INDEMNIFICATION OF EMPLOYEES

By Allen M. Terrell, Jr.*

I. Introduction

MANY ARTICLES have been written over the years about the indemnification of officers and directors. Most of the common law indemnification cases dealt with the protection sought by directors, and the first state indemnification statutes focused exclusively on the rights of officers and directors. Generally, corporate by-laws dealing with indemnification either refer only to officers and directors, or fail to distinguish between such rights for management and non-management employees. In short, the indemnification rights of non-management employees have been largely neglected.

It is the premise of this article that corporations can ill-afford to ignore their employees' concern with indemnification. There is more legislation and more litigation involving corporations and their employees than there was almost four decades ago when the first indemnification statutes were enacted.[1] Now, a security guard may be sued by a store customer, claiming false imprisonment.[2] Also, hypothetically, in refusing to honor a personal check from a customer, a cashier might be charged by the customer with libel and slander. Since claims such as these can exceed the employee's net worth or, at least, his liquid assets, employees are naturally concerned as to whether their corporations will indemnify them and provide them with an attorney if they are sued in the performance of their corporate duties.[3]

This article focuses on the indemnification rights of these non-management employees. The article traces the history of employee indemnification (Part II), discusses the statutory amendments of approximately ten years ago, specifically covering indemnification of employees (Part III), identifies current development in indemnification statutes and by-laws affecting employees (Part IV), and finally, deals with employees' right to indemnification in specific situations (Part V). Five situations are separately analyzed: (a) the em-

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1. Sheridan, *Can Your Job Put You in Jeopardy?*, Industry Week, May 31, 1976, at 21-22.

2. *See, e.g.*, Neisner Bros., Inc. v. Ramos, 326 A.2d 239 (D.C. C.A. 1974).

3. Industry Week, *supra* note 1, at 19.

ployee who prevails on the merits or otherwise, (b) the advancement of expenses, (c) the employee who loses, (d) the employee who compromises and settles and (e) grand jury investigations.

II. HISTORY OF EMPLOYEE INDEMNIFICATION

Prior to 1941 there were no indemnification statutes. New York was the first state to enact an indemnification statute,[4] followed by Delaware in 1943. These early indemnification statutes covered only directors and officers.[5]

As former Chancellor Seitz observed, "the [Delaware] statute was passed primarily to permit corporate executives to be indemnified in situations where the propriety of their actions as corporate officials is brought under attack." [6] The intent of the early indemnification statutes was to protect those who were acting as corporate officials, that is, corporate officials themselves and others who controlled in a substantial way the corporation's activities. Non-management employees, who by definition acted at the behest of those in control rather than asserted any decision-making power themselves, apparently did not need any separate statutory protection.

In the 1940's and 1950's most states adopted indemnification statutes that covered only directors and officers.[7] A few states' statutes indemnified "employees" in addition to "directors" and "officers." [8]

4. Formerly *N.Y. Gen. Corp. Law*, c. 209, §§ 27-a (1941).

5. Delaware Act of April 15, 1943, 44 *Del. Laws*, c. 125, § 1:

> Every corporation created under the provisions of this chapter shall have power to indemnify any and all of its directors or officers or former directors or officers or any person who may have served at its request as a director or officer of another corporation in which it owns shares of capital stock or which it is a creditor against expenses actually and necessarily incurred by them in connection with the defense of any action, suit or proceeding in which they, or any of them, are made parties, or a party, by reason of being or having been directors or officers or a director or officer of the corporation, or of such other corporation, except in relation to matters as to which any such director or officer or former director or officer or person shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duty. Such indemnification shall not be deemed exclusive of any other rights to which those indemnified may be entitled, under any by-law, agreement, vote of stockholders, or otherwise.

6. Essential Enterprises Corp. v. Automatic Steel Prod., 39 Del. Ch. 371, 378, 164 A.2d 437, 441 (1960).

7. Note, *Corporations—Indemnification of Management for Litigation Expenses*, 52 MICH. L. REV. 1023, 1030 (1954).

8. *See* CAL. CORP. CODE § 830(a), c. 1038 (West 1947) (current version at CAL. CORP. CODE § 317(a)-(b) (West 1975)); CONN. GEN. STAT. ANN. § 33-320(b) (West 1959) (current version at CONN. GEN. STAT. ANN. §§ 33-320a (West 1978)); R.I. GEN. LAWS P.L. 1952, Ch. 2919, §§ 1-4 (current version at R.I. GEN. LAWS § 7-1.1-4.1 (1969)); WIS. STAT. ANN. § 180.407 (West 1953) (current version at WIS. STAT. ANN. § 180.05 (West 1972)). England had its own indemnification statute which covered directors, managing directors, agents, auditors, secretaries, and other officers. The Companies Act, 1948, 11 & 12 Geo. b., c. 38, § 205.

The rationale of the statutes that omitted "employees" in their coverage was the presumption that non-fiduciary employees had common law rights to indemnification and reimbursement of their expenses in defending litigation arising out of their employment.[9] This presumption, however, did not rest on a consistent and thorough judicial treatment of indemnification.[10]

There is scant common law on the rights to indemnification of employees,[11] as distinguished from directors and officers.[12] Most of the common law indemnification cases arose out of derivative actions by stockholders against directors and officers for purported wrongs to the corporation.[13] After establishing their defenses, or winning on the merits, the successful directors and officers might sue their corporation to be reimbursed for their expenses. The employees' ability to be indemnified at common law turned on a number of factors, not all of which were consistently applied by the various courts.

One of the earliest indemnification cases was *Figge v. Bergenthal.*[14] In *Figge* the directors successfully defended a derivative action and the court allowed them indemnification; however, fifteen years later the same court in *Jesse v. Four Wheel Drive Auto Co.*[15] refused to grant indemnification to directors in an action brought against them for fraud in the purchase of stock. A distinction between *Figge* and *Jesse* was that the underlying action in *Jesse* had not yet been decided when the directors sought to recover their litigation expenses. Thus, common law indemnification at least required that the directors have been successful in the primary suit before they could be indemnified.

Stockholder approval of the indemnification sought by the directors was also an ingredient for common law indemnification of fiduciary employees. In both *Figge* and *Jesse,* the stockholders had authorized the indemnification.[16] These cases follow the same rea-

9. Comment, *Corporate Responsibility for Litigation Expenses of Management,* 40 CAL. L. REV. 104, 111 (1952) [hereinafter *Corporate Responsibility*]. *But see* Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 895-96 (3rd Cir. 1953); McLean v. Alexander, 449 F. Supp. 1251, 1265 (D. Del. 1978).

10. *See, e.g.,* Jesse v. Four-Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922); Griesse v. Lang, 37 Ohio App. 533, 175 N.E. 222 (1931); Figge v. Bergenthal, 130 Wis. 594, 109 N.W. 581 (1907).

11. Case law was so scant, in fact, that sometimes it was said not to exist. *See* Bailey v. Bush Terminal Co., 46 N.Y.S.2d 877, 878-80 (Sup. Ct. 1943), *aff'd mem.,* 267 App. Div. 899, 48 N.Y.S.2d 324 (1944), *aff'd mem.,* 293 N.Y. 735, 56 N.E.2d 739 (1944). *But see Corporate Responsibility, supra* note 9, at 106-08.

12. *Corporate Responsibility, supra* note 9, at 104.

13. *See, e.g.,* Jesse v. Four-Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922); Figge v. Bergenthal, 130 Wis. 594, 109 N.W. 581 (1907).

14. Figge v. Bergenthal, 130 Wis. 594, 109 N.W. 581 (1907).

15. Jesse v. Four-Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922).

16. Jesse v. Four-Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922); Figge v. Bergenthal, 130 Wis. 594, 109 N.W. 581 (1907).

soning as *Griesse v. Lang*,[17] where the successful directors were denied indemnification because of the lack of shareholder approval.

Concern for directors' and officers' ability to be indemnified grew after a New York court, in *New York Dock Co. v. McCollom*, required that the directors must persuade the court that their indemnification would be of "benefit" to the corporation.[18] This placed a much heavier burden on those directors who had been successful in defending shareholders' derivative litigation brought against them.[19]

The decision in *McCollom* might have been different if non-fiduciary employees, as opposed to directors, had been successful in the underlying suit and had sought indemnification. The New York court treated directors as *sui generis* and not in the position of corporate agents whom the corporation was legally obligated to reimburse for their business expenses.[20] Although the legally obligated language implies an automatic right of non-management employees to be indemnified if successful on the merits, the New York court did not analyze the rights of non-management employees.

The implication in *McCollom* that non-fiduciary employees have a right to indemnification is correct to the extent that employees are generally entitled to reimbursement of their expenses in defending litigation connected with their employment.[21] The employee's right to indemnification at common law arose when he had performed his tasks for his employer in good faith and had no reason to believe his acts were illegal.[22]

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17. Griesse v. Lang, 37 Ohio App. 533, 175 N.E. 222 (1931).

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

19. *Compare McCollom, with* Solomine v. Hollander, 129 N.J. Eq. 264, 19 A.2d 344 (1941), granting indemnification where the directors had prevailed on the merits. In *Hollander* the New Jersey court specifically declined to follow the "benefit" requirement of *McCollom:*

> I, therefore, hold that the directors and officers who have successfully defended this suit on the merits and who have demonstrated honesty and loyalty to their trust are entitled to be reimbursed by the corporate defendant for their reasonable expenses and counsel fees either already expended incurred in connection with this cause.

129 N.J. Eq. at 273, 19 A.2d at 348.

However, not all courts recognized a common law right in successful directors to be indemnified. Bailey v. Bush Terminal Co., 46 N.Y.S.2d 877 (Sup. Ct. 1943), *aff'd mem.*, 267 App. Div. 899, 48 N.Y.S.2d 324 (1944), *aff'd mem.*, 293 N.Y. 735, 56 N.E.2d 739 (1944).

20. *McCollom* further distinguished directors and employees on the grounds that the former derive their authority from the state and not from the corporation. 173 Misc. at 109-10, 16 N.Y.S.2d at 847.

21. R. STEVENS & H. HENN, *Note on Indemnification of Directors, Officers and Other Corporate Personnel for Litigation Expenses,* CASES ON CORPORATIONS 1316 (1964).

22. 53 AM. JUR. 2d *Master-Servant* § 132 (1970); *see also* RESTATEMENT (SECOND) OF AGENCY, § 438 (1957). For text, *see* note 111 *infra*. In Delaware, *see*

A non-fiduciary employee's right to indemnification does not arise in the same manner as does that of an officer or director.[23] The employee's indemnification rights, originating in the law of agency, derive from his position as the agent of his employer. An agent has the right to recover his reasonable expenses in protecting himself against what he believes in good faith to be an unfounded claim brought because of the agent's authorized conduct on behalf of his principal.[24] Since management employees—directors and officers—can be considered the principal in the employment context, it follows that their indemnification rights are not necessarily the same as those for non-management employees.

Thus because indemnification rights of officers and directors were essentially derived from statute, they were readily distinguishable from non-management employees' common law rights.[25] However, these distinctions became blurred when indemnification statutes in many states were amended in the 1960's to cover "employees" as well as managers. So, too among the amendments found in later indemnification provisions of the Delaware General Corporation Law and of the Model Business Corporation Act [MBCA] [26] was the coverage of "employees." [27]

Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 893 (3rd Cir. 1953) (dictum); and McLean v. Alexander, 449 F. Supp. 1251, 1265 (D. Del. 1978) (dictum).

23. Scott v. Crescent Tool Co., 306 F. Supp. 884, 888 (N.D. Ga. 1969), which required, under Georgia law, express agreement for employee indemnification.

24. RESTATEMENT (SECOND) OF AGENCY § 439 (1959):

> Unless otherwise agreed, a principal is subject to a duty to exonerate an agent who is not barred by the illegality of his conduct to indemnify him for:
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> (a) authorized payments made by the agent on behalf of the principal;
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> (b) payments upon contracts upon which the agent is authorized to make himself liable, and upon obligations arising from the possession or ownership of things which he is authorized to hold on account of the principal;
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> (c) payments of damages to third persons which he is required to make on account of the authorized performance of an act which constitutes a tort or a breach of contract;
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> (d) expenses of defending actions by third persons brought because of the agent's authorized conduct, such actions being unfounded but not brought in bad faith; and
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> (e) payments resulting in benefit to the principal, made by the agent under such circumstances that it would be inequitable for indemnity not to be made.

25. Merritt-Chapman & Scott Corp. v. Wolfson, 264 A.2d 358 (Del. 1970); Mooney v. Willys Overland Motors, Inc., 204 F.2d 888 (3rd Cir. 1953).

26. ABA-ALI MODEL BUS. CORP. ACT § 5 (1953) [hereinafter MBCA].

27. DEL. CODE ANN. tit. 8, § 145(c) (1975); MBCA, note 26 *supra*, § 5(c) (1967). The sections, which are identical, provide that:

> To the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) or (b), or in defense of any claim, issue or matter therein, he shall be indemnified against expenses

III. STATUTORY INDEMNIFICATION AMENDMENTS TO COVER EMPLOYEES

Delaware's indemnification statute was amended in 1967 to permit corporations to protect its employees. The suggestion that the Delaware statute be amended to include "employee" came from Professor Folk's 1964 Report to the Delaware Corporation Law Revision Committee.[28]

Professor Folk termed the initial Delaware statute, "so indefinite as to coverage that by-laws and other intra-corporate indemnification procedures must suffer from the uncertainty. Accordingly, this Report recommends additional language making unmistakably clear that the power to indemnify extends to all types of proceedings." [29] Delaware's Court of Chancery had also suggested study of the indemnification provisions in order to determine "whether it should deal with compromise situations." [30]

The 1967 amendment to the Delaware indemnification statute required the person seeking indemnification to have "acted in good faith and in the manner he reasonably believed to be in or not opposed to the best interests of the corporation." [31] The statute also allowed advance payment of litigation expenses under certain conditions,[32] and gave an absolute right of indemnification to any director, officer, employee, or agent of the corporation who has been successful

(including attorneys' fees) actually and reasonably incurred by him in connection therewith.

28. E. FOLK, THE REPORT TO THE DELAWARE CORPORATION LAW REVISION COMMITTEE 81-82 (1964) [hereinafter cited as REPORT].

29. *Id.* at 78.

30. Essential Enterprises Corp. v. Dorsey Corp., 40 Del. Ch. 343, 357, 182 A.2d 647, 656 (Del. Ch. 1962).

31. DEL. CODE ANN. tit. 8, § 145(a) (1975):

> A corporation may indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that his conduct was unlawful.

32. DEL. CODE ANN. tit. 8, § 145(e) (1975). For text, *see* note 74 *infra*.

"on the merits or otherwise" [33] in the defense of any proceeding or claim.[34]

Under the pre-1967 Delaware indemnification statute, management employees who were not officers at the time of the alleged offense had limited statutory indemnification rights.[35] "Many persons properly entitled to indemnification are not technically officers, and, at least in antitrust proceedings, often sub-officer personnel such as sales executives are parties." [36] Thus a principal purpose of the 1967 statute was to clarify the indemnification rights of employees.[37] The original Delaware indemnification statute had omitted mention of employees "because it was believed employees were protected under common law principles." [38]

In 1967 the MBCA provisions on indemnification were amended through the joint effort of the Delaware Corporation Law Committee and the ABA Committee on Corporate Laws,[39] and these MBCA revisions essentially conform with the Delaware 1967 amendments.[40]

33. DEL. CODE ANN. tit. 8, §145(c) (1975). For text, *see* note 27 *supra*.

34. The Delaware 1967 statutory amendments included numerous other provisions. For example, the standard of conduct required for indemnification in derivative cases, DEL. CODE ANN. tit. 8, §145(b) (1967), absent success on the merits or otherwise, was more stringent than DEL. CODE ANN. tit. 8, §145(a) (1967). However, since employees are rarely sued in derivative actions, this article will not deal with the subsection (b) standard. DEL. CODE ANN. tit. 8, §145(g) (1967) permits the corporation to procure insurance on and for the conduct of its officers, directors and employees. *Cf.* Bishop, *A New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92 (1966) (discusses the problems involved in such insurance).

35. Sorensen v. Overland Corp., 242 F.2d 70 (3rd Cir. 1957), *aff'g* 142 F. Supp. 354 (D. Del. 1956).

36. REPORT, *supra* note 28, at 81-82.

37. E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 93 (1972). *See also* REPORT, *supra* note 28, at 81-82. Nevertheless, the addition of "employee" and "agent" to the indemnification statute has permitted a Delaware court to construe broadly the term "employee." An employee for purposes of indemnification includes a person who was serving as chairman of the board and as president of a wholly-owned subsidiary under an employment agreement with the corporation. Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 142 (Del. Super. 1974). In *Wolfson*, plaintiffs sought indemnification for their expenses incurred in defending against criminal actions brought against them for performance of their corporate duties. The corporation rejected their claims, arguing that their indictments did not relate to their area of employment, and they had not been made a party to the criminal proceedings because of their employment by the corporation. The court disagreed, finding that the prosecution of plaintiff Kosow for misuse of inside information in violation of the Securities & Exchange Act of 1934, 15 U.S.C. §78j(b) (1934) and SEC Rule 10b-5, 17 C.F.R. §240.10b-5 (1979), resulted from his "employment or agency relationship" with the corporation. Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 142 (Del. Super. 1974).

38. Sebring, *Recent Changes in the Law of Indemnification of Directors*, 23 BUS. LAW. 95, 97 (1967).

39. Committee on Corporate Laws, *Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel*, 34 BUS. LAW. 1595 (1979) [hereinafter cited as Committee].

40. Sebring, note 38 *supra*, at 96. For example, DEL. CODE ANN. tit. 8, §145(g) (1975) is identical to MBCA, note 26 *supra*, at §5(g) (1967):

The inclusion of the word "employee" in MBCA section 5, as amended in 1967,[41] was intended to clarify the fact, as did the Delaware amendment, that indemnification rights were available to employees, as well as to officers and directors.

IV. CURRENT STATUTORY AND BY-LAW DEVELOPMENTS IN INDEMNIFICATION OF EMPLOYEES

Since the 1967 amendments to the MBCA and to the Delaware indemnification statutes, the types of issues and problems arising out of indemnification of directors, officers and employees have changed.[42] Many of the troublesome considerations created by the older and less expansive statutes seem to have been laid to rest. Yet a new crop of concerns are evidenced by recent litigation that examines indemnification in light of other developing areas of law. The most significant effects stem from interaction with federal regulation, particularly the prohibition of certain overseas payments and the rules promulgated under the Occupational Safety and Health Act.[43]

As a result of the developments in the law, amendments have been proposed to the MBCA's indemnification provisions[44] with the objective of establishing "standards and procedures for indemnification that are workable in meritorious cases, and yet are not subject to abuse."[45] The proposed amendments would make significant changes

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A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request for the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section.

41. *See, e.g.*, MBCA, note 26 *supra*, at § 5(g) (1967).

42. From time to time after 1967, the Delaware indemnification statute was amended and expanded. In 1970 a new subsection (h) was passed. *See* Delaware Act of May 16, 1970, 57 Del. Laws c. 421, § 2 (current version at DEL. CODE ANN. tit. 8, § 145(h) (1975)). That subsection permitted the surviving corporation in a merger to provide continuing indemnification to employees of a non-surviving constituent corporation in a merger. In 1974 subsection (h) was amended to narrow its scope. Delaware Act of July 11, 1974, 59 Del. Laws c. 437, § 7 (current version at DEL. CODE ANN. tit. 8, § 145(h) (1975)). The significance of subsection (h) to this article is that the corporation can advance expenses to an employee sued in his position as an employee of a non-surviving corporation in a merger, where that person is neither a present nor former employee of the corporation making the advance. In such a situation, it may have been difficult for such an employee to sustain a common law right to indemnification. DEL. CODE ANN. tit. 8, § 145(c) (1975). For text, *see* note 27 *supra*.

43. *See generally* Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993 (1978).

44. Committee, *supra* note 39, at 1595-96.

45. *Id.* at 1596.

in the current provisions of MBCA section 5.[46] Perhaps the most noteworthy change would be to make the MBCA indemnification statute exclusive as to directors.[47]

The proposed amendments to MBCA section 5 depart from the Delaware statutory model in making the indemnification statute the exclusive indemnification provision for directors. While the proposals set forth specific standards and circumstances for indemnification of directors, employee rights to indemnification would, under subsection (j) of the proposed amendments, be returned to the pre-1967 status.[48]

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46. *Id.* at 1595-615. *Compare* the current MBCA, *supra* note 26, at §5(a) (1967) *with* MBCA, *supra* note 26, at §5(b) (Proposed Amendment 1979), *reprinted in* Committee, *supra* note 39, at 1595. Subsection (a) states:

> A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that his conduct was unlawful.

Proposed Amendment, subsection (b) states:

> A corporation shall have power to indemnify any person made a party to any proceeding (other than a proceeding referred to in subsection (c)) by reason of the fact that he is or was a director against judgments, penalties, fines, settlements and reasonable expenses, actually incurred by him in connection with such proceeding, if
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> (1) he conducted himself in good faith and
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> (A) in the case of conduct in his official capacity with the corporation, he reasonably believed his conduct to be in its best interest, or
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> (B) in all other cases, he reasonably believed his conduct to be at least not opposed to its best interests; and
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> (2) in the case of any criminal proceeding, he had no reasonable cause to believe his conduct was unlawful. The termination of any proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, be determinative that the person did not meet the requisite standard of conduct set forth in the preceding sentence.

47. Committee, *supra* note 39, at 1596.

48. MBCA, *supra* note 26, at §5(j) (Proposed Amendment 1979) (emphasis added), *reprinted in* Committee, *supra* note 39, at 1606.

> Unless otherwise limited by the articles of incorporation,
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> (1) an officer of the corporation shall be indemnified as and to the extent provided in subsection (e) for a director and shall be entitled to seek indemnification pursuant to the provisions of subsection (e) to the same extent as a director;

It was the intent of the drafters of the proposal that employees' rights of indemnification arise from principles of agency law, the doctrine of *respondeat superior,* collective bargaining, or other contractual agreement, rather than from statute.[49] Therefore, if adopted, the proposed MBCA amendments would preceptively separate the indemnification standards for directors from the more flexible indemnification rights of employees.

In distinguishing between directors and employees, and in relegating employees to whatever provisions the corporation chooses consistent with public policy, the MBCA drafters may be shifting the authority over employee indemnification from statute to by-law and agreement. The proposed MBCA amendments would not prohibit the corporation's using contract or by-law to grant such indemnification rights as it feels appropriate for its employees, subject to public policy constraints.[50] Hence, the indemnification by-laws of most corporations should be inspected.

The certificate of incorporation and by-laws of most corporations do not explicitly and separately set forth indemnification provisions for officers and employees who are not directors of the corporation. In October, 1978, a member of the Committee on Corporate Law Departments of the Section on Corporation, Banking and Business Laws of the American Bar Association circulated among a number of major corporations a questionnaire as to the extent of their by-law indemnification provisions for employees. Forty-three corporations responded. Twenty-one of the forty-three corporations stated that they were mandated to indemnify their employees "to the fullest ex-

(2) a corporation shall have the power to provide indemnification, including advances of expenses, to an officer, *employee* or agent of the corporation to the same extent that it may indemnify directors pursuant to this section; and

(3) a corporation, in addition, shall have the power to indemnify an officer who is not a director, as well as *employees* and agents of the corporation who are not directors, to such further extent, consistent with law, as may be provided by its articles of incorporation, by-laws, general or specific action of its board of directors, or contract.

49. Committee, *supra* note 39, at 1615.

50. The Delaware Corporation Law Committee, which helped revise the Model Act in 1967, also believes it is important to make clear (as is done in proposed subsection (j)) that officers who are not directors may be indemnified within whatever limits public policy may set (i.e., 'consistent with law'). . . . As in New York, 'exclusivity' of the statute prohibits charter, by-law or contractual provisions inconsistent with the statute but does not purport to be prescriptive by way of limitation. This 'exclusivity' does not either prevent procedural machinery that is not inconsistent with the statute in order to authorize the indemnification, nor does it prohibit a by-law or contract provision by which the permissive provisions of subsection (b) and (c) are made mandatory if and when the occasion for indemnification arises.

Id. at 1613.

tent permitted by law." Sixteen other corporations replied that their indemnification of employees was discretionary with the corporation. Six others' responses were not definitive on the question.[51]

Even the responses indicating that the corporations provided "mandatory indemnification for employees" allowed for variations in the approaches of some corporations. For example, most of the corporations whose by-laws contained "mandatory indemnification" simply followed the provisions of the Delaware statute.[52] Since Delaware law provides for mandatory indemnification only where an employee's defense has been successful on the merits "or otherwise," [53] these "mandatory indemnification" by-laws are not as protective as they might be. Other mandatory indemnification responses referred to by-laws providing that indemnification "shall be at the discretion of the board of directors," except where the employee's defense has been successful on the merits.[54] Such by-laws merely restate existing common law since a "successful" employee is automatically entitled to indemnification under both the Delaware statute and the MBCA.[55] Thus, a corporation purporting to have "mandatory indemnification" may in reality only have "discretionary indemnification" for its employees.

The flexibility sought by many corporations in having "discretionary indemnification" has merit. A corporation may believe employees are more careful when indemnification is discretionary; the corporation's discretion may well affect an employee's degree of cooperation. Employees might also seek indemnification in substantially disparate situations;[56] both society and a corporation might prefer that a corporation have the flexibility to deal with the particularities of the matter at hand, rather than have a court apply one unvarying standard in dissimilar situations or wrestle with an un-

51. The author is most appreciative of questionnaire materials made available by Edward W. Franklin, Vice President, Secretary and General Counsel of General Signal Corporation, Stamford, Connecticut.

52. *Id.*

53. DEL. CODE ANN. tit. 8, § 145(c) (1975). For text, *see* note 27 *supra.*

54. *See* note 51 *supra.*

55. DEL. CODE ANN. tit. 8, § 145(c) (1975); MBCA, *supra* note 26, at § 5(c) (1967). For texts of both, which are identical, *see* note 27 *supra.*

56. Circumstances in which an employee might seek indemnification could range from the complex to the simple, or from the seemingly justifiable to the apparently questionable. Consider the different issues that may be presented by the following two hypothetical cases: A) a situation in which an employee is required to testify before a grand jury investigating the corporation's conduct, and B) the defense of a misdemeanor action brought against an employee while driving a truck on the job. In A, is the employee's position substantially different from a corporation executive's, if the two worked hand-in-hand on the same transactions under investigation? In the arguably more common situations such as B, which are apparently covered by *respondeat superior,* what interest does society have in whether or not a corporation extends additional protection?

workable series of tests. Similarly, there are efficiency arguments to be made in favor of allowing corporations to establish policies concerning employees who are fighting minor criminal or civil claims, rather than taking up individual court's or board of directors' time with a stream of comparatively insignificant cases.

On the other hand, "mandatory indemnification" presumably promotes morale and confidence, in that employees are protected in the performance of their duties in an era of increasing litigation.[57] It should also eliminate the inconsistent decisions that result when indemnification may turn on the personnel involved in a particular situation.

Some corporations' indemnification by-laws run the risk of being more restrictive than the applicable state statute.[58] By-laws may be more restrictive than a statute permits, but may not be inconsistent with public policy or statutory limits.[59] To the extent that a corporation's indemnification by-laws are broader than the statute, they are not illegal on their face so long as they do not violate public policy and do not conflict with the statute.[60] Thus, a corporation should determine what its indemnification by-laws are intended to do for its employees and whether or not that intent is met by its current provisions.

Many of the same questions arise when a corporation considers the extent of insurance to cover its employees' litigation expenses and, in some instances, settlements and judgments where corporate employees, who are not officers and directors, are involved in lawsuits and claims. Who is insured and for what risks will directly affect the cost of a policy. Since policy interpretations may differ between the corporation and its insurer, exclusions should be carefully defined and considered. The employee who violates company policy or gov-

57. Even the common law decisions granting indemnification to successful directors recognized the importance of indemnification in reassuring corporate employees that the expenses of litigation should not be a hazard of their employment. Washington, *Litigating Expenses of Corporate Directors in Stockholders' Suits*, 40 COLUM. L. REV. 431 (1940).

58. This result is avoided where the bylaws simply provide for "indemnification to the fullest extent now or hereafter permitted by law."

59. For example, in Essential Enterprises Corp. v. Dorsey Corp., 182 A.2d 647 (Del. Ch. 1962), where a corporation's bylaws did not include payments in compromise of litigation, directors who settled a derivative action were precluded from indemnification under the Delaware statute before 1967.

In another Delaware case, Sorensen v. Overland Corp., 242 F.2d 70 (3rd Cir. 1957), *aff'g* 142 F. Supp. 354 (D. Del. 1956), recovery was denied based upon the corporation's by-law (conforming to the pre-1967 statute), which did not permit indemnification of litigation expenses for a corporate employee prior to his becoming a director and officer.

60. G. WASHINGTON & I. BISHOP, INDEMNIFYING THE CORPORATE EXECUTIVE 190 (1963).

ernmental laws and regulations usually is excluded from recovering his litigation expenses under most corporate insurance policies.[61]

Before adopting an indemnification by-law and deciding on insurance coverage, the corporation should consider the varied ramifications of indemnification of its employees under current law.

V. INDEMNIFICATION IN SPECIFIC SITUATIONS

A. *The Employee Who Prevails on the Merits or Otherwise*

Imagine, hypothetically, that a guard, believing a suspect is breaking into the building, pulls his gun and orders the suspect to stop. The presumed intruder shoots at the guard, who returns the fire, killing the suspect. Civil and criminal suits are filed against the guard and his company. Since the ultimate verdicts are in favor of the guard, he seeks to recover all of his expenses in defending himself.

Under the Delaware statute and the current MBCA, the guard is an employee who "has been successful on the merits . . . ." He is entitled to be "indemnified against expenses (including attorneys' fees), actually and reasonably incurred by him in connection therewith." [62]

However, in Delaware as well as under the MBCA, the guard may be indemnified even if not acquitted on all of the charges. As to criminal charges, the guard need only have acted in good faith, in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and have had no reasonable cause to believe his conduct was unlawful.[63] *Merritt-Chapman & Scott Corp. v. Wolfson* [64] upheld partial indemnification as a matter of right for an individual convicted of a crime, because he was successful in getting some of the charges dropped. In *Wolfson,* the government dropped all but one count in an indictment in order to get a plea and a conviction on the remaining count.[65]

61. *See* Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability,* 22 BUS. LAW. 92 (1966); Hinsey, *The New Lloyd's Policy Form for Directors' and Officers' Liability Insurance—An Analysis,* 33 BUS. LAW. 1961 (1978).

62. DEL. CODE ANN. tit. 8, § 145(c) (1975); MBCA, *supra* note 26, at § 5(c) (1967). For text, *see* note 27 *supra.*

63. DEL. CODE ANN. tit. 8, § 145(a) (1975); MBCA, *supra* note 26, at § 5(a) (1967). For texts, *see* notes 31 and 46 *supra.* Indemnification in such a situation is permissive, not mandatory.

64. Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Super. 1974).

65. This is not the only case where partially successful defendants have received indemnification. *Cf.,* Herald Co. v. Bonfils, 315 F. Supp. 497, 500 (D. Colo. 1970), *rev'd on other grounds, sub nom.* Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972) (the defendants did not have to pay the proportionate part of their expenses equal to their degree of vindication).

One proposed amendment to the MBCA would make directors eligible for mandatory indemnification under the statute only if "wholly successful." [66] Similarly, under this proposal an employee would have no statutory right to indemnification unless he had won the case. Presumably the "wholly successful" requirement would have precluded the result in *Wolfson,* if it had been the applicable law.[67]

However, success "on the merits or otherwise" under the current MBCA and under the Delaware statute [68] does not extend to dismissal without prejudice, where the same issue may be litigated in another pending case.[69] The statutory language is mandatory and, as a result, the courts are reluctant to stretch the "or otherwise" phrase.[70] Where the defendant in the underlying suit has not been vindicated and is still at risk in litigation on the issues, indemnification as of statutory right is premature.[71] On the other hand, statutory "success" can be achieved by a settlement without payment of monies. Such "success" includes a dismissal with prejudice.[72]

In effecting indemnification for the successful employee the corporation should obtain copies of the final orders in the action, suit, or proceeding in which the employee was successful. The corporation should also receive a statement from the employee's counsel as to the expenses, including attorneys' fees. Where the employee is a low-level employee performing ministerial duties for the corporation, and he succeeds on the merits in defending a lawsuit arising out of his employment, there is no reason for his indemnification to be reviewed by the board of directors. Depending on the employee's level of responsibility and the nature of the litigation, as well as the amount of

66. Proposed MBCA, *supra* note 26, at §5(e)(1) (Proposed Amendment 1979), *reprinted in* Committee, *supra* note 39, at 1601, states:

> Unless otherwise limited by the articles of incorporation,
>
> (1) a director who has been wholly successful, on the merits or otherwise, in the defense of any proceeding referred to in subsection (b) or (c) shall be indemnified against reasonable expenses incurred by him in connection with the proceeding . . . .

67. Note the drafters' intent to avoid the result in Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Super. 1974). *Cf.* Committee, *supra* note 39, at 1596 (which comments on the Delaware Corporation Law Revision Committee's inability to foresee such partial indemnification).

68. DEL. CODE ANN. tit. 8, §145(c) (1975); MBCA, *supra* note 26, at §5(c) (1967). For text, *see* note 27 *supra.* The Delaware statute is identical to the MBCA.

69. Galdi v. Berg, 359 F. Supp. 698 (D. Del. 1973).

70. *Id.* at 701.

71. *Id.* at 702; *citing* E. FOLK, THE DELAWARE GENERAL CORPORATION LAW, *supra* note 37, at 99.

72. B & B Investment Club v. Kleinert's Inc., 472 F. Supp. 787 (E.D. Pa. 1979) (applying a Pennsylvania statute, PA. STAT. ANN. tit. 15, §410 (Purdon), comparable to DEL. CODE ANN. tit. 8, §145(c) (1975)).

the expenses, the corporation may choose, but is not required, to involve senior management where there is indemnification as a matter of statutory right. Yet, where an officer or another director is entitled to indemnification under the statute, the entire board of directors should probable be notified.

B. *The Advancement of Expenses*

Imagine that a grocery store clerk has directed a customer to an aisle where the customer seeks a particular product. In following the clerk's directions, the customer slips and falls. He sues the clerk for not warning him of the newly polished condition of the floor. Since the clerk cannot afford an attorney to defend himself, he asks the company to provide one. If the clerk relies on the statute permitting advancement of his expenses, he will sign a formal "undertaking" to reimburse the company if he loses.[73]

Neither the MBCA nor Delaware statute automatically grants employees the right to be advanced their expenses in defending a civil or criminal action. The statutes are discretionary—"may be paid by the corporation." They require an "undertaking" by the indemnitee to repay the amounts advanced, unless it "shall ultimately be determined" that the individual is entitled to indemnification.[74]

Under Delaware law the corporation is not required to make a determination that the individual's defense to the suit is meritorious at the time expenses are advanced. There need not be a finding that the individual has acted in good faith and in a manner reasonably believed to be in, or not opposed to, the best interests of the corporation. Thus, no evaluation of the underlying merits is necessary at that time, either by disinterested directors or by independent counsel for the corporation.

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73. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(a) (1975); MBCA, *supra* note 26, at § 5(a) (1967). For texts, *see* notes 31 and 46 *supra*.

74. *Compare*, DEL. CODE ANN. tit. 8, § 145(e) (1975):

> Expenses incurred in defending a civil or criminal action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding as authorized by the board of directors in the specific case upon receipt of an undertaking by or on behalf of the director, officer, employee or agent to repay such amount unless it shall ultimately be determined that he is entitled to be indemnified by the corporation as authorized in this section.

with MBCA, *supra* note 26, at § 5(e) (1967):

> Expenses (including attorneys' fees) incurred in defending a civil or criminal action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding as authorized in the manner provided in subsection (d) upon receipt of an undertaking by or on behalf of the director, officer, employee or agent to repay such amount unless it shall ultimately be determined that he is entitled to be indemnified by the corporation as authorized in this section.

If the employee proceeds solely under the MBCA or Delaware statute, the board of directors must determine that the individual has given a valid, legal and binding undertaking to repay the amount advanced.[75] The undertaking need not be secured by collateral or by a showing of the financial responsibility of the indemnitee.[76] If the indemnitee's financial condition is precarious and the amount of the advance is significant, it is a matter of business judgment for the board of directors to determine whether or not the expenses should be advanced.

The policy behind the Delaware statute and MBCA[77] lends further support to the proposition that there is no requirement of financial responsibility or of adequate security for an advancement of expenses. The expenses reimbursable in Delaware, and under the MBCA, are necessarily those directly resulting from a suit against the employee which arose in connection with his employment by the corporation. The purpose of the indemnification statutes is to encourage employees to accept positions of responsibility and to make good-faith decisions without fear of penalty. To require a security as requisite for the advancement of expenses of litigation would run counter to this policy. Indeed, as the financial responsibility, or the ability to provide security, of the individual goes up, the need for advance of expenses arguably goes down.[78] This can again be contrasted with section 143 of Delaware Corporation Law, where loans to an officer or employee may be for his personal purposes, only indirectly affecting his work for and duties to the corporation.[79] Both the language and the policy of section 143 dictate that the board of directors make a judgment as to the security that may be required of the employee to whom the loan is made. In the case of an advance

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75. DEL. CODE ANN. tit. 8, § 145(e) (1975). For text, *see* note 74 *supra.*

76. DEL. CODE ANN. tit. 8, § 143 (1975). For text, *see* note 79 *infra.*

77. DEL. CODE ANN. tit. 8, § 145(e) (1975); MBCA, *supra* note 26, at § 5(e) (1967). For texts, *see* note 74 *supra.*

78. Committee, *supra* note 39, at 1613.

79. DEL. CODE ANN. tit. 8, § 143 (1975):

> Any corporation may lend money to, or guarantee any obligation of, or otherwise assist any officer or other employee of the corporation or of its subsidiary, including any officer or employee who is a director of the corporation or its subsidiary, whenever, in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation. The loan, guaranty or other assistance may be with or without interest, and may be unsecured, or secured in such manner as the board of directors shall approve, including, without limitation, a pledge of shares of stock of the corporation. Nothing in this section contained shall be deemed to deny, limit or restrict the powers of guaranty or warranty of any corporation at common law or under any statute.

under section 145(e) and MBCA section 5(e),[80] both the language of the statutes and the policy lead to the opposite conclusion.[81]

One might inquire whether a retainer demanded and received by an attorney for an employee is an expense that may possibly be advanced under the Delaware statute or MBCA. A retainer should be considered an expense within the meaning of the statute.[82] It does not stand in a different category than fees and out-of-pocket disbursements incurred in connection with the litigation. If the retainer or the fee is a reasonable one, it is one for which the employee may be indemnified.[83] No distinction between expenses or disbursements is made by the statute. The only test is whether the expenditure or liability was "actually and reasonably incurred" by the employee in connection with his defense of the action.[84] Whether or not the retainer is to be credited against future services makes no difference, except for its possible bearing on the reasonableness of the expense incurred. The purposes of both the Delaware statute and MBCA are to make the employee whole if it should develop that he was entitled to be indemnified and to protect him against interim loss in defending the action.[85]

One proposed MBCA amendment [86] provides that the advancement of expenses to an employee, who is not a director, shall be under the same terms as that for advancement of expenses to a director.[87]

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80. DEL. CODE ANN. tit. 8, §145(e) (1975); MBCA, *supra* note 26, at §5(e) (1967). For texts, *see* note 74 *supra*.

81. *Id.*

82. *See* MBCA, *supra* note 26, at §5a (Proposed Amendment 1979) (Comment), *reprinted in* Committee, *supra* note 39, at 1598-99. "It is believed that this omission was inadvertent and was intended to restrict the advancement of attorneys' fees."

83. *See* Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 143 (Del. Super. 1974). A seemingly unreasonable legal fee, $250,000, was considered reasonable in the defense of a director. A number of factors were cited to support that conclusion, including the stiffness of the criminal penalty the director was facing, the persistence with which the prosecution was pursuing the charge, and the national reputation of Edward Bennett Williams, the attorney for the defense.

84. DEL. CODE ANN. tit. 8, §145(e) (1975); MBCA, *supra* note 26, at §5(e) (1967). For texts, *see* note 74 *supra*.

85. Committee, *supra* note 39, at 1611.

86. MBCA, *supra* note 26, at §5(j)(2) (Proposed Amendment 1979), *reprinted in* Committee, *supra* note 39, at 1606. For text, *see* note 48 *supra*.

87. Committee, *supra* note 39, at 1612, 1614. *See also* MBCA, *supra* note 26, at §5(g) (Proposed Amendment 1979), *reprinted in* Committee, *supra* note 39, at 1604-05.

> Reasonable expenses incurred by a director who is a party to a proceeding may be paid or reimbursed by the corporation in advance of the final disposition of such proceeding
>
> (1) after a determination, made in the manner specified by subsection (f), that the information then known to those making the determination (without undertaking further investigation for purposes thereof) does not establish that indemnification would not be permissible under subsection (b) or (c), and

This requires an undertaking by the indemnitee. Such an undertaking, according to the statute, "need not be secured and may be accepted without reference to financial ability to make the repayment." [88] The proposed subsection establishes a new standard to be applied before expenses are advanced; "that the information then known to those making the determination (without undertaking further investigation . . .) does not establish that indemnification would not be permissible under" certain other subsections of MBCA section 5.[89]

The proposed MBCA amendments, therefore, specifically set forth the determination that must be made by the corporation before expenses may be advanced prior to final disposition of the proceedings. This standard is mandatory for directors in all instances and for employees who seek advancement of expenses under the proposed MBCA amendments. The drafters felt that the present MBCA provision was unworkable in that it requires a determination that the person seeking an advance for expenses has met the applicable standard of conduct set forth in present subsections (a) or (b); i.e., that he has acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation.[90] Such a determination as to the probable merits cannot usually be made early in a proceeding. Therefore, the proposed MBCA amendments require a determination based only upon information then available. But, is such a determination meaningful if it does not require an investigation? Will the proposed amendments lead to litigation over the knowledge and state of mind of those making the determination?

The proposed MBCA amendment section 5(g) [91] further illustrates the distinction between indemnification of directors and of non-management employees. It is reasonable for disinterested directors to be required to determine whether a fellow director should be advanced his expenses in defending litigation against him; presum-

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(2) upon receipt by the corporation of

(A) a written affirmation by the director of his good faith belief that he has met the standard of conduct necessary for indemnification by the corporation as authorized in this section, and

(B) a written undertaking by or on behalf of the director to repay such amount if it shall ultimately be determined that he has not met such standard of conduct.

The undertaking required by clause (2)(B) shall be an unlimited general obligation of the director but need not be secured and may be accepted without reference to financial ability to make the repayment.

88. MBCA, *supra* note 26, at §5(g) (Proposed Amendment 1979), *reprinted in* Committee, *supra* note 39, at 1604-05. For text, *see* note 87 *supra*.

89. *Id.*

90. Committee, *supra* note 39, at 1612.

91. For text of Proposed MBCA Amendment §5(g), *see* note 87 *supra*.

ably, the directors have knowledge of the situation. However, it is quite another thing to require any such determination by the directors, where a low-level employee seeks advancement of his expenses in defense of harassing litigation or unmeritorious claims involving, from the corporation's point of view, an insignificant amount of money. Isn't it non-productive for the board of directors of a public company to be involved in determining whether litigation expenses should be advanced to a store clerk who is defending a minor civil claim?[92]

C. *The Employee Who Loses*

The employee who loses a lawsuit involving his conduct during his employment does not necessarily lose all his rights to indemnification.[93] The termination of any action by a finding against the employee does not, of itself, create a presumption that he did not act in good faith, and that he is not entitled to indemnification under either the Delaware statute or the MBCA. But, both statutes distinguish between derivative actions and other types of actions[94] against the employee, with regard to his right to indemnification if he loses.[95] There are separate standards of conduct depending upon whether it is a third-party or a derivative action.[96]

With regard to third-party actions where the employee is unsuccessful, the MBCA and Delaware statutes provide that the board, before granting indemnification, must determine that the employee has acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation. If he is convicted in a criminal case, he must also show that he had no reasonable cause to believe that his action was unlawful.[97] The board of directors should make an investigation of all facts available to it, including a review of the proceedings, investigation of the relevant files, and interviews with appropriate employees or witnesses, in order to make the required determination as to the indemnitee's standard of conduct. If granted, the indemnification may include judgments and fines, in addition to expenses.

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92. It could be argued, however, that the advancement of insignificant amounts in payment of a non-management employee's litigation expenses can be treated as a business expense and is subject only to the business judgment rule.

93. DEL. CODE ANN. tit. 8, § 145(a) (1975). For text, *see* note 31 *supra*.

94. *E.g.*, third-party actions.

95. DEL. CODE ANN. tit. 8, § 145 (1975); MBCA, *supra* note 26, at § 5 (1967).

96. *See* DEL. CODE ANN. tit. 8, § 145(a)-(b) (1967). For texts, *see* notes 81 *supra* and 98 *infra*.

97. DEL. CODE ANN. tit. 8, § 145(a) (1975); MBCA, *supra* note 26, at § 5(a) (1967). For texts, *see* notes 31 and 46 *supra*.

With regard to derivative actions, no indemnification may be made when the court has determined that the employee is liable for negligence or misconduct in the performance of his duty to the corporation. An exception would be the court's determination that despite the adjudication of liability and in view of all the other circumstances of the case, the person is fairly and reasonably entitled to indemnity.[98] Such a decision can only be made by the Delaware Court of Chancery or the court in which such action or suit is brought.[99]

The proposed amendments to MBCA section 5 would relegate the employee to his common law indemnification rights where he is the loser in a lawsuit or proceeding.[100] At common law an employee is not entitled to indemnification from his employer where the employee

98. *Compare* DEL. CODE ANN. tit. 8, § 145(b) (1975):

> A corporation may indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request for the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by him in connection with the defense or settlement of such action or suit if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

with MBCA, *supra* note 26, at § 5(b) (1975):

> A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by him in connection with the defense or settlement of such action or suit if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation unless and only to the extent that the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which such court shall deem proper.

99. DEL. CODE ANN. tit. 8, § 145(b) (1967). For text, *see* note 98 *supra*.

100. *Cf.* MBCA, *supra* note 26, at § 5(d) (Proposed Amendment 1979) (precluding indemnification of a director who has been held liable if he improperly received a personal benefit), *reprinted in* Committee, *supra* note 39, at 1601.

knowingly has committed an illegal or wrongful act.[101] But, if the employee was not aware that his act was illegal, and he otherwise acted in good faith, the corporation may be bound to indemnify him for his damages.[102]

Even under the current statutes an employee may have an independent right to indemnification. Delaware cases indicate that the Delaware statute does not control every situation in which indemnification would be appropriate.[103] Both the Delaware statute and the current MBCA contain a "non-exclusive" subsection,[104] which provides that the indemnification is not exclusive of any other rights to which a person seeking indemnification may be entitled under any by-law, agreement, vote of stockholders or disinterested directors, "or otherwise."[105] The word "otherwise" could include a company policy or guideline to indemnify or reimburse its non-management employees for their litigation expenses arising as a result of their employment relationship where they are performing their normal duties on behalf of the corporation.

Similarly, the proposed amendments to the MBCA would continue this nonexclusivity except as to directors' indemnification rights.[106] These proposals, therefore, do not restrict a corporation's

101. 42 C.J.S., *Indemnity* § 20 (1944); and RESTATEMENT (SECOND) OF AGENCY § 439 (1957), wherein an agent knowingly committing an illegal act ordinarily has no right to indemnity from the principal. For text of § 439, *see* note 24 *supra*.

102. *See* Guirney v. St. Paul, M&M R. Co., 43 Minn. 496, 46 N.W. 78 (1890), where the corporation was required to indemnify an employee who, in following the corporation's orders, unknowingly violated an injunction.

103. *See* Mooney v. Willy-Overland Motors, Inc., 204 F.2d 888 (3rd Cir. 1953); Sorensen v. Overland Corp., 242 F.2d 70 (3rd Cir. 1957) (dealing with agreements to indemnify).

104. DEL. CODE ANN. tit. 8, § 145(f) (1975); MBCA, *supra* note 26, at § 5(f) (1967). The two sections are identical:

> The indemnification provided by this section shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office, and shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

105. DEL. CODE ANN. tit. 8, § 145(f) (1967); MBCA, *supra* note 26, at § 5(f) (1967).

106. Proposed MBCA, *supra* note 26, at § 5(h) (Proposed Amendment 1979), *reprinted in* Committee, *supra* note 39, at 1605:

> No provision for the corporation to indemnify a director who is made a party to a proceeding, whether contained in the articles of incorporation, the by-laws, a resolution of shareholders or directors, an agreement or otherwise (except as contemplated by subsection (k)), shall be valid unless consistent with this section or, to the extent that indemnity hereunder is limited by the articles of incorporation, consistent therewith. Nothing contained in this section shall limit the corporation's ability to reimburse expenses incurred by a director in connection with his appearance as a witness

right to indemnify its non-management employees, even if they are unsuccessful in the underlying proceedings, so long as to do so would not violate public policy or statutory restrictions on indemnification.

D. *The Employee Who Compromises and Settles*

The employee who settles or compromises an action related to his employment is not deprived of an opportunity to seek indemnification. The Delaware statute, as well as the current MBCA, provides that in third-party actions against the employee, the employee may seek indemnification for amounts paid in settlement if the board of directors makes a determination that he acted in good faith and in the best interests of the corporation.[107] For derivative lawsuits, the same determination must be made, but the indemnitee cannot recover the amount paid in settlement to the corporation.[108]

In determining whether a settlement was reasonably incurred in connection with a suit, the board of directors should review the merits of the litigation. It should balance the probability of success, the possible financial exposure, the adverse impact of continuing litigation on the indemnitee and on the corporation, the cost of going forward with the action, and what is involved in the settlement. The corporation would want to meet with the indemnitee and with his counsel to discuss reasons for the settlement and their evaluation of the case. For example, directors have been indemnified where they obtained dismissals with prejudice through a settlement to which they contributed no monies.[109]

The proposed amendment to the MBCA does not grant discretion in the board to indemnify an employee for his settlement or compromise of a lawsuit.[110] Such an employee is left to his common law indemnification rights. Although little case law exists in this respect, there is some authority for the proposition that an employee has a right to indemnification for payments made in a reasonable

in a proceeding at a time when he has not been made a named defendant or respondent in the proceeding.

107. DEL. CODE ANN. tit. 8, § 145(a) (1975); MBCA, *supra* note 26, at § 5(a) (1967). For texts, *see* notes 31 and 46 *supra*. *See also* Koster v. Warren, 297 F.2d 418, 423 (9th Cir. 1961), in which the indemnification of an officer and an employee who pled *nolo contendere* at the request of the corporation was allowed by the court.

108. DEL. CODE ANN. tit. 8, § 145(b) (1975); MBCA, *supra* note 26, at § 5(b) (1967). For texts, *see* note 98 *supra*.

109. Goldstein v. Alodex Corp., 409 F. Supp. 1201 (E.D. Pa. 1976) (applying Tennessee law).

110. *See* MBCA, *supra* note 26, at § 5(h), (j) (Proposed Amendment 1979) (Comment) *reprinted in* Committee, *supra* note 39, at 1613-15.

compromise of an action.[111] The employee's ability to achieve indemnification, however, might require his persuading the corporation that he did not act wrongfully, and that it was far more expedient to compromise the action rather than to undergo the expense and delay of a successful defense on the merits. In short, he may have to convince the corporation of the benefit of a settlement. For example, where individual defendants pleaded *nolo contendere,* indemnification for payment of their fines has been upheld on a finding that the corporation was benefited by this outcome of the litigation.[112]

One of the reasons for distinguishing between derivative and third-party actions with regard to indemnification of amounts paid in settlement is the purported therapeutic purpose of derivative lawsuits.[113] While it may be inequitable to indemnify directors for the amounts paid in settlement of derivative suits, that argument may have less persuasion where the indemnitee is a non-management employee. However, the prohibition in section 145(b) of Delaware Corporation Law and section 5(b) of the MBCA [114] would probably prevent a corporation from agreeing to indemnify its employees for derivative judgments where they have been found liable for negli-

111. RESTATEMENT (SECOND) OF AGENCY § 438 (1957):

(1) A principal is under a duty to indemnify the agent in accordance with the terms of the agreement with him.

(2) In the absence of terms to the contrary in the agreement of employment, the principal has a duty to indemnify the agent where the agent

(a) makes a payment authorized or made necessary in executing the principal's affairs or, unless he is officious, one beneficial to the principal, or

(b) suffers a loss which, because of their relation, it is fair that the principal should bear.

112. Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1947), *aff'd,* 267 App. Div. 890, 47 N.Y.S. 589 (1944). *See also* Koster v. Warren, 297 F.2d 418, 423 (9th Cir. 1961), where the court allowed indemnification of an officer and an employee who, at the corporation's request, pled *nolo contendere* to an antitrust indictment, on the ground that the indemnitees had forgone their right to defend for the corporation's benefit. The court did note in dictum that an agreement in advance by the corporation to indemnify anyone convicted of antitrust violations would be against public policy.

Notice, however, the distinction implicit in the Delaware statute between pleas of guilty and *nolo contendere:*

The termination of any action, suit or proceeding . . . upon a plea of nolo contendere or its equivalent, shall not, of itself create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interest of the corporation, and, with respect to any criminal action or proceeding had reasonable cause to believe that his conduct was unlawful.

DEL. CODE ANN. tit. 8, § 145(a) (1975). For full text, *see* note 31 *supra; see also* MBCA, *supra* note 26, at § 5(a) (1967).

113. *See* McLean v. Alexander, 449 F. Supp. 1251 (D. Del. 1978), as to concern for the procedure for indemnification of directors in derivative actions.

114. For texts of DEL. CODE ANN. tit. 8, § 145(b) (1975) and MBCA, *supra* note 26, at § 5(b) (1967), *see* note 98 *supra.*

gence or misconduct in the absence of court approval of such indemnification.

E. *Grand Jury Investigations*

A grand jury investigation may involve the company's employees in a variety of ways. Differences as to indemnification may result, depending on whether the employee or the company is the target of the investigation and as to whether the employee's participation in the investigation is limited to being a subpoenaed witness.[115] Generally, under the current MBCA and Delaware statute, an employee is entitled to indemnification for his expenses if he meets the standards discussed above, *i.e.*, he acted in good faith, in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and he had no reasonable cause to believe his conduct was unlawful.[116]

It follows that if the employee is not indicted after having been made the target of a grand jury investigation he ought to be able to rely on the Delaware statute and current MBCA to recover his expenses as a matter of right. Under these statutes, he has been successful if there has been no prosecution against him. On the other hand, an employee who receives transactional immunity in return for his grand jury testimony against the company arguably has not been successful in the statutory indemnification sense.[117] The company might conclude that such an employee was not acting in a manner "he reasonably believed to be in or not opposed to the best interest of the corporation." [118]

The proposed MBCA amendment subsection 5(b) supports a claim by an employee for indemnification of his expenses where he

115. *See* MBCA, *supra* note 26, at § 5(h) (Proposed Amendment 1979) (Comment), *reprinted in* Committee, *supra* note 39, at 1613-14.

116. DEL. CODE ANN. tit. 8, § 145(a) (1975); MBCA, *supra* note 26, at § 5(a) (1967). For texts, *see* notes 31 and 46 *supra*.

117. *But see* Stewart v. Continental Copper & Steel Indus., 67 App. Div. 2d 293, 414 N.Y.S.2d 910 (1967), where a different result obtained involving a grant of "use" immunity. There, the court found that a former president and vice president was entitled to indemnification under the Delaware statute for his own legal expenses in testifying before a grand jury investigation of the copper wire industry, of which his company was a member. Stewart had been granted "use," not "transactional," immunity by the government under 18 U.S.C. § 6002 (1970).

In so holding, the court interpreted Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 141 (Del. Super. 1974), as suggesting "a more expansive approach to indemnification that does not preclude recovery in either a criminal or a criminal investigative proceeding if a corporate official has upheld his honesty and integrity in the service of the corporation." *Id.* at 914.

118. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(a) (1975). For text, *see* note 31 *supra*.

participates solely as a witness at the grand jury investigation.[119] Prior to the MBCA proposals, there was a question whether or not a witness to a grand jury investigation is a "party" within the meaning of the statute. The decision to reimburse an employee for his expenses in testifying would be subject to the business judgment rule, which is applicable where corporate funds are used to repay an employee for his expenses incurred on the company's behalf.[120]

CONCLUSION

Non-management employees have common law indemnification rights which were neither changed by statute nor by amendment covering employees. However, at common law these rights are not clearly defined. The cases, and now the proposed MBCA amendments, distinguish between directors and other employees as to indemnification. Thus employees may correctly perceive their indemnification rights to be uncertain in some situations.

Subject to public policy and statutory constraints, a corporation should consider preparing agreements expressly providing for indemnification rights, for specific groups of non-management employees. These agreements would improve employee morale since not only the corporation, but also those employees would have the benefit of greater clarity as to the substance of and the procedures for their indemnification rights. Such agreements between the corporation and non-management employees will be judged by their reasonableness; they are a matter of business judgment for the corporation.

Further, corporations should consider amending their bylaws to make indemnification mandatory for non-management employees whose conduct meets the standard of section 145(a) or (b) of Delaware Corporation Law. The by-laws could make advancement of expenses mandatory for non-management employees. It is lawful for bylaws to make indemnification mandatory in situations where indemnification is currently only statutorily permissive. The corporation may lawfully choose to distinguish between management and non-management employees for purposes of mandatory, as opposed to permissive, indemnification by-laws.

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119. MBCA, *supra* note 26, at § 5(b) (Proposed Amendment 1979). For text, *see* note 46 *supra*. *See also* comment to Proposed MBCA, *supra* note 26, at § 5(h) (Proposed Amendment 1979) (Comment), *reprinted in* Committee, *supra* note 39, at 1613-14.

120. *See* MBCA, *supra* note 26, at § 5(b) (Proposed Amendment 1979) (Comment), *reprinted in* Committee, *supra* note 39, at 1609-10.