STATUTORY INDEMNIFICATION AND INSURANCE PROVISIONS FOR CORPORATE DIRECTORS—TO WHAT END?

*Paula Walter**

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I. Introduction

In July 1986 the New York legislature amended its indemnification and insurance provisions to provide greater protection for directors and officers of New York corporations.[1] There was irony in this action. At a time when academic literature highlighted New York corporate law as the most appropriate model for adoption by other states, New York enacted into law the equivalent of those lenient indemnification provisions discredited by legal commentators.[2]

In the aftermath of *Smith v. Van Gorkom*,[3] the popular press expressed

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* B.A. 1970, McGill University; B.C.L. 1973, McGill University; L.L.B. 1974, McGill University; Assistant Professor of Law, Baruch College, City University of New York.

1. 1986 N.Y. Laws 513 (codified at N.Y. Bus. Corp. Law § 723(a) (Consol. 1989).

2. *See* Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 Bus. Law. 92 (1966); Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers and Accountants*, 63 Cal. L. Rev. 375 (1975); Pillai & Tractenberg, *Corporate Indemnification of Directors and Officers, Time for a Reappraisal*, 15 H. of L. Reform 101 (1981); Note, *Liability Insurance for Corporate Officers and Directors: The Search for a Model Enabling Statute*, 50 N.Y.U.L. Rev. 1120 (1975); Note, *Indemnification of Corporate Directors: A Disincentive to Corporate Accountability in Indiana*, 17 Val. U.L. Rev. 229 (1983).

3. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

fear of an immediate diminution of the competent, risk-taking, entrepreneurial pool of talented directors.[4] (In *Van Gorkom* the Delaware Supreme Court had concluded that the business judgment rule no longer conferred automatic protection from personal liability on a director.[5]) That fear was exacerbated by the insurance malpractice crisis, which caused director and officer insurance premiums to rise dramatically, and which produced coincident exclusions from insurance coverage. The result was that no protection was afforded to a corporate director in those instances where suit was most likely to occur.[6]

Given the concurrence of these twin conditions, New York Governor Mario Cuomo stated that the purpose of the insurance and indemnification amendments was to "encourage capable and experienced persons to serve in corporate management by providing reasonable indemnification of the directors and of officers of public corporations for their defense of both third party and derivative actions."[7] The amendments implement the recommendations of the Governor's blue-ribbon Advisory Commission on Liability Insurance chaired by Judge Hugh Jones.[8] The Commission found:

> it is crucial to secure the continued service of competent and experienced people in senior corporate positions and to insure that they will be able to exercise business judgment without fear of personal liability, so long

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4. *The D & O Crisis: Corporate Boardroom Woes Grow*, NAT'L L.J., Aug. 4, 1986, at 1; *The Job Nobody Wants*, BUS. WEEK, Sept. 8, 1987, at 56; Darlin, *Most of Armada's Directors Resign over Insurance*, Wall St. J., Feb. 5, 1985, at 40, col. 3; *Crutcher's Chairman and Three Directors Quit: Lack of Insurance Cited*, Wall St. J., Feb. 12, 1986, at 21, col. 2.

5. *See* Veasey & Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483 (1985); Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505 (1985); Walter, *The Directors' Business Judgment Rule*, ___ SUFFOLK U.L. REV. ___ (1989); Note, *Smith v. Van Gorkom: A Narrow Interpretation of the Business Judgment Rule*, 15 CAP. U.L. REV. 725 (1986).

6. Block, Barton & Garfield, *Advising Directors on the D & O Insurance Crisis*, 14 SEC. REG. L.J. 130 (1986).

7. In approving the indemnification amendments, New York Governor Mario Cuomo stated:

> The bill, which is part of my 1986 Legislative Program, is intended to provide reasonable indemnification of the directors and officers of New York corporations and thereby allow New York corporations to continue to attract capable and experienced directors and officers . . . . This legislation is a significant measure in enhancing the business climate in New York State for the continuing success of New York corporations. The bill is approved.

Governor's Accompanying Memorandum on Approving L. 1986, ch. 513, 209th N.Y. Annual Leg. Sess., effective July 24, 1986.

8. *See Insuring Our Future*, Vol. II, REPORT OF THE GOVERNOR'S ADVISORY COMMISSION ON LIABILITY INSURANCE (July 1, 1986). The Commission was composed of twenty-five members and was chaired by Judge Hugh R. Jones and vice-chairman and executive director Orin S. Kramer. The New York legislature responded with exquisite ease and speed to the recommendations made by this blue-ribbon panel. Within months of the Commission's recommendations, these legislative amendments were drafted, adopted, and enacted into law.

as they [have] fulfilled the basic duties of honesty, care and good faith.[9]

The Governor, in endorsing the Commission's recommendations, stated: "The New York statute has lagged behind other states in providing reasonable indemnification to corporate directors and officers."[10]

This article will analyze New York's newly enacted indemnification and insurance provisions and examine how these provisions modify prior law. It will evaluate the extent to which the amendments have met the Governor's stated goals. Finally, it will discuss other legislative efforts to close loopholes created by the 1986 amendments.

II. Historical Background

The stated purpose of New York's indemnification statute for corporate directors was to accommodate the tension between society's interest in corporate accountability to the public and society's concomitant interest in attracting entrepreneurial, aggressive directors. Indemnification provides protection for directors who take good faith business risks in furtherance of fiduciary duties. Through the medium of indemnification, a delicate balance is struck between society's need for public accountability and society's need to protect able, though mistaken, business judgments made by corporate directors.

The common law business judgment rule afforded virtually complete protection to the corporate director whose business decisions had miscarried. The rule rendered the director immune from any second-guessing by the judiciary, which had the advantage of hindsight.[11] The unstated premise of the rule was the assumption that the corporate boardroom and not the courtroom was the most appropriate forum for corporate decision-making.

The rule traditionally operated in tandem with statutory provisions on indemnification. Historically, such statutory protection had been subjected to careful scrutiny because the common law did not confer any protection through agency principles on the director.[12]

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9. *Id.* at 103.

10. *See* Governor's Accompanying Memorandum on Approving L. 1986, ch. 513, 209th N.Y. Annual Leg. Sess., effective July 24, 1986.

11. *See* authorities cited *supra* note 5. *See also* Calfas, *Boards of Directors: A New Standard of Care*, 9 Loy. L.A.L. Rev. 820 (1976); Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 Tex. L. Rev. 591 (1983); Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 Baylor L. Rev. 157 (1970); Comment, *Director Liability Under the Business Judgment Rule: Fact or Fiction*, 35 Sw. L.J. 775 (1981); Krieder, *Corporate Takeovers and the Business Judgment Rule: An Update*, 11 J. Corp. L. 633 (1986); Arscht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93 (1979); Comment, *The Business Judgment Rule: A Guide to Corporate Directors' Liability*, 7 St. Louis U.L.J. 151 (1962); Note, *The Business Judgment Rule in a Hostile Tender Offer: Tearing at the Seams of a Confusing Doctrine—Norlin v. Rooney Pace, Inc.*, 17 Rutgers L.J. 321 (1986).

12. *See* New York Dock Co. v. McCollum, 173 Misc. 106, 16 N.Y.S.2d 844 (N.Y. Sup. Ct.

The New York case, *New York Dock Co. v. McCollum,*[13] was based on the rationale that the director, as a legal person, was *sui generis* since his authority was derived neither from the shareholders nor from the corporation but from the state.[14] Consequently, even when his defense was successful, the court reasoned that the director was not entitled to reimbursement of expenses incurred in defending an action instituted against him as director, whether successful or not. The court further concluded that the defense, regardless of its success, could in no way offer the corporation a definite benefit. Therefore, any attempt at indemnification of directors by the corporation was *ultra vires* the corporation.[15]

The New York position, which assumed the lack of a benefit to the corporation, was immediately criticized. In *Solimine v. Hollander*[16] the New Jersey Supreme Court concluded that reimbursement of a director was of direct benefit to the corporation because of the need to attract competent individuals and induce them to assume the post of director.[17] *Solimine* rejected *McCollum* because the latter prevented innocent directors from protecting themselves against unjust charges.[18]

The New York legislature also rejected *McCollum* by statutorily permitting indemnification of corporate personnel. Other states followed the New York initiative.[19]

The current issue for legislatures and courts is how best to protect the director without simultaneously sacrificing the power to call him to account for errant behavior. Different jurisdictions have resolved this issue in different ways.

1939); Greisse v. Lang, 175 N.E. 222 (Ohio 1931).

13. New York Dock Co. v. McCollum, 173 Misc. 106, 16 N.Y.S.2d 844 (N.Y. Sup. Ct. 1939).

14. The perception of the legal community following *McCollum* was that absent express legislative authorization, the common law did not recognize the right to reimbursement of the expenses of a derivative action.

On appeal the court found that disinterested approval of the reimbursement had not been given, that no corporate benefit was provided, and that it would have been more appropriate to bring the reimbursement claim before the trial judge in the original suit, who would have been "in a much better position than any judge to evaluate the alleged benefits to the corporation of the legal services rendered." *Id.* at 113, 16 N.Y.S.2d at 850.

15. *Id.*

16. Solimine v. Hollander, 129 N.J.L. 264, 19 A.2d 344 (1941). The court stated, "[t]he right to reimbursement is a circumstance that would actuate and induce responsible businessmen 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." *Id.* at ____, 19 A.2d at 348. *See also In re* E.C. Warner Co., 232 Minn. 207, 45 N.W.2d 388 (1950).

17. Solimine v. Hollander, 129 N.J.L. 264, ____, 19 A.2d 344, 348 (1941).

18. *Id.*

19. New York adopted enabling legislation in 1941. Delaware followed suit in 1943. *See* G.Washington & J. Bishop, Indemnifying the Corporate Executive (1963).

III. Statutory Responses to Indemnification

A. *Mandatory Indemnification*

Some states have adopted statutes which provide mandatory indemnification in the event that the director has met the necessary standards of care and loyalty to the corporation and has incurred expenses in the defense of actions undertaken in pursuit of his corporate function.[20] Mandatory indemnification confers on the director a judicially enforceable right to indemnification.[21]

B. *Permissive Indemnification*

Other states have adopted statutes which provide for permissive indemnification of directors.[22] A corporation may indemnify the director, but is not required to do so. Because indemnification is permissive, a director aggrieved by a negative decision cannot seek redress from a court of law to compel indemnification by the corporation. Even if the corporation chooses to indemnify the director, the director need not be indemnified to the full extent allowed by statute. Generally, where the indemnification statute is permissive, decisions are rendered on a case-by-case basis, with the consequence that uniformity and predictability are sacrificed.

The availability of indemnification is often determined by corporate bylaws. The decision to indemnify the director is discretionary and will depend on (1) the nature of the director's activity from which the liability arose, (2) the standard of care required of the director for indemnification, and (3) the body which determines whether the director acted with the requisite care.[23] Even though the applicable standard for indemnification under corporate bylaws may be identical in both mandatory and permissive statute jurisdictions, the practical applications can differ widely.

Few jurisdictions have adopted the all-or-nothing approach. Instead, most have combined mandatory and permissive provisions within a single statute.[24] The central issue has become the extent and degree to which a

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20. N.Y. Bus. Corp. Law § 723(a) (Consol. 1989); Del. Code Ann. tit. 8, § 145(c) (1983); Cal. Corp. Code § 317(d) (Deering 19__).

21. Del. Code Ann. tit. 8, § 145(c) (1983) provides: "to the extent that [the person to be indemnified] has been successful . . . he shall be indemnified." At least twenty states have adopted indemnification statutes which follow the Delaware model. For example, N.Y. Bus. Corp. Law § 723(a) (Consol. 1986, Supp. 1989) provides: "a person who has been successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding of the character described in § 722 ***shall*** be entitled to indemnification as authorized." *Id.* (emphasis added).

22. Cal. Corp. Code § 830 (Deering 1976). *See* N.Y. Bus. Corp. Law § 723 (McKinney 1980) (repealed by L. 1986, ch. 513).

23. *See* N.Y. Bus. Corp. Law § 723(b) (Consol. 1986, Supp. 1989); Del. Code Ann. tit. 8, § 145(d) (1983).

24. *See* N.Y. Bus. Corp. Law § 723(b) (Consol. 1989); Del. Code Ann. tit. 8, § 145(d) (1983).

corporation may indemnify its director. Resolution of that issue, in turn, depends on whether the statutory provisions are exclusive[25] or non-exclusive.[26]

IV. Exclusive Versus Non-Exclusive Statutory Provisions

A. *Exclusive Statutory Indemnification Provisions*

An indemnification statute is said to be exclusive where it precisely describes the circumstances under which indemnification may be granted. The statute provides express guidelines which directors must follow. Further, exclusive provisions establish the foundation for subsequent substantive sections.

B. *Non-Exclusive Statutory Indemnification Provisions*

Non-exclusive provisions enable a corporation to exceed the limitations specified by statute and permit the corporation to create indemnification rights greater than those provided by statute. What then sets boundaries to the corporation's apparently unlimited ability to create absolute indemnification rights? Such limitations appear to be derived from the twin concepts of "good faith" and the requirement that the director act in "a manner reasonably believed to be in the best interests of the corporation."[27]

These limitations have engendered much controversy and comment, but the literature has not resolved the issue. At best, an unhedged opinion may be expressed that the concept of public policy is best suited to determine whether broader indemnification rights will be enforced by a court of law. However, the notion of public policy remains fluid and difficult to define.

Some decisions regard the non-exclusive statutory provisions as an independent source of power analogous to a contract right. These cases hold that it is unnecessary even to refer to the statute which granted the indemnification rights.[28] Non-exclusivity allows a corporation to create indemnifi-

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25. *See* N.Y. Bus. Corp. Law § ____ (McKinney 1980) (repealed by L. 1986, ch. 513).

26. 209th N.Y. Annual Leg. Sess., L. 1986, ch. 513, effective July 24, 1986 (codified at N.Y. Bus. Corp. Law § 621 (Consol. 1986)).

27. N.Y. Bus. Corp. Law § 722(a) (Consol. 1986); Del. Code Ann. tit. 8, § 145(a)(b) (1983). The standard of care which the director must exercise has been phrased by way of both positive and negative injunction. Those states which follow the Model Business Corporations Act place the standard at a more minimal level, which is that the director's conduct "not [be] opposed to the best interests of the corporation." 1 Model Bus. Corp. Act § 5. *See* Del. Code Ann. tit. 8, § 145(b) (1983). Delaware has adopted the Model Act. Other states, New York among them, hold the director to a stricter standard. In order to merit indemnification, the director must act in "a manner he reasonably believed to be in the best interests of the corporation." N.Y. Bus. Corp. Law § 722 (Consol. 1986).

28. This point was illustrated in Beneficial Indus. Loan Corp. v. Smith, 170 F.2d 44 (3d Cir. 1948), *aff'd sub nom.* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949). The court

cation rights greater than those allowed by statute. On the other hand, some courts have set limits on broad statutory provisions which seemingly grant unlimited discretion.[29] To hold otherwise, these courts reason, would be to frustrate any judicial remedy which the shareholders might have.

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held that "the right of the officers and directors of Beneficial to indemnification under the by-laws is analogous to a contract right." *Id.* at 50. The point was reaffirmed in Cambridge Fund, Inc. v. Abella, 501 F. Supp. 598 (S.D.N.Y. 1980), where the court held that "indemnification would be proper even if all we find is that the directors acted under some discretionary authority to indemnify. We think this discretionary authority may be found whether in a vote of independent directors referred to in the statute, or in a by-law of the corporation." *Id.* at 617.

The most exhaustive examination and evaluation of the legal consequences of the non-exclusive provision occurred in Mooney v. Willys-Overland Motors, 204 F.2d 888 (3d Cir. 1953)(applying Delaware law), where the court approved indemnification of a former director based on independent grounds authorized by the Delaware statute. The court found that:

> where there exists, as there does here, an independent ground for the payment of litigation expenses, we see no reason to make an overriding reference to the Statute. The final sentence of the statute states: "Such [statutory] 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."

Id. at 896.

This implies that once an independent legal ground has been shown, indemnification beyond the statutory provisions is possible. There is some thought that *Mooney* has been limited by Essential Enters. Corp. v. Automatic Steel Prods., 39 Del. Ch. 371, 164 A.2d 437 (1960), to apply to cases involving successful defenses. *See* Veasey, Finkelstein & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 Bus. Law. 399, 413 n.52 (1987) [hereinafter Veasey, Finkelstein & Bigler].

29. There is no case law as to whether a court would permit indemnification pursuant to an independent ground where the proposed indemnification could be prohibited by law or public policy. The term "public policy" cannot be defined in a positive manner except to state that it represents instances where the judiciary is unwilling to permit indemnification. What are these instances? In Merritt-Chamman & Scott Corp. v. Wolfson, 264 A.2d 358 (Del. 1970), where charges of perjury, fraud, and obstruction of justice had been made, the court stated that "it would be anomalous indeed, and diametrically opposed to the spirit and purpose of the statute and sound public policy to extend the benefits of indemnification to these defendants under the facts and circumstances of this case." *Id.* at 360.

Similarly, public policy considerations preclude indemnification of directors for liabilities incurred under the Federal Securities Act of 1933. That appears to have been the *ratio decidendi* in Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), where indemnification to an underwriter was denied because he had actual knowledge of the omission of material facts from the prospectus. *Id.* at 1288. The court reasoned that indemnification for liability under the Securities Act is against the public policy expressed in the Act. *Id.*

In New York, before the non-exclusive indemnification provisions were enacted, the court in People v. Uran Mining Corp., 13 A.D.2d 419, 216 N.Y.S.2d 985 (1961), denied indemnification where the suit alleged fraudulent conduct. The better view is that "[a]lthough it is far from self-evident exactly where the line should be drawn, it is clear that the courts will not enforce by-law or contractual indemnification provisions purporting to indemnify corporate fiduciaries against the more egregious forms of fraudulent and willful misconduct." Johnson, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 Bus. Law. 1993, 2006-07 (1978).

V. Nature of Legal Action Instituted Against Directors

Corporate directors are subject to both third-party actions and shareholders' derivative actions. In the latter type of action, the aggrieved shareholder asserts that a wrong has been done to the corporation. In his capacity as plaintiff, the shareholder seeks relief for the corporation rather than for his personal benefit. Thus, the corporation is the ultimate beneficiary of the lawsuit. The shareholder does not receive any direct, tangible benefit if the lawsuit is successful. If the plaintiff-shareholder is successful and the defendant-director is negligent, the director is then compelled by the court to redress the wrong directly to the corporation.

Questions of policy have arisen with respect to whether the corporation should be permitted to repay to the director the precise amount which it receives as a result of a successful derivative action, especially in the case where the director's judgment was not tainted by dishonesty, but was instead exercised in good faith and in what the director believed to be the best interests of the corporation.[30] Some state statutes have allowed the corporation to repay only the director's expenses.[31] Other state statutes have prohibited indemnification of expenses incurred in an action "which is settled without court approval."[32] Some states allow indemnification of amounts paid in settlement.[33]

Some statutes may not contain express language permitting the corporation to reimburse a director for monies he paid to satisfy the shareholders' derivative action.[34] However, in view of the ambiguous language of non-exclusivity provisions, it is unclear whether the corporation can take advantage of non-exclusivity to indemnify the director where such indemnification is neither mandated nor authorized by statute. If it can, then two types of problems arise. First, circuity of payment or "circularity" occurs, since funds won in the name of the corporation are then paid out by the corporation to the alleged wrongdoer-director. The very purpose of the shareholders' derivative action is subverted and undermined. Second, serious questions of accountability are created. When the corporate executive need no longer fear any personal liability, he cannot be deterred from errant behavior. In fact, the errant director would be rewarded for his wrongdoing.

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30. *See supra* note 27 and accompanying text.

31. Del. Code Ann. tit. 8, § 145(a) (1983); N.Y. Bus. Corp. Law § 722(a) (Consol. 1986).

32. Cal. Corp. Code § 317(c)(3) (Deering 19__); N.Y. Bus. Corp. Law § 723(b)(2) (McKinney 1980) (repealed by L. 1986, ch. 513).

33. Minn. Stat. § 302A.521(2) (1985); S.D. Codified Laws Ann. § 47-2-58(15) (1983); Wyo. Stat. § 17-1-105.1(a) (1987).

34. There are some exceptions. Arizona permits such indemnification if court approval is received. Ariz. Rev. Stat. Ann. § 10-005B (1977). Louisiana allows indemnification up to but "not exceeding, in the judgment of the board of directors, the estimated expense of litigating the action to conclusion." La. Rev. Stat. Ann. § 12:83 (West 1969).

VI. New York—1986 Amendments

A close examination of the 1986 New York amendments is in order. The major thrust of the new legislation is the introduction of a non-exclusive indemnification provision. This change permits the corporation to draft new authorizations for indemnification independent of statute.[35] It is incumbent upon a New York corporation to amend its certificate of incorporation or bylaws in response to this statutory enactment.

As discussed above, the outside limits of these provisions are undetermined and are more open to intelligent speculation than to precise definition. New York corporations were formerly guided by the twin notions of public accountability and deterrence of errant behavior. Those concerns appear to have given way in the face of corporate apprehension. The resulting legislative enactments evidence that reaction.[36]

In section 721 the new indemnification provisions state that the director's rights created by the statute are not exclusive of other rights contained in the certificate of incorporation or the corporate bylaws.[37] This independent provision for indemnification may be authorized by resolution of the shareholders, by resolution of the directors, or by prior agreement providing for such indemnification.[38]

From the director's vantage point, it is preferable to obtain a contractual agreement in advance. One commentator suggests, however, that such contractual agreements can be made only between parties bargaining at arm's length since it is inherently impossible for scattered shareholders to bargain on an equal footing with management.[39] Consequently, it is deemed to be the lawmaker's duty to represent the shareholders and to fix the extent of the duty owed by the corporation to the shareholders.[40]

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35. N.Y. Bus. Corp. Law § 721 (Consol. 1986) states: "Nonexclusivity of statutory provisions for indemnification of directors and officers." The 1986 Act substituted the word "nonexclusivity" for "exclusivity."

36. *See* authorities cited in note 4 *supra*. It is amazing how quickly the recommendations of Judge Jones' Commission were enacted. The Commission handed down its recommendations on April 1, 1986, and by July 1, 1986, the new statutory indemnification provisions were in effect.

37. N.Y. Bus. Corp. Law § 721 (Consol. 1986) provides:

> The indemnification . . . provided by this article shall not be deemed exclusive of any other rights to which a director or officer seeking indemnification or advancement of expenses may be entitled, whether contained in the certificate of incorporation or the by-laws or, when authorized by such certificate of incorporation or by-laws, (i) a resolution of shareholders, (ii) a resolution of directors, or (iii) an agreement providing for such indemnification.

38. N.Y. Bus. Corp. Law § 721 (Consol. 1986).

39. *See* Bishop, *supra* note 2.

40. Bishop, *supra* note 2, at 102. Bishop goes so far as to say:

> But even if there is no objection in principle to such exculpation, one may doubt whether, in the case of the ordinary public corporation, a court would find that management's adoption of an indemnification by-law, even where it received the usual

The New York legislature has placed a policy limitation on such contractual agreements. Notwithstanding any such agreement, the statute prohibits indemnification of a director where his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action.[41] Similarly, where the director personally gained a financial profit or other advantage to which he was not legally entitled, the statute prohibits outright indemnification regardless of the blanket provisions negotiated in advance and contained in a contractual agreement.[42]

Section 722 provides for indemnification of any person made or threatened to be made a party to a civil or criminal proceeding by reason of the fact that he is a director.[43] In short, status suits are subject to indemnification.

A new provision of this subsection permits reimbursement of monies paid by the director in settlement, and of reasonable expenses, including attorneys' fees, which were actually and necessarily incurred by the director in connection with the defense or settlement of the action.[44] The former law appears to have been amended to permit indemnification in the event of settlement of a shareholders' derivative suit.[45] Under former law reimbursement of monies paid in settlement of a shareholders' derivative action had not been permitted, even where the settlement of the lawsuit met with court approval.[46] The new law has been enacted without strict restraints on the

> perfunctory approval of 98% of the proxies, amounted to a valid contract, in effect relieving management of a duty which it would otherwise owe the corporation—i.e., the stockholders.

Id.

41. N.Y. Bus. Corp. Law § 721 (Consol. 1986).
42. *Id.*
43. N.Y. Bus. Corp. Law § 722 (Consol. 1986) provides:

> A corporation may indemnify any person made, or threatened to be made, a party to an action or proceeding . . . by reason of the fact that he . . . was a director or officer of the corporation . . . if such director or officer acted, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation, not opposed to, the best interests of the corporation . . . .

44. N.Y. Bus. Corp. Law § 722(c) (Consol. 1986).
45. N.Y. Bus. Corp. Law § 722(c) (Consol. 1986) provides:

> A corporation may indemnify any person [if he] was serving at the request of the corporation as a director or officer . . . against amounts paid in settlement of reasonable expenses, including attorney's fees actually and necessarily incurred by him in connection with the defense or settlement of such action, or in connection with an appeal therein.

46. The former New York law prohibited indemnification of a director who was "adjudged to have breached his duty to the corporation." N.Y. Bus. Corp. Law § 722(a) (McKinney 1980) (repealed by L. 1986, ch. 513).

Former section 722(b) specifically denied reimbursement for amounts paid in settlement and for defense expenses incurred in settling an action without court approval. However, there was no statutory provision for court-awarded indemnification if the director was adjudged liable.

reimbursement of settlement monies. The director must only demonstrate that he acted in good faith and for a purpose which he reasonably believed to be in the best interests of the corporation.[47]

The amended provision, however, contains confusing language regarding those instances where the director has been adjudged liable to the corporation. The statute states that a court may permit indemnification of the settlement amount and its expenses "as the court deems proper" under "all the circumstances of the case."[48] The exact relationship between these two standards is unclear. The first part of the section speaks to reimbursement for a director's settlement payments and expenses necessarily incurred in a shareholders' derivative action.[49] The second part states that indemnification is forbidden where the director is adjudged liable to the corporation. The single exception arises in those cases where the court approves indemnification "in view of all the circumstances of the case" where the director, although guilty, could at the same time be "fairly and reasonably entitled to indemnity."[50] The second part of the section would appear to contradict the first part.

Does this mean that the corporation's apparently uncontrolled power to indemnify a director is in fact controlled by judicial discretion? Or does it mean that the court must now permit, pursuant to statute, indemnification of all guilty directors in a shareholders' derivative action, except those who are not "fairly and reasonably entitled to indemnity for such portion of the settlement amount and expenses as the court deems proper?"[51]

The latter interpretation would constitute a radical and dramatic departure from prior law. Did the legislature intend such consequences? Nothing in this section's legislative history would lead to this conclusion. The Governor's Commission on Liability Insurance concluded that reimbursement of amounts paid in settlement of derivative suit should be made to directors to encourage talented executives to sit on boards of directors.[52]

47. N.Y. Bus. Corp. Law § 722(c) (Consol. 1986).

48. N.Y. Bus. Corp. Law § 722(c) (Consol. 1986) states:

> no indemnification under this paragraph shall be made in respect of . . . (2) any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation, unless and only to the extent that the court in which the action was brought, or, if no action was brought, any court of competent jurisdiction, determines upon application that, in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for such portion of the settlement amount and expenses as the court deems proper.

49. N.Y. Bus. Corp. Law § 722(c) (Consol. 1986) provides: "A corporation may indemnify . . . against amounts paid in settlement and reasonable expenses, including attorneys' fees, actually and necessarily incurred . . . in connection with the defense or settlement of such action, or in connection with an appeal therein."

50. *See* statutory language set forth in note 48 *supra*.

51. N.Y. Bus. Corp. Law § 722(c) (Consol. 1986).

52. The Governor's Committee recommended:

> The Bus. Corp. Law be amended to provide that (a) corporations may indemnify

Must the Commission's conclusions be accepted *in toto* simply because the Governor endorsed its recommendations?

While a settlement agreement might appear to authorize indemnification of a director in a shareholders' derivative action (even in cases of his guilt), the public policy arguments discussed above would limit reimbursement to those instances where the court determines that the guilty director is "fairly and reasonably entitled to indemnity."[53]

Under the new statute a director is entitled to mandatory reimbursement whether or not he is "wholly" successful on the merits.[54] The term "wholly successful" remains unclear. Is the defense successful if the director prevails on procedural rather than substantive grounds? Under prior law mandatory reimbursement was reserved only for the director who was successful on the merits.[55] Some commentators have questioned the wisdom of mandating reimbursement in cases involving a successful technical defense.[56] The argument advanced is that mandatory indemnification encourages a director, who would probably be found guilty on the merits, to seek adjudication hoping to prevail by use of a technical defense. In states with non-exclusive statutes, it would appear to be best to draft more protective articles, bylaws, or contracts since the availability of indemnification will turn on construction of the corporate documents rather than on a statute.

The New York statute provides for reimbursement other than by way of a court order.[57] Indemnification may be granted:

> their directors and officers for any judgment, settlement or related expense for which insurance may currently be purchased by the corporation under Bus. Corp. L. sec. 727, provided that any indemnity payments in derivative actions are approved by a majority vote of disinterested directors or by a court.

Insuring Our Future, Vol. II, REPORT OF THE GOVERNOR'S ADVISORY COMMISSION ON LIABILITY INSURANCE 103-04 (July 1, 1986).

53. *See* statutes cited in notes 24 and 25 *supra*. *See also* Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92 (1966); Cheek, *Control of Corporate Indemnification: A Proposed Statute*, 22 VAND. L. REV. 255 (1969); Irenas & Moskowitz, *Indemnification of Corporate Officers, Agents, and Directors: Statutory Mandates and Policy Limitations*, 7 SETON HALL LEGIS. J. 117 (1984); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968).

54. N.Y. BUS. CORP. LAW § 723(a) (McKinney Supp. 1989) provides: "A person who has been successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding of the character described in section 722 shall be entitled to indemnification as authorized in such section."

55. N.Y. BUS. CORP. LAW § 724 (McKinney 1980) (repealed by L. 1986, ch. 513). The 1986 Act deleted the qualifying adjective of "wholly," so there is no longer a requirement that an individual be "wholly successful" in order to be entitled to indemnification.

56. *See* Pillai & Tractenberg, *Corporate Indemnification of Directors and Officers: Time for a Reappraisal*, 15 J.L. REF. 101, 112-13 (1981); Veasey, Finkelstein & Bigler, *supra* note 28, at 406-07.

57. N.Y. BUS. CORP. LAW § 725(d) (McKinney Supp. 1989) provides that where directors have been indemnified otherwise than by way of court order, the shareholder must be apprised

(1) by the board acting by a quorum consisting of directors who were not parties to the action, or
(2) by a quorum of disinterested directors, or
(3) by a board upon the written opinion of independent legal counsel recommending indemnification to be proper.

Unlike the Ohio statute, which defines an "independent counsel" as an attorney who has not offered his legal services to the director or the corporation for five years immediately preceding his present retainer,[58] the New York statute does not define the term "independent legal counsel." Case law in New York, however, has defined an independent counsel as an attorney who is free from past connections with the corporation or the persons to be indemnified.[59] Some commentators suggest that, because the director and the independent counsel are likely to share similar socio-economic backgrounds and normative values, the so-called independent counsel is likely to be biased in favor of the director.[60] Such reasoning is open to criticism since it overlooks the purpose of the legal profession and assumes that attorneys' socio-economic environments will cause them to act at variance with the principles of their legal training.

Section 723(c)(2) provides that a director who incurs expenses while defending a civil or a criminal action may be paid those expenses by the corporation in advance of the final disposition of the action. This advancement of

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of such indemnification not later than the next annual shareholders' meeting, but in no event later than fifteen months from the date of such action. Mandatory notification of the shareholder is desirable to keep a shareholder's judicial remedy from being frustrated simply because the shareholder did not find out about the director's activity.

58. Ohio Rev. Code Ann. § 1701.13(E)(4) (Anderson 1985) defines "independent counsel" as: "an attorney, or a firm having associated with it an attorney, who has been retained by or who has performed services for the corporation, or any person to be indemnified within the past five years." *Cf.* Rev. Model Bus. Corp. Act § 8.55, which—unlike the Ohio statute—has not attempted to define "independent" in terms of years of service.

In the Official Comment the drafters of the Model Business Corporation Act state that "special legal counsel" should normally be counsel having no prior professional relationship with those seeking indemnification, should be retained for the specific occasion, and should not be either inside counsel or regular outside counsel. It is important that the selection process be sufficiently flexible to permit selection of counsel in light of the particular circumstances and to avoid unnecessary expense.

59. Schmidt v. Magnetic Head Corp., 97 A.D.2d 151, 468 N.Y.S.2d 649 (1983). The court noted that an attorney would not necessarily be disqualified because he had previously performed services for the corporation. The critical element was that an "independent" counsel should not have an ongoing relationship with the corporation, and he should be "free from past connections with the corporation or the person to be indemnified." *Id.* at ____, 468 N.Y.S.2d at 656-57.

60. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 Duke L.J. 895. For the legal implications of the "group think" psychology of boards of directors, see: Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 Law & Contemp. Probs. 83 (1985); Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 Mich. L. Rev. 1 (1981).

expenses is discretionary with the board.[61] When funds are advanced, the board must obtain the director's commitment that any amounts advanced will be repaid to the corporation in the event of an unfavorable disposition, or where the defendant is ultimately found not to be entitled to reimbursement of expenses.[62] The corporation need not determine whether or not the individual's defense has merit at the time expenses are advanced. Nor is the corporation required to secure from the director any collateral to bind the undertaking. Similarly, the director need not show financial responsibility. These circumstances create a situation where a director who is adjudged liable to the corporation may have no monies left to repay the expenses advanced, after he has compensated the corporation. That concern is not addressed by the new enactments.

The most critical provision of the recently enacted legislation is its requirement that shareholders must be notified where indemnification takes place without a court order.[63] This appears to be the major check on the newly enacted non-exclusivity provision. The obvious danger of such a provision resides in the possibility that it may allow management to disregard the shareholder. The requirement of shareholder notification recognizes that it is the shareholder's investment which the director must manage to the best of his ability.[64] Any abuse of that trust could not be monitored easily given the legislatively sanctioned non-exclusive provisions for privately arranged reimbursement agreements between the corporation and the director. The only restraint on excess is the shareholder. The newly enacted stat-

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61. N.Y. Bus. Corp. Law § 723(2)(c) (McKinney Supp. 1989) provides:

> Expenses incurred in defending a civil or criminal action or proceeding *may* be paid by the corporation in advance of the final disposition of such action or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount as, and to the extent, required by paragraph (a) of section 725 [emphasis added].

62. N.Y. Bus. Corp. Law § 725(a) (McKinney Supp. 1989) provides:

> All expenses incurred . . . shall be repaid in case the person receiving such advancement or allowance is ultimately found, under the procedure set forth in this article, not to be entitled to indemnification or, where indemnification is granted, to the extent the expenses so advanced by the corporation or allowed by the court exceed the indemnification to which he is entitled.

63. N.Y. Bus. Corp. Law § 725(d) (Consol. 1986, Supp. 1989) provides:

> If any action with respect to indemnification of directors and officers is taken by way of amendment of the by-laws, resolution of directors or by agreement, then the corporation shall not later than the next annual meeting of shareholders, unless such meeting is held within three months from the date of such action, and, in any event, within fifteen months from the date of such action, mail to its shareholders of record at the time entitled to vote for the election of directors a statement specifying the action taken.

64. There has been academic debate as to whether the directors serve the shareholder or the corporation. *See* Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev. 1365 (1932); Dodd, *For Whom Are Corporate Managers Trustees?* 45 Harv. L. Rev. 1145 (1932).

utory provisions—which require that shareholders receive notice within three months from the date of the private indemnification agreement between the director and the corporation, and in no event later than the next annual meeting of shareholders—meet society's need for shareholder control.

Another innovative amendment is a mandatory grant to the corporation of the power to purchase and maintain insurance both for the corporation (to indemnify it for any obligation it incurs) and also for directors (to indemnify them in cases where they may be indemnified by the corporation).[65] The amendments also allow the corporation to maintain insurance which will indemnify directors in those instances where they would otherwise not be indemnified.[66] Historically, liability insurance was deemed *ultra vires* the corporation since it benefited only the director, and not the corporation.[67]

Prior to the amendments to section 726, the insurance provisions afforded greater protection than that provided by direct corporate indemnity.[68] Former section 727 contained specific language permitting a corporation to purchase insurance against those situations in which direct corporate indemnification would be unavailable.[69] Thus, prior law created a gap between the legal availability of insurance and the statutory restrictions on corporate indemnification. Many, including the New York Business Council, were troubled by this gap and proposed measures which would achieve greater consistency between the indemnity and insurance provisions of the

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65. N.Y. Bus. Corp. Law § 726(a) (McKinney Supp. 1989) provides: "Subject to paragraph (b), a corporation *shall* have [the] power to purchase and maintain insurance" (emphasis added).

66. N.Y. Bus. Corp. Law § 726(a)(3) (McKinney Supp. 1989) allows corporations:

> [t]o indemnify directors and officers in instances in which they may not otherwise be indemnified by the corporation under the provisions of this Article provided the contract of insurance covering such directors and officers provides, in a manner acceptable to the superintendent of insurance, for a retention amount and for co-insurance.

67. The following articles discuss the evolution of liability insurance for directors: Bishop, *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 Duke L.J. 1153; Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 Bus. Law. 92 (1966); Block, Barton & Garfield, *Advising Directors on the D & O Insurance Crisis*, 14 Sec. Reg. L.J. 130 (1986); Greenberg & Dean, *Protecting the Corporate Executive: Director and Officer Liability Insurance Reevaluated*, 58 Marq. L. Rev. 555 (1975); Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 Bus. Law. 1993 (1978); Note, *Public Policy and Directors' Liability Insurance*, 67 Colum. L. Rev. 716 (1967); Note, *Liability Insurance for Corporate Executives*, 80 Harv. L. Rev. 648 (1967); Note, *Indemnification of the Corporate Insider: Directors' and Officers' Liability Insurance*, 54 Minn. L. Rev. 667 (1970).

68. N.Y. Bus. Corp. Law § 727(3) (McKinney 1980) (repealed by L. 1986, ch. 513) provided that insurance could be used to "indemnify directors and officers in instances in which they may not otherwise be indemnified by the corporation."

69. *Id.* For a discussion of the legal problems created by the gap between indemnification provisions and insurance see authorities cited in note 67 *supra*.

New York Business Corporations Law.[70] It was vigorously asserted that it was neither logical nor equitable to allow a corporation to do indirectly, through insurance coverage or legally sanctioned insurance indemnification contracts, what it could not legally do directly. The need to conform the statutory indemnity and insurance provisions caused the Governor's Advisory Commission to support the change in the law.[71] The Commission believed that statutory revision would result in a higher level of compliance with both aspects of the law, and as a consequence, would free domestic corporations from what it characterized as "unreasonable dependence upon

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70. The following represents a pro and con discussion within the Governor's Advisory Commission on Liability Insurance on conforming the indemnification provisions to the insurance provisions to permit indemnification for any judgment or settlement for which insurance would be available:

> *Pro:* The gap between the legal availability of directors' and officers' insurance and the statutory restrictions on corporate indemnification has become troublesome to many in the context of the current liability crisis . . . . [The Business Council of New York State] has proposed that business corporations be authorized to indemnify their directors and officers for any judgment, settlement or related expenses for which insurance would be available . . . . [T]he law must be altered in order to avoid disincentives for capable and experienced people to serve in corporate management . . . . [T]here is neither logic nor justice in barring a corporation from doing directly what it is authorized to do through insurance if the insurance market can provide coverage . . . . They feel that these insurance provisions are fully consistent with the loss spreading policy of the State as articulated in Section 727(e), and that equivalent provisions for direct indemnification would be just as consistent.
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> . . . .
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> *Con:* Critics of this and other such proposals are concerned that any extension of corporate indemnity in derivative actions would dull the incentive for corporate directors and officers to be attentive to their duties and to act in the best interests of the corporation . . . . Permitting the corporation to indemnify payments made by directors or officers in such derivative actions arguably creates a "circularity" problem, where funds won in the name of the corporation are then paid out by the corporation to the adjudged or alleged wrongdoer. Thus, they say, the proposed modification of indemnity law would undermine the very purpose of derivative actions. Moreover, proceeds this line of argument, extending the availability of indemnity to settlements in derivative cases may in effect reward wrongdoing, since derivative suits may be settled for various reasons, and the settling officer or director may in fact have violated his or her duty of care.

Insuring Our Future, Vol. II, Report of the Governor's Advisory Commission on Liability Insurance 100-02 (July 1, 1986).

71. The conclusions of the Governor's Advisory Commission on Liability Insurance were as follows:

> [W]e support the conforming of the indemnity provisions of the Business Corporations Law with the insurance provisions of the same statute. We believe that this change will result in greater enforcement of both the indemnity and insurance provisions, and will free New York corporations from unreasonable dependence upon the vagaries of the insurance market for adequate protection of the personal finances of their directors and officers.

Id. at 103.

the vagaries of the insurance market for adequate protection."[72]

The power of the corporation to purchase insurance for its directors, errant and honest alike, has continued to be the subject of much scholarly comment.[73] Those commentators opposed to insurance powers argue that the power to compensate the errant director, by way of insurance, is subversive of public policy, eliminates deterrence, and encourages the unscrupulous director to pursue questionable activity, since he knows that the insurance payout rather than his personal assets will ultimately be the source of any payment.[74]

The opposing viewpoint posits that the corporation's maintenance of insurance is nothing more than a form of compensation to the director, and that there are no questionable public policy issues where the effect of such insurance is to spread the risk of corporate management.[75] Thus, insurance becomes as beneficial to the plaintiff as to the director, in that a fund is available for the plaintiff's benefit. The New York legislature accepted the latter viewpoint, and stated that the public policy of New York is to spread the risk of corporate management.[76]

New York prohibits insurance coverage where the director was actively and deliberately dishonest or where he obtained an illegal financial gain.[77] In

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72. *See id.*

73. *See* authorities cited in note 56 *supra*. *See also* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968).

74. The most persuasive argument against the charge that directors' and officers' insurance permits circumvention is the fact that directors' and officers' insurance carriers themselves require appropriate exclusions from coverage. *See also* Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), where an indemnification agreement between an underwriter and an insurer was held to violate public policy.

75. *See* authorities cited in note 56 *supra*. *See also* Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648 (1967). The Note states:

> Liability insurance . . . furthers the compensatory purposes of civil liability by providing a fund out of which a plaintiff's judgment can be satisfied . . . . Second, the extensive public regulation of the insurance industry reflects a policy in favor of assuring the viability of any scheme of insurance publicly offered—so that claims can always be paid as guaranteed—and of maintaining the fairness of the rate structure.

Id. at 653.

76. N.Y. BUS. CORP. LAW § 726(3)(e) (McKinney Supp. 1989) provides: "This section is the public policy of this state to spread the risk of corporate management, notwithstanding any other general or special law of this state or of any other jurisdiction including the federal government."

77. N.Y. BUS. CORP. LAW § 726(b)(1) (McKinney Supp. 1989) provides:

> No insurance under paragraph (a) may provide for any payment, other than cost of defense, to or on behalf of any director or officer, (1) if a judgment or other final adjudication adverse to the insured director or officer establishes that his acts of active and deliberate dishonesty were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled.

This provision is intended to allow a court to interpret liberally the insurance provisions in this connection some scholars argue that the medium of insurance best accommodates both society's interest in accountability to the public and its competing interest in protecting the corporate director: insurance, they say, induces responsible individuals to serve as directors, while the policy limitations, co-insurance, and deductibility provisions deter wrongful conduct.[78] Other scholars have suggested reorganizing the present system of indemnification insurance and replacing it with a system in which the director's liability is in direct proportion to the gains he achieves from his position.[79]

Insurance has utility in filling in the gaps where: (1) the availability of statutory indemnification is unclear, (2) indemnification provisions are discretionary with the board, or (3) a newly elected board chooses not to indemnify in a case where the predecessor board would have reimbursed. Insurance will reimburse those directors who find that the corporation which they once served has no other funds, or is plainly insolvent and cannot reimburse its director.

The insurance industry itself discourages certain wrongful acts since it does not write policies which allow indemnification for an intentional wrong. The insurance market can cause the director to assume the risks of his conduct, either by refusing to insure the director fully or by insuring only at unaffordable rates. It may be that the insurance industry is the only market mechanism which can police management decisions.

The New York statute provides for the involvement of the Superintendent of Insurance as another mechanism to prevent otherwise unacceptable payouts to directors.[80] Contracts of insurance must be framed in a manner acceptable to the Superintendent. Provisions are also made for a retention (deductible) amount as well as for co-insurance.[81] Director and officer insurance in New York may be written on a claims-made or on a claims-paid basis.[82]

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favor of director indemnification despite federal laws which might be seen as opposed to director indemnification.

78. Pillai & Tractenberg, *Corporate Indemnification of Directors and Officers: Time for a Reappraisal*, 15 J.L. Ref. 101, 119 (1981) ("Moreover, most policies contain substantial deductible amounts and have co-insurance provisions requiring insureds to bear a percentage of any loss incurred. The co-insurance and deductible features of [director] and [officer] policies further public policy by creating disincentives for wrongful conduct.").

79. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 Duke L.J. 895, 912-16.

80. *See supra* note 66.

81. *Id.* Ordinarily, there are two deductibles, a deductible for each director in respect to each loss, and an aggregate deductible for all directors and officers against whom a claim is made in respect to each loss. If several lawsuits are instituted, based on the same underlying act(s), only one deductible applies to losses arising out of such interrelated acts. However, where a lawsuit involves more than one cause of action, or is based on different sets of underlying acts, more than one deductible will apply.

The insured usually must bear five percent of each loss.

82. "Claims made" insurance means that only those claims made during the policy period

It remains open to question whether the new non-exclusive indemnification provisions, together with the new insurance provisions, will allow absolute indemnification of judgments for director liability in shareholders' derivative actions. A narrow reading of section 726(b)(i) would disallow insurance payments for amounts other than the cost of a defense, in any case where the director personally gained a financial profit or other advantage to which he was not legally entitled. Thus an adjudication of fault or negligence in cases where there is no personal benefit to the guilty director would permit reimbursement by way of insurance. Such insurance payouts would remain subject to the approval and control of the Superintendent of Insurance. The amended insurance provision also mandates notification to shareholders of both the fact of the purchase of any insurance policies and also of any payments made under the indemnification insurance contract.[83]

VII. Conclusion

The New York legislature, in amending the indemnification and insurance provisions, has succeeded in conforming the corporate indemnification provisions to the insurance provisions. Providing greater availability of indemnification for directors acting in good faith should make it possible for capable and experienced individuals to assume directorships without undue fear of personal liability. The legislature has recognized the logic of permitting a corporation to do directly what it could previously accomplish indirectly through insurance. Accordingly, corporations are no longer dependent on the often disorderly insurance market (which is beyond their control) for indemnification of their directors.

However, in the effort to close the gap between indemnification and insurance, the legislature has drafted statutory language which creates ambiguity. The statute does not make it clear whether the corporation can reimburse the director for amounts the director has paid in settlement of a shareholders' derivative action. Similarly, the amendments fail to clarify whether the director, if found liable in a derivative action, may be reim-

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are covered, regardless of when the underlying wrongful act occurred. This means that even where a wrongful act was committed before the policy period, the director is protected if the claim is brought within the policy period, while if the claim is brought after the policy is terminated, the director does not have insurance protection. To prevent this result, the insured should present the insurer with a "notice of occurrence" of a possible claim prior to the expiration of the policy period. If the insured gives notice of any occurrence, the insurer is said to have notification of a possible claim and the insured is protected, even though no claim has been made by a third party.

83. N.Y. Bus. Corp. Law § 726(d) (Consol. 1986, Supp. 1989) provides:

> The corporation shall, within the time and to persons provided . . . mail a statement in respect of any insurance it has purchased or renewed under this section, specifying the insurance carrier, date of the contract, cost of the insurance, corporate positions insured, and a statement explaining all sums, not previously reported in a statement to shareholders, paid under any indemnification insurance contract.

bursed for amounts he paid to the corporation as a consequence of his unsuccessful legal defense.

Prior New York law specifically excluded such reimbursement on public policy grounds. The present law does not specifically allow such indemnification by the corporation, but does not exclude it. However, the Governor's Advisory Commission on Liability Insurance recommended that a director receive indemnification regardless of the outcome of the derivative action, provided that the director acted in good faith.[84] Governor Cuomo, in his Accompanying Memorandum to the Bill, accepted the conclusions and recommendations of the Commission and by implication accepted this particular recommendation. The amendments, however, do not clearly embody this recommendation.

The legal conundrum engendered can only be resolved by further legislative action to make it clear that a director may be allowed indemnification and reimbursement of monies paid out as a consequence of an unsuccessful shareholders' derivative action. Corrective legislation is the best and only means for the legislature to dispel the confusion inadvertently created by the new law and to provide the necessary predictability within which a business community can flourish.

The New York legislature, in enacting these indemnification and insurance amendments, has articulated the state's policy of balancing the public interest in encouraging capable individuals to serve as directors without fear of personal liability against the public interest in refusing to protect those individuals when they breach the trust of shareholders. The only reasonable course for the legislature is to complete the task: delineate with precision the limits of directors' indemnification, and include provisions concerning reimbursement of monies paid in settlement of a shareholders' derivative action. In this manner New York can continue to serve as a model for legislative consistency to other states.

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84. *See Insuring Our Future*, Vol. II, Report of the Governor's Advisory Commission on Liability Insurance 98-104 (July 1, 1986).