kentucky*, Ky. Rev. Stat. (1956) §271.375; *Maine*, Me. Rev. Stat. (1954) c. 53, §24; *Maryland*, Md. Code Ann. (1951) art. 23, §60; *Michigan*, Mich. Comp. Laws (1948) §450.10 (l); *Minnesota*, Minn. Stat. Ann. (1947, 1956 Cum. Supp.) §301.09(7); *Missouri*, Mo. Stat. Ann. (Vernon, 1952) §351.355; *Montana*, Mont. Rev. Code Ann. (1947) §15-412; *Nevada*, Nev. Rev. Stat. (1955) §78.070(6); *New Jersey*, N.J. Stat. Ann. (1956 Cum. Supp.) §14:3-14; *Wisconsin*, Wis. Stat. Ann. (1957) §180.04(14).

¹¹ E.g., *Connecticut*, Conn. Gen. Stat. (1949) §5129; *Maine*, Me. Rev. Stat. (1954) c. 53, §24; *Maryland*, Md. Code Ann. (1951) art. 23, §60; *Minnesota*, Minn. Stat. Ann. (1947, 1956 Cum. Supp.) §301.09(7); *Missouri*, Mo. Stat. Ann. (Vernon, 1952) §351.355; *Nevada*, Nev. Rev. Stat. (1955) §78.070(6); *New Jersey*, N. J. Stat. Ann. (1956 Cum. Supp.) §14:3-14; *New York*, 22 N.Y. Consol. Laws (McKinney, 1943; 1957 Cum. Supp.) §63; *Rhode Island*, R.I. Acts (1948) c. 2154; *Wisconsin*, Wis. Stat. Ann. (1957) §180.04(14). See note 2 supra for the Delaware statute.

¹² *Mooney v. Willys-Overland Motors, Inc.*, note 3 supra, indicates that the Overland by-law, which is in terms somewhat broader than the controlling statute, meets the requirements of public policy by the reasonable limits set on the right of indemnification. Also, the court does not believe the statute need be construed as controlling all situations that might be called indemnification. See also *Schwarz v. General Aniline & Film Corp.*, note 5 supra; Bishop, "Current Status of Corporate Directors' Right to Indemnification," 69 HARV. L. REV. 1057 (1956).

¹³ E.g., *Kentucky*, Ky. Rev. Stat. (1956) §271.375; *Michigan*, Mich. Comp. Laws (1948) §450.10 (l); *Montana*, Mont. Rev. Code Ann. (1947) §15-412; *New York*, 22 N.Y. Consol. Laws (McKinney, 1943; 1957 Cum. Supp.) §64. In *California*, the statutory relief is ex-

must not be inconsistent or contrary to the governing statute,¹⁴ certain extensions in the by-laws beyond the statutory language would seem justifiable as within the policy of the statute.¹⁵ For the individual director, a surer method of protection is an independent contract for that purpose. Such a contract is indirectly sanctioned by those statutes containing saving clauses and should fully protect the director.¹⁶ While protection would not be so certain under those statutes with no saving clause, this type of contract would seem to be a legitimate extension of the statute.¹⁷ Use of an independent contract should also be suggested in those states not having indemnity provisions, since under the common law of most states, there is no clear right to any indemnification.¹⁸ Therefore, although the decision of the court in the principal case is correct, it should serve as a warning to prospective directors that existing statutes and by-laws may not fully protect them against personal expense arising from unfounded stockholders' actions. Additional safeguards may have to be imposed by the individual himself when asked to become a director.

John P. Williams

pressly made exclusive and could not be extended by contract or by-law. Cal. Corp. Code Ann. (Deering, 1953) §830.

¹⁴ *Gaskill v. Gladys Belle Oil Co.*, 16 Del. Ch. 289, 146 A. 337 (1929); *Security S. & T. Co. v. Coos Bay L. & C. Co.*, 219 Wis. 647, 263 N.W. 187 (1936).

¹⁵ See WASHINGTON, CORPORATE EXECUTIVES COMPENSATION 426 (1942).

¹⁶ *Mooney v. Willys-Overland Motors, Inc.*, note 3 *supra*, used an independent contract as an alternative basis for decision allowing reimbursement. See also 40 CALIF. L. REV. 104 (1952).

¹⁷ See WASHINGTON, CORPORATE EXECUTIVES COMPENSATION 426 (1942).

¹⁸ Compare *Figge v. Bergenthal*, 130 Wis. 594, 109 N.W. 581 (1907) and *In re E. C. Warner Co.*, note 7 *supra*, with *Jesse v. Four Wheel Drive Auto Co.*, 177 Wis. 627, 189 N.W. 276 (1922); *Griesse v. Lang*, 37 Ohio App. 553, 175 N.E. 222 (1931) and *N.Y. Dock Co. v. McCollum*, 173 Misc. 106, 16 N.Y. S. (2d) 844 (1939).