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The Right of Directors to Indemnification in Actions Brought Directly by the Corporation: A Study of BCL Sections 722 and 723

COMMENT

THE RIGHT OF DIRECTORS TO INDEMNIFICATION IN ACTIONS BROUGHT DIRECTLY BY THE CORPORATION: A STUDY OF BCL SECTIONS 722 AND 723

I. INTRODUCTION

Ever since its enactment in 1961,[1] the New York Business Corporation Law (BCL) has been praised by commentators.[2] The sections on indemnification of officers, directors, and employees have especially been singled out as comprising a comprehensive example of legislative art.[3] For example, according to one commentator, the BCL "probably constitutes the most advanced and realistic approach to the problem of indemnifying corporate directors and officers."[4] The basic provisions authorizing indemnification are embodied in sections 722[5] and 723.[6] Both sections are drafted in permissive terms in that they allow a corporation to indemnify a director if it so chooses. Such indemnification must be made either by a vote of a quorum of the board of directors "who are not parties to such action or proceeding upon a finding that the director . . . has met the standard of conduct set forth in section 722 or 723 . . ."[7] or, if a quorum is not obtainable with due diligence, by the board acting upon the opinion of independent legal counsel or by vote of the shareholders.[8] However, the option of sections 722 and 723 becomes a mandate when read together with sections 724 and 725. Section 724 provides that "[a] person who has been wholly successful, on the merits or otherwise . . . *shall* be entitled to indemnification as authorized in [sections 722 and 723]."[9] Section 725 provides for the mandatory award of indemnification by a court to the extent authorized by sections 722 and 723 "[n]otwithstanding the failure of a corporation to provide indemnification, and despite any contrary resolution of the board or

1. Law of April 24, 1961, ch. 855, [1961] N.Y. Laws 184th Sess. 2356.

2. E.g., Andrews, New York Business Corporation Law, 27 Albany L. Rev. 202 (1963); Folk, Corporation Statutes: 1959-1966, 1966 Duke L.J. 875; Kessler, The New York Business Corporation Law, 36 St. John's L. Rev. 1 (1961); Macchiarola, The Close Corporation and the New York Business Corporation Law—After Five Years, 6 Am. Bus. L.J. 655 (1968); Stevens, New York Business Corporation Law of 1961, 47 Cornell L.Q. 141 (1962).

3. See 13 W. Fletcher, Cyclopedia of the Law of Private Corporations § 6045.2 (rev. perm. ed. 1970); H. Henn, Law of Corporations § 380 (2d ed. 1970); Cheek, Control of Corporate Indemnification: A Proposed Statute, 22 Vand. L. Rev. 255 (1969); Sebring, Recent Legislative Changes in the Law of Indemnification of Directors, Officers and Others, 23 Bus. Law. 95 (1967).

4. 13 W. Fletcher, supra note 3, § 6045.2 (footnote omitted).

5. N.Y. Bus. Corp. Law § 722 (McKinney 1963).

6. Id. § 723.

7. Id. § 724(b)(1).

8. Id. § 724 (b)(2).

9. Id. § 724(a) (emphasis added).

of the shareholders . . . ."[10] The result is that indemnification under sections 722 and 723 may, in fact, become mandatory notwithstanding the permissive phraseology of the sections.

If a director has a right of indemnification for the defense of an action brought directly by the corporation, it must be found in either section 722 or section 723.[11] Were it not for the Legislative Comments this right would seem to fall naturally into section 722 which authorizes indemnification "in actions by or in the right of a corporation . . . ."[12] However, the Legislative Comment to section 722, despite the plain language of the statute, states that the section is to apply to "derivative actions only."[13] Section 723, on the other hand, authorizes the indemnification of directors for actions "other than [those brought] by or in the right of the corporation . . . ."[14] The Comment to section 723, however, indicates it is to apply to "non-derivative" actions.[15] The Comments thus speak of a distinction between "derivative" and "non-derivative" actions as being the key to the distinction between the sections.[16] Derivative actions have variously been referred to as "actions 'in the right of the corporation', 'secondary actions by shareholders', or 'actions to enforce a secondary right on the part of shareholders.' "[17] Consequently, the usual definitions of the word "derivative" do not encompass the direct action by the corporation. The question then arises as to which, if either, of these two sections is applicable when a director is sued, not derivatively, but directly by the corporation. To answer this question the conflict between the language of section 722 and its Comment must be resolved and the relationship between sections 722 and 723 understood. This comment will deal with the rights of a director to

10. Id. § 725(a). Under this section, indemnification will be denied if such award would "be inconsistent with a corporate provision disallowing indemnification, or otherwise limiting it, in effect at the time of the accrual of the cause of action asserted in the action or proceeding in which the expenses were incurred or other amounts were paid . . . ." Legislative Comment to N.Y. Bus. Corp. Law § 725, at 947 (McKinney 1963) (citation omitted). For other provisions specifically limiting indemnification, see N.Y. Bus. Corp. Law § 726(b)(1) (McKinney 1963) (indemnification inconsistent with the law of the state of incorporation of a foreign corporation); id. § 726(b)(2) (same as Legislative Comment to § 725, supra); id. § 726(b)(3) (award inconsistent with court approved settlement).

11. Under New York law a corporation cannot provide for indemnification which would be inconsistent with the statutory provisions. N.Y. Bus. Corp. Law § 721 (McKinney 1963).

12. Id. § 722. Section 722 of the BCL authorizes such indemnification where the director has not been adjudged to have breached his fiduciary duty to the corporation.

13. Legislative Comment to N.Y. Bus. Corp. Law § 722 (McKinney 1963).

14. Id. § 723. Under section 722 indemnification shall not include amounts paid in settlement. N.Y. Bus. Corp. Law § 722(b)(1). If settlement is without court approval, indemnification shall not include expenses incurred in defending that action. Id. § 722(b)(2). Section 723, on the other hand, contains no such limitations, but does require the director to have acted in good faith. Id. § 723(a).

15. Legislative Comment to N.Y. Bus. Corp. Law § 723 (McKinney 1963).

16. Compare Legislative Comment to N.Y. Bus. Corp. Law § 722 (McKinney 1963), with Legislative Comment to N.Y. Bus. Corp. Law § 723 (McKinney 1963).

17. H. Henn, supra note 3, § 358, at 751. See also N.Y. Bus. Corp. Law § 626(a) (McKinney 1963).

secure indemnification from his corporation in an action brought by the corporation itself.

II. Common Law

Prior to the advent of the codification of directors' rights of indemnification there was much uncertainty as to whether a director was entitled to reimbursement for the defense of an action brought against him. The certificate of incorporation, the by-laws, a resolution, or an agreement approved by a majority of disinterested shareholders could create a *power* of indemnification in the corporation at common law.[18] This *power* would become a *duty* to indemnify if the corporation then agreed to pay the legal expenses of the directors.[19]

Absent such an agreement, the existence of the right seemed to depend upon the benefit which accrued to the corporation as a result of the defense.[20] Although there are few cases on the subject,[21] a successful defense of the action seemed to play a major role in the determination of the existence of a benefit. If the director was unsuccessful there would seem to be no reason for the corporation to be required to indemnify him.[22] In *McCourt v. Singers-Bigger*,[23] unsuccessful directors were denied indemnification because "[t]hey did nothing to recover or save a trust fund, or to prevent its waste or dissipation, but everything in their power to prevent its recovery or restitution to its original owner. Their proceedings, while in the name of the old company . . . were adversary to its equitable rights."[24] The mere fact that the director was unsuccessful, however, did not preclude the courts from finding that a benefit existed and thus granting indemnification. In *Kanneberg v. Evangelical Creed Congregation*,[25] the corporation, in good faith, had hired attorneys to defend an action brought against the directors. When the defense failed, the attorneys brought an action against the corporation for their fees. The trial court held the directors to be individually liable for the attorneys' fees, rather than the corporation.[26] The Wisconsin Supreme Court reversed, holding that the contract with the attorneys had been executed "to the benefit of the corporation in the sense

18. H. Henn, supra note 3, § 379, at 803.

19. Id.

20. See Wickersham v. Crittenden, 106 Cal. 329, 39 P. 603 (1895); Godley v. Crandall & Godley Co., 181 App. Div. 75, 168 N.Y.S. 251 (1st Dep't 1917), aff'd mem., 227 N.Y. 656, 126 N.E. 908 (1920); New York Dock Co. v. McCollum, 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939); Griesse v. Lang, 37 Ohio App. 553, 175 N.E. 222 (1931). Contra, Solimine v. Hollander, 129 N.J. Eq. 264, 19 A.2d 344 (Ch. 1941). See generally H. Henn, supra note 3, § 379, at 803.

21. See Comment, Corporations—Indemnification of Management for Litigation Expenses, 52 Mich. L. Rev. 1023, 1025 (1954).

22. G. Washington, Corporate Executives' Compensation 334 (1942).

23. 145 F. 103 (8th Cir. 1906).

24. Id. at 114; see General Mortgage & Loan Corp. v. Guaranty Mortgage & Sec. Corp., 264 Mass. 253, 162 N.E. 319 (1928); McConnell v. Combination Mining & Milling Co., 31 Mont. 563, 79 P. 248 (1905).

25. 146 Wis. 610, 131 N.W. 353 (1911).

26. Id. at 616, 131 N.W. at 355.

that it received the services rendered and needed under the circumstances."[27] In *Esposito v. Riverside Sand & Gravel Co.*,[28] the court allowed indemnification in an action for the appointment of both a temporary and permanent receiver defended by a director. Although the director was successful in resisting the appointment, the court indicated that this was not essential to his indemnification, stating that: "Whether these prayers could have legally been granted or not, the practical danger to the corporation cannot be pronounced so negligible that it could well have ignored the plaintiff's suit . . . ."[29]

Following the benefit theory, New York also allowed indemnification for an unsuccessful defense. In *Godley v. Crandall & Godley Co.*,[30] plaintiff sought to force repayment of counsel fees paid by the corporation to the directors in resisting the appointment of a receiver. The court held that: "Cases may arise . . . where the interests of the corporation are injuriously threatened by such a suit, or by some incidental relief sought therein. In such a case the directors may properly employ and pay counsel in behalf of the corporation . . . ."[31]

Where the director was successful in his defense and the corporation received no benefit there was a split in the authorities as to whether the director was entitled to indemnification. In *Figge v. Bergenthal*,[32] the Wisconsin Supreme Court implied that success, not benefit, was the criterion in saying 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."[33] New Jersey followed the reasoning of *Figge* in *Solimine v. Hollander*.[34] There it was held that a director who had successfully defended a suit on the merits was entitled to reimbursement by the corporation. Although finding that benefit had inured to the corporation,[35] the court stated that is was not holding "that the fact of benefit to the company is an element of the directors' right to reimbursement or indemnification . . . ."[36] A major justification given by the court for the existence of this right was the weight it would have in convincing businessmen to accept corporate directorships. "[T]he right to reimbursement is a circumstance that would actuate and induce responsible business men [*sic*] to accept the post of directors, the emoluments of which would otherwise never be commensurate with the risk of

27. Id.

28. 287 Mass. 185, 191 N.E. 363 (1934).

29. Id. at 187, 191 N.E. at 364.

30. 181 App. Div. 75, 168 N.Y.S. 251 (1st Dep't 1917), aff'd mem., 227 N.Y. 656, 126 N.E. 908 (1920).

31. Id. at 78, 168 N.Y.S. at 254. In Albrecht, Maguire & Co. v. General Plastics, Inc., 256 App. Div. 134, 9 N.Y.S.2d 415 (4th Dep't), aff'd mem., 280 N.Y. 840, 21 N.E.2d 887 (1939), unsuccessful directors were awarded indemnification because "[t]he interests of the corporation were sufficiently threatened . . . as to warrant the employment of counsel to defend it." Id. at 139, 9 N.Y.S.2d at 420.

32. 130 Wis. 594, 109 N.W. 581 (1906).

33. Id. at 625, 109 N.W. at 592.

34. 129 N.J. Eq. 264, 19 A.2d 344 (Ch. 1941).

35. The benefit derived by the corporation was the demonstration to the investing public of the honesty of the corporate management. Id. at 271, 19 A.2d at 347.

36. Id. at 272, 19 A.2d at 348; see Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888 (3rd Cir. 1953); In re E.C. Warner Co., 232 Minn. 207, 45 N.W.2d 388 (1950).

loss involved in paying out of their own pocket the costs involved in defending their conduct."[37]

However, in *Griesse v. Lang*,[38] payment was denied by the Ohio Court of Appeals after the successful defense of a stockholder's derivative action because the corporation had received no benefit from the legal services. New York has followed the strict benefit theory as applied in *Griesse*. In *New York Dock Co. v. McCollum*,[39] it was held that a successful director was not entitled to reimbursement unless "he has conserved some substantial interest of the corporation which otherwise might have been conserved, or has brought some definite benefit to the corporation which otherwise might have been missed . . . ."[40] In *McCollum*, the corporation had brought the action seeking a declaratory judgment that it was not legally obligated to pay or reimburse legal expenses incurred by the directors in the successful defense of a stockholder's derivative action. The court reasoned that although the rule of indemnity might be a rule of law in a principal-agent relationship, it was only a rule of guidance in the corporation-director relationship because "a director of a corporation is not an agent either of the corporation or of its stockholders, except in a convenient rhetorical sense . . . ."[41] Thus the matter rested on whether the corporation itself benefited from this defense. Defendant-directors in *McCollum* argued that a benefit did accrue since the corporation was attacked as well as the directors. But the court stated that "[t]he sins alleged were the sins of the directors against the corporation . . . ."[42] and therefore found this argument to be insubstantial.

Thus, prior to the enactment of corrective legislation in 1941,[43] New York, as evidenced by *McCollum*, strictly followed the benefit theory, preventing a director from receiving indemnification if it was determined that, regardless of the outcome of the action, the corporation had received no benefit from the defense. It would be difficult to conceive of a case in which the defense of an action brought directly by a corporation against a director would inure to the corporation's benefit. Therefore, prior to the enactment of legislation, it would

37. 129 N.J. Eq. at 272, 19 A.2d at 348.

38. 37 Ohio App. 553, 175 N.E. 222 (1931).

39. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

40. Id. at 111, 16 N.Y.S.2d at 849. See generally 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); Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct. 1941).

41. 173 Misc. at 109, 16 N.Y.S.2d at 847. But see Bishop, Current Status of Corporate Directors' Right to Indemnification, 69 Harv. L. Rev. 1057 (1956). "When a director acts for his corporation in dealing with outsiders, the relationship between him and the corporation is that of principal and agent. It is well established that there is an implied promise on the part of a principal to indemnify his agent for losses which are the 'direct and natural consequence of the execution of the agency'—including not only counsel fees expended in litigation based on such acts, but damages which an agent acting in good faith may be compelled to pay third persons upon a determination that his conduct was wrongful. The rule should be no less applicable because the principal happens to be a corporation and the agent one of its directors . . . ." Id. at 1065 (footnotes omitted).

42. 173 Misc. at 111, 16 N.Y.S.2d at 849.

43. See notes 45 & 46 infra.

seem that there was no right of indemnification in New York in an action brought directly by the corporation.

III. Legislative History

A. *General Corporation Law*

In order to overcome the effects of the *McCollum* decision, the New York legislature found it necessary[44] to enact sections 27-a[45] and 61-a[46] of the General Corporation Law (GCL). Section 27-a was essentially a permissive provision which allowed a corporation to grant its directors the right of indemnification through the certificate of incorporation, by-laws, or a shareholder resolution. Thus a corporation could assure itself of not losing potential directors because of possible liability by providing for their complete indemnification.[47] The facts of the *McCollum* case, however, came more precisely within the scope of section 61-a. Where a corporation chose not to indemnify a director, this section provided for mandatory assessment of expenses for a successful defense made by a director of an action brought "by the corporation, or brought in its behalf by . . . one or more stockholders . . . ."[48] The "benefit to the corporation" doctrine was eliminated,[49] and even the defense of an action brought

44. See Recommendation of the Law Revision Commission to the Legislature, 1945 N.Y. Legis. Doc. No. 65(E), at 9; 13 W. Fletcher, supra note 3, § 6045.2, at 578.

45. Law of April 2, 1941, ch. 209, § 1 [1941] N.Y. Laws 164th Sess. 813. Section 27-a read as follows: "The certificate of incorporation of a corporation or other certificate filed pursuant to law or the by-laws of a corporation or a resolution in a specific case or an amendment to any of the foregoing, adopted by the vote of the holders of record of a majority of the outstanding shares at the time entitled to vote for the election of directors . . . may provide that each director of the corporation shall be indemnified by the corporation against expenses actually and necessarily incurred by him in connection with the defense of any action, suit or proceeding in which he is made a party by reason of his being or having been a director of the corporation, except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of his duties as such director . . . ." Id. at 814.

46. Law of April 14, 1941, ch. 350, § 1 [1941] N.Y. Laws 164th Sess. 1034 (repealed 1945). Section 61-a read as follows: "In any action, suit or proceeding against one or more officers or directors, or former officers or directors, of a corporation, domestic or foreign, brought by the corporation or brought in its behalf by . . . one or more stockholders . . . and whether brought under the provisions of this article or otherwise, the reasonable expenses, including attorneys [sic] fees, of any party plaintiff or party defendant incurred in connection with the successful prosecution or defense of such action, suit or proceeding shall be assessed upon the corporation . . . ." Id. at 1035.

47. The fear of losing potential directors was expressed in Solimine v. Hollander, 129 N.J. Eq. 264, 19 A.2d 344 (Ch. 1941).

48. Law of April 14, 1941, ch. 350, § 1 [1941] N.Y. Laws 164th Sess. 1034 (repealed 1945).

49. Despite the passage of legislation to override the effects of McCollum (see Recommendation of the Law Revision Commission to the Legislature, supra note 44, at 9; 13 W. Fletcher, supra note 3, § 6045.2, at 578), New York persisted in the use of the benefit theory. In Drivas v. Lekas, 182 Misc. 567, 48 N.Y.S.2d 785 (Sup. Ct. 1944), the court stated: "If the benefit to the corporation is the test, as seems to be thus indicated, these defendants do not show that their success has benefited the corporation." Id. at 570, 48 N.Y.S.2d at 787.

directly by the corporation had to be indemnified if the defense proved to be successful.[50] Thus the 1941 amendments clearly recognized the difference between a "derivative" action and a "direct" action by the corporation and made it clear that if no contractual indemnification was available, the successful defense of a suit would assure the director of reimbursement in both types of actions.[51]

In 1945 the legislature set out to correct some inconsistencies in the sections.[52] The major inconsistency was that section 61-a was "mandatory" in providing that the court was to assess a corporation the reasonable expenses of a successful defense despite any previous adoption by the shareholders of a more limited provision under the "permissive" section 27-a.[53] The Law Revision Commission thought that otherwise the sections were not basically inconsistent but did differ in important respects.[54] The difference in the type of action covered was that section 27-a applied to "any action, suit or proceeding" to which the defendant was a party "by reason of his being or having been a director"[55] and section 61-a applied to "any action, suit or proceeding . . . brought by the corporation, or brought in its behalf by . . . one or more stockholders . . . ."[56] The Commission noted that the language in section 27-a was broader and suggested it might potentially cover certain situations not covered by section 61-a.[57] It is clear, therefore, that the language "any action, suit or proceeding" encompassed the language "any action brought by the corporation."

The result of the Commission's labors was the modification of section 27-a and its renumbering as section 63[58] and the incorporation of the provisions of section 61-a into sections 64 through 67.[59] In suggesting the changes, the Commission's primary concern was the defense of actions "where the gravamen of the action or proceeding is something done or omitted to be done which, it is claimed, was not in the ordinary course of business and therefore constitutes

50. Law of April 14, 1941, ch. 350, § 1 [1941] N.Y. Laws 164th Sess. 1034 (repealed 1945). The effect, however, of the McCollum decision and its benefit to the corporation test persisted as late as 1944. See note 49 supra.

51. Despite the plain language of § 61-a, the New York Court of Appeals 13 years later said of the 1941 amendments: "Obviously, the Legislature was talking about the financial difficulties that had befallen certain corporate directors . . . when they were sued, individually, in stockholders' suits . . . ." Schwarz v. General Aniline & Film Corp., 305 N.Y. 395, 401, 113 N.E.2d 533, 535 (1953).

52. See Recommendation of the New York Law Revision Commission to the Legislature, supra note 44, at 9-10: "The proposed act is designed to make the two statutes consistent so far as possible, having due regard to the basic difference in their theory . . . ." Id. See also 13 W. Fletcher, supra note 3, § 6045.2, at 580 n.2.

53. See Report of the New York Law Revision Commission, 1945 N.Y. Legis. Doc. No. 65(E), at 30.

54. Id.

55. Law of April 2, 1941, ch. 209, § 1 [1941] N.Y. Laws 164th Sess. 813.

56. Law of April 14, 1941, ch. 350, § 1 [1941] N.Y. Laws 164th Sess. 1034 (repealed 1945).

57. Report of the New York Law Revision Commission, supra note 53, at 31.

58. Law of April 18, 1945, ch. 869, § 1 [1945] N.Y. Laws 168th Sess. 1971.

59. Id. § 2, at 1972 n.**.

a breach of duty to the corporation . . . ."[60] Noting the existence of a fiduciary relationship and yet realizing that their interests may not be one and the same, the Commission recommended changes "to make available a simple and flexible machinery by which an official of a corporation . . . subjected to the expense of litigation, may obtain reimbursement therefor in a manner calculated to protect his interests and those of the corporation involved."[61]

The new sections 63 and 64 both applied to "any action, suit or proceeding" where the defendant "is or was a director."[62] The Law Revision Commission's aim of consistency seems to have been frustrated since section 63 remained permissive while section 64 remained mandatory.[63] On the other hand, the difference in the language of applicability was eliminated, with the result that the language of both sections included a direct action by the corporation.[64] A few minor inconsistencies remained, however. In a footnote to the section repealing section 61-a, the legislature noted that "[a]ll of the essential provisions of section 61-a which regulate the granting of allowances in actions *brought on behalf of a corporation* are incorporated in new sections 64-67 . . . ."[65] This thinking was reiterated in *Schwarz v. General Aniline & Film Corp.*,[66] where the court of appeals referred to the whole of article 6-A (of which sections 63 and 64 were a part) as representing "legislative and professional thinking as to *stockholders' suits* . . . ."[67]

B. *Business Corporation Law*

In the 1945 amendments to the GCL[68] the legislature had emphasized the application of the indemnification statutes to derivative actions. On the other hand, the Joint Committee which did much of the research for the Business Corporation Law was primarily concerned with the possibility that sections 63 and 64 were not applicable to an action brought by an outside third party against a director.[69] For this reason it was recommended that a new section be

60. Report of the New York Law Revision Commission, supra note 53, at 20; see 3 W. Fletcher, supra note 3, § 838.

61. Recommendation of the New York Law Revision Commission to the Legislature, supra note 44, at 10.

62. Compare Law of April 18, 1945, ch. 869, § 1 [1945] N.Y. Laws 168th Sess. 1971, with id. § 4.

63. See notes 52 & 53 supra, and accompanying text.

64. See text following note 57 supra.

65. Law of April 18, 1945, ch. 869, § 2 [1945] N.Y. Laws 168th Sess. 1972 n.** (emphasis added).

66. 305 N.Y. 395, 133 N.E.2d 533 (1953).

67. Id. at 403, 113 N.E.2d at 536 (emphasis added).

68. See Law of April 18, 1945, ch. 869, § 2 [1945] N.Y. Laws 168th Sess. 1972 n.**.

69. 10 New York (State) Legislature Joint Committee to Study Revision of Corporation Laws—Documents—Summary of Researcher's Report-132 (1959) [hereinafter cited as Documents]. The Tentative Reviser's Notes stated: "There is serious question whether directors . . . are reimbursable under the present law for expenses . . . incurred in the defense of suits brought by third party outsiders . . . ." Id. at 3. The Joint Committee stated that the New York Court of Appeals had suggested sections 63 through 68 of the GCL were "designed solely with the derivative action in contemplation." Id.

added which authorized indemnification for actions brought by third persons.[70]

The Working Draft of the BCL prepared by the Joint Committee empowered the corporation, in the section which eventually became section 722, to provide for indemnification in "any action, suit or proceeding."[71] As such, it was identical to section 63 of the GCL[72] and consequently failed to solve the problem of whether indemnification was proper in actions brought by third parties. Therefore, a new section was created which solved this problem by providing for such indemnification.[73] This new section became section 723.[74] Thus, the Joint Committee's aim of providing for indemnification in actions by third parties was realized early in the preliminary drafts. However, the confusion engendered in the 1945 amendments was continued by the use of the term "derivative action" in the Reviser's Notes referring to the applicability of section 722.

The conflict between the words of section 722 and the Reviser's Notes first arose in the Tentative Staff Draft. There the words "by or in the right of the corporation" were substituted for "any action, suit or proceeding."[75] On the other hand, the Reviser's Notes stated: "This section is a substantial re-enactment of G.C.L. § 63, modified, however, to the extent that it has been made applicable in terms only to *derivative actions*."[76] At this point it can be seen that the application of the statute has run the gamut from the clear distinction between direct action and derivative action in section 61-a of the GCL to the unclear applicability of "any action, suit or proceeding" in sections 63 and 64 of the GCL to the conflicting language of the Tentative Staff Draft and its Reviser's Notes.

The applicability of section 723 solely to third party actions was further emphasized in the Reviser's Comments on the Study Bill introduced into the Senate in 1960.[77] The Comments to the section which became section 722 remained essentially the same as they were in the Tentative Staff Draft.[78] But in the Comment to the section which became section 723 it was noted that the section's "purpose is to codify the common law principle that corporate agents . . . should be reimbursed by the corporate principal for costs and expenses incurred when they are sued, *not by the corporation, directly or indirectly . . . but by a third party . . .*."[79] Thus it is apparent that section 722 was to cover everything which had been covered by GCL section 63 with the sole exception of third party actions.[80]

70. Id. at 2.

71. 12 Documents § 7.15, at 24.

72. Law of April 18, 1945, ch. 869, § 1 [1945] N.Y. Laws 168th Sess. 1971.

73. 12 Documents § 7.16, at 26.

74. N.Y. Bus. Corp. Law § 723 (McKinney 1963).

75. 13 Documents § 7.15, at 4.

76. Id., Reviser's Notes (emphasis added).

77. Sen. Int. No. 3124, Pr. No. 3316 (1960).

78. Supplement to Fourth Interim Report to 1960 Session of New York State Legislature, 1960 N.Y. Legis. Doc. No. 15, at 49.

79. Id. at 50 (emphasis added).

80. Since section 722 was to be "a substantial re-enactment of General Corporation Law § 63," and section 723 was to be an explicit codification of what was questionable under

When the BCL became the law of New York on April 24, 1961,[81] the contradiction became complete. The plain words of section 722 made it applicable to actions "by or in the right of a corporation"[82] while the Legislative Comment continued to refer to its application to "derivative actions only."[83] The final Comment to section 723 referred to its application to "actions or proceedings, other than derivative actions."[84] Senator Warren M. Anderson, who introduced the bill, referred to the sections as making "a clear distinction between indemnification in derivative actions (§ 722) and in non-derivative actions (§ 723)."[85] Nowhere was mention made of the fact that a derivative action does not necessarily include direct corporate action. With this state of affairs the New York courts were left to decipher the meanings of sections 722 and 723.[86]

IV. Judicial Interpretation

Two recent New York cases, both arising from the same series of transactions, have confronted the courts with this conflict in the BCL. In *Professional Insurance Co. v. Barry*,[87] Chaut, an officer of the third party defendant, M.A. Schapiro & Company, Inc. (Schapiro) served as director of Professional for the benefit of Schapiro. Professional brought an action against Chaut for breach of his fiduciary duties and Chaut sought indemnification from Schapiro.[88] Schapiro contended that section 723 could not be applied where a director was sued directly by a corporation for breach of his fiduciary duties.[89] It also argued that sections 722 and 723 were mutually exclusive and that Chaut's right to indemnification was only from Professional under section 722.[90] The court noted that section 723 was applicable to an action brought " 'by or in the right

section 63, the language of section 723 making it inapplicable to direct and indirect actions by the corporation lends some support to the proposition that both these actions were covered under GCL secion 63 and are presently covered under BCL section 722.

81. Law of April 24, 1961, ch. 855, [1961] N.Y. Laws 184th Sess. 2356.

82. Revised Supplement to Fifth Interim Report to 1961 Session of New York State Legislature, 1961 N.Y. Legis. Doc. No. 12, at 53.

83. Id. at 54.

84. Id.

85. Anderson & Lesher, The New Business Corporation Law, 33 N.Y.S.B.J. 428, 429 (1961.)

86. The sections as they presently stand are amended versions of the 1961 Act. N.Y. Bus. Corp. Law §§ 722-23 (McKinney 1963). However, the committee bill which amended the sections was based no a redraft submitted on behalf of the New York State Bar Association Committee on Corporate Law: "The announced intention for the submission of these changes by the Bar Committee was to improve the clarity and understandability of the sections covering indemnification as they will be applied by the practicing bar and their corporate clients and not to make any policy, substantive or procedural change in the provisions as they appear in the Business Corporation Law as passed in 1961." 1962 N.Y. Legis. Doc. No. 30, at 42.

87. 60 Misc. 2d 424, 303 N.Y.S.2d 556 (Sup. Ct.), aff'd, 32 App. Div. 2d 898, 302 N.Y.S.2d 722 (1st Dep't 1969).

88. Id. at 425, 303 N.Y.S.2d at 558.

89. Id. at 426, 303 N.Y.S.2d at 558.

90. Id.

of *any other corporation*' "[91] and was thus applicable to the case at bar.[92] The court defined actions by a third party corporation to procure a judgment in its favor as "so-called 'derivative suits.' "[93] In order to give "full effect to the language utilized in section 723," the court maintained that such actions must be included within the scope of that section.[94]

The decision in *Barry* becomes important in light of the misapplication of its reasoning in a subsequent case arising out of the same facts, *Professional Insurance Co. v. Guerrini-Maraldi*.[95] Professional was formed in 1957 by individuals associated with Oakeley, Vaughan, & Johnston, Inc. (Oakeley), a closely held corporation. Maraldi, along with others, wielded absolute control over Oakeley, and upon organizing Professional became one of its directors and officers. Oakeley was then signed to a management contract by which it was to act as Professional's manager and sole general agent. Subsequently, Professional went public and, through the acquisition of substantial stock interests, a new management team came into power. Maraldi, among others, was then sued for the breach of his fiduciary duties while he was a director of Professional.[96] As a result of the subsequent legal proceedings, Maraldi incurred expenses for which he sought and was granted interim indemnification under sections 723 and 725(c)[97] from Professional.

On appeal Professional contended that the BCL did not intend to protect a former director when he is sued directly by the corporation itself.[98] The

91. Id. at 427, 303 N.Y.S.2d at 559, quoting N.Y. Bus. Corp. Law § 723 (McKinney 1963).

92. 60 Misc. 2d at 427, 303 N.Y.S.2d at 559. In response to Schapiro's contention that Chaut raised no "genuine issues of fact or law" the court noted there was an issue of fact raised by the pleadings. Id., 303 N.Y.S.2d at 560. Also, "[r]egarding Schapiro's argument that Chaut has failed to establish a 'reasonable probability of success,' it must be noted that no such requirement is set forth in sections 722, 723 or 725 of the Business Corporation Law." Id. at 427-28, 303 N.Y.S.2d at 560. The court further held that an interim indemnification allowance under section 725(c) is proper "within the ambit of a derivative (§ 722) or nonderivative (§ 723) category as long as such allowance is necessary in connection with the defense in the litigation." Id. at 428, 303 N.Y.S.2d at 561.

93. Id. at 427, 303 N.Y.S.2d at 559.

94. Id., 303 N.Y.S.2d at 559-60. The court further stated: "Such statutory construction is further buttressed by the careful use of the phrase 'the corporation' when referring to the party against which indemnification is sought and of the phrase 'any other corporation' when referring to the third party asserting the claim." Id., 303 N.Y.S.2d at 560.

95. 34 App. Div. 2d 756, 311 N.Y.S.2d 799 (1st Dep't 1970) (mem.).

96. Brief for Plaintiff-Appellant at 8-12, Professional Ins. Co. v. Guerrini-Maraldi, 34 App. Div. 2d 756, 311 N.Y.S.2d 799 (1st Dep't 1970) (mem.).

97. N.Y. Bus. Corp. Law § 725(c) (McKinney 1963) provides: "Where indemnification is sought by judicial action, the court may allow a person such reasonable expenses, including attorneys' fees, during the pendency of the litigation as are necessary in connection with his defense therein, if the court shall find that the defendant has by his pleadings or during the course of the litigation raised genuine issues of fact or law."

98. Brief for Plaintiff-Appellant at 39-41, Professional Ins. Co. v. Guerrini-Maraldi, 34 App. Div. 2d 756, 311 N.Y.S.2d 799 (1st Dep't 1970) (mem.). Maraldi contended that indemnification was proper under section 722 in the case at bar despite the holding in the supreme court that section 723 was the applicable section. Brief for Respondent at 16,

supreme court had relied on the reasoning of *Barry*.[99] By unanimously affirming the supreme court without opinion the New York Appellate Division agreed that section 723 was the proper section under which a director was to receive indemnification in a direct action by the corporation. In light of the legislative history of the BCL, the court seemed to have applied the wrong section and to have failed to meet the real issue—did the legislature mean to have section 722 apply to a direct action by the corporation?

V. Conclusion

The contradiction between section 722 and its Comment arises from the fact that the Comment was itself a product of legislative assumption and oversight. Perhaps it was the fact that "it is not usual for such actions to be instituted by corporations"[100] which caused this laxity in the legislature's drafting of the Comment. This laxity seems to have confused some of the commentators in their interpretations of sections 722 and 723. Hornstein, in analyzing the BCL, stated:

> In general, indemnification may be ordered by resolution of the board of directors or shareholders either (i) in a *derivative action* except in relation to matters as to which the director or officer is adjudged to have breached his duty, or (ii) in a civil or criminal proceeding other than one *in the right of the corporation*, if he acted in good faith and had no reasonable cause to believe that his conduct was unlawful.[101]

Professor Hoffman explained the new law as authorizing "indemnification of directors and officers in both *derivative* (*Section 722*) and *non-derivative* (*Section 723*) categories."[102] On the other hand, Professor Henn clearly thought that the BCL differentiates between the direct and the derivative action. "New York . . . impose[s] high standards for indemnification, especially in actions by

Professional Ins. Co. v. Guerrini-Maraldi, supra. An alternative argument made was that if section 722 did not apply, section 723 must. Id. at 21. The situation in this case was extraordinary. The plaintiff corporation claimed to be in dire financial straits and would be forced out of court if ordered to grant indemnification. Reply Brief for Plaintiff-Appellant at 22-25, Professional Ins. Co. v. Guerrini-Maraldi, supra. Thus, part of the reasoning for interim indemnification, i.e., the greater financial resources of the corporation, seems to be missing. See Cheek, Control of Corporate Indemnification: A Proposed Statute, 22 Vand. L. Rev. 255, 286-87 (1969).

99. Record on Appeal at 347, Professional Ins. Co. v. Guerrini-Maraldi, 34 App. Div. 2d 756, 211 N.Y.S.2d 799 (1st Dep't 1970) (mem.): "The fact that the movant is sued by the corporation itself in the 'Oakeley' action, rather than by another in its behalf, also does not constitute a basis for a different result. While the statement to that effect by the Court in the decision on the Chaut motion is dictum, the reasoning employed is compelling." Id. at 348.

100. Report of the New York Law Revision Commission, supra note 53, at 21.

101. Hornstein, Analysis of Business Corporation Law, N.Y. Bus. Corp. Law app. 1, at 441, 470 (McKinney 1963) (emphasis added). This would apply also to court-ordered indemnification in that a court's power to indemnify is no more extensive than that of the board of directors or shareholders. See N.Y. Bus. Corp. Law § 725(a) (McKinney 1963).

102. Hoffman, The Status of Shareholders and Directors under New York's Business Corporation Law: A Comparative View, 11 Buffalo L. Rev. 496, 573-74 (1962) (emphasis added & footnote omitted). See also note 85 supra, and accompanying text.

or in the right of the corporation . . . *i.e.*, actions *by the corporation or derivative actions.*"[103]

From an examination of the history of the BCL, *i.e.*, the reasons for changes together with the plain language used and the assumptions made in implementing the changes, it would appear that the court in *Maraldi* incorrectly applied section 723. The court relied on the reasoning in *Barry*, a case in which the director sought indemnification from a corporation other than the one bringing the action. By applying such reasoning to reach the same result in a case where indemnification was sought from the corporation bringing the action, the court has apparently misconstrued the legislative purpose.

The difference between the actions was clearly recognized under the amendments to the GCL in 1941[104] which encompassed both the direct and derivative actions. However, in the 1945 changes the derivative action seems to have been of paramount concern to the legislature in its restructuring of section 61-a into section 64,[105] although the actual language of section 64 was apparently broad enough to include both types of actions.[106] It was here that the confusion began. Because the direct action was rare, it was assumed that the statute would be applicable to the direct action.[107] Thus the legislature apparently confined its emphasis to the section's applicability to the derivative action. In drafting the BCL, this thinking was naturally carried forward because the emphasis was no longer on the applicability of the statute to "derivative" actions but to "third-party" actions. The resultant aim of the BCL was to separate what was surely applicable before—the "derivative" action—from what was more doubtful in its application—the third-party action.[108] That the term "derivative" action included, in the minds of the New York legislature, the direct action by the corporation is indicated by the plain words of applicability of section 722—an action "brought by or in the right of the corporation."[109]

Proper statutory interpretation dictates that one first look to the language in the statute itself "[f]or it must be presumed that the means employed by the legislature to express its will are adequate to the purpose and do express that will correctly."[110] Instead, however, the Supreme Court of New York,

103. H. Henn, supra note 3, § 380, at 810-11 (emphasis added).

104. Law of April 14, 1941, ch. 350, § 1 [1941] N.Y. Laws 164th Sess. 1034 (repealed 1945).

105. Law of April 18, 1945, ch. 869, § 1 [1945] N.Y. Laws 168th Sess. 1971.

106. Id. § 4.

107. See Report of the New York Law Revision Commission, supra note 53, at 21.

108. See 10 Documents 3-4.

109. N.Y. Bus. Corp. Law § 722 (McKinney 1963). One commentator, in discussing the words "by or in the right of the corporation" in the Delaware statute, 4 Del. Code Ann. tit. 8, § 145(b) (Supp. 1969), said: "The suit, in the name of the corporation may be initiated by the corporation, but is usually brought by a stockholder in the name of the corporation." Sebring, Recent Legislative Changes in the Law of Indemnification of Directors, Officers and Others, 23 Bus. Law. 95, 101 (1967). It is interesting to note that in discussing the New York BCL the same author referred to it as distinguishing between "indemnification in the case of the third party suit . . . and the derivative action . . . ." Id. at 99.

110. H. Black, Construction and Interpretation of the Laws 45 (2d ed. 1911). However,

persuaded perhaps unwittingly by the Legislative Comment, reached the correct result, albeit relying on an incorrect section of the statute.

In any case, it seems clear that the BCL applies to *any* action brought against a director of a corporation in connection with his duties as a director. However, it would be desirable to have the Legislative Comments to sections 722 and 723 changed to both achieve the legislative purpose and conform to the usual definition of a derivative action. Otherwise, the doors will remain open to the possibility of a higher court determining that a director sued directly by a corporation will have to bear the expense of his own defense, regardless of liability.

"[i]f the language of the statute is ambiguous, or lacks precision, or is fairly susceptible of two or more interpretations, the intended meaning of it must be sought by the aid of all pertinent and admissible considerations." Id. at 45-46. Also, "[i]n aid of the interpretation of an ambiguous statute, or one which is susceptible of several different constructions, it is proper for the courts to study the history of the bill in its progress through the legislature, by examining the legislative journals." Id. at 308. See also Peter Pan Fabrics, Inc. v. Jobela Fabrics, Inc., 329 F.2d 194, 196 (2d Cir. 1964).