

NOTES

INDEMNIFICATION OF DIRECTORS IN A FEDERAL CHARTERING SYSTEM

Federal chartering of corporations is not a new issue to confront businessmen, legislators, and commentators. James Madison first voiced demands for a federal chartering system at the Constitutional Convention of 1787.¹ Although the Convention rejected Madison's proposal,² similar plans have been advanced during periods of heightened public concern over the political, economic, and social power of the corporation.³ From 1903 to 1914 Presidents Roosevelt, Taft, and Wilson supported over twenty bills that would have required federal licensing of corporations, but none became law.⁴ During the Depression Senators O'Mahoney and Borah sponsored the cause of federal chartering, but their proposals likewise met defeat.⁵

Concern over the expanding power of the corporation has again come to the forefront of political debate, along with numerous and diverse proposals to reform state chartering laws,⁶ strengthen judicial en-

1. Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 GEO. L.J. 123, 125 (1972). See Brabner-Smith, *Federal Incorporation of Business*, 24 VA. L. REV. 159, 159 (1937).

2. On August 18, 1787, James Madison proposed that the Constitution confer on Congress "a power to grant charters of incorporation where the interest of the United States might require and the legislative provisions of individual states may be incompetent." J. MADISON, *JOURNAL OF THE FEDERAL CONVENTION* 549 (E. Scott ed. 1898). Although three states favored the proposal, eight states voted against it as unnecessary and conducive to monopolies. Note, *supra* note 1, at 126.

3. See FEDERAL TRADE COMMISSION, *COMPILATION OF PROPOSALS AND VIEWS FOR AND AGAINST INCORPORATION AND LICENSING OF CORPORATIONS*, S. DOC. NO. 92, 70th Cong., 1st Sess., pt. 69-A (1934); L. LOSS, *SECURITIES REGULATION* 107 (2d ed. 1961); Note, *supra* note 1, at 124-28.

4. See L. LOSS, *supra* note 3, at 108; R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 67 (1976) [hereinafter cited as R. NADER]; Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125, 1126 (1976).

5. *Hearings on S. 10 Before a Subcomm. of the Senate Comm. on the Judiciary*, 75th Cong., 1st Sess. 326 (1937). See R. NADER, *supra* note 4, at 69-70; Henning, *Federal Corporate Chartering of Big Business: An Idea Whose Time Has Come?*, 21 DEPAUL L. REV. 915, 919 (1972).

6. Commentators indicate that the possibility of reform through changes in state law is only theoretical. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 668 (1974); Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 BUS. LAW. 1031, 1034 (1976); Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 992 (1976); Schwartz, *supra* note 4, at 1131-33.

forcement of existing codes,⁷ and enact federal legislation in the form of either a federal incorporations⁸ or minimum standards act.⁹

Part I of this Note examines the problems inherent in the present system of state chartering that have led reformers to advocate a federal solution. Part II focuses on one specific concern in state chartering systems—the power of the corporation to indemnify or insure its directors for corporate acts that give rise to causes of action against individual directors. Part III then analyzes the strengths and weaknesses of the indemnification and insurance provisions in several state codes to develop a model federal statute for the indemnification of corporate management.

I. STATE CORPORATE CHARTERING SYSTEMS

The present-day corporation is a development of the post-Civil War era.¹⁰ Before the Civil War state legislatures individually chartered corporations for specific purposes, such as the building of bridges or highways, to advance the welfare of the general public.¹¹ The states rigidly defined the corporate entity through specific requirements on capitalization, detailed restrictions on permissible business purposes, and time limitations on the corporation's period of existence.¹² New York, for example, revised its constitution in 1846 to provide that corporations could not be created by special act "[e]xcept . . . in cases

7. See Schwartz, *supra* note 4, at 1133-34. See generally note 27 *infra* and accompanying text.

8. Under a federal incorporations act, the federal government would preempt the states' power to charter corporations. The foremost contemporary advocate of federal chartering of corporations is Ralph Nader. See R. NADER, *supra* note 4. See also Schwartz, *supra* note 4; Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89, 110 (1972).

9. Professor William Cary is the leading advocate of a federal minimum standards act, which would establish a dual (state and federal) system of corporate chartering. Corporations would continue to draw their charters from the states, but the states would be subject to general standards imposed by the federal act. See Cary, *supra* note 6, at 700-05.

For criticisms of Cary's proposal, see Arshat, *Reply to Professor Cary*, 31 BUS. LAW. 1113 (1976); Drexler, *Federalism and Corporate Law, A Misguided Missile*, 3 SEC. REG. L.J. 374 (1976); Henning, *Federalism and Corporate Law: The Chaos Inherent in the Cary Proposal*, 3 SEC. REG. L.J. 362 (1976); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

10. J. BLUM, B. CATTON, E. MORGAN, A. SCHLESINGER, JR., K. STAMPP & C. WOODWARD, *THE NATIONAL EXPERIENCE* 437 (2d ed. 1968).

11. Henning, *supra* note 5, at 915.

12. Cary, *supra* note 6, at 664; Rubin, *Corporations and Society: The Remedy of Federal and International Incorporation*, 23 AM. U.L. REV. 263, 269 (1973).

where, in the judgment of the legislature, the objects of the corporation cannot be attained under general laws."¹³

The modern corporation emerged in response to demands for a business structure that would facilitate the accumulation and utilization of capital created by the industrial revolution of the post-Civil War period.¹⁴ The states encouraged the development of a new business entity by enacting general incorporation laws that resulted in virtually automatic corporate chartering.¹⁵ New Jersey adopted the first liberal incorporation statute in 1896.¹⁶ The statute permitted unlimited corporate size and market concentration, lessened capital requirements, and weakened shareholder control.¹⁷

The Supreme Court further strengthened the position of the corporation through its extension of the fourteenth amendment definition of "person" to the corporate entity in *Santa Clara County v. Southern Pacific Railroad*.¹⁸ As a result of this decision, a corporation could conduct its business in states other than the one in which it had been chartered, and moreover, all states would be required to grant "full faith and credit" to the laws of the chartering state even if these laws were more liberal than those of the state in which the corporation was "doing business."¹⁹

In response to criticisms from reformers such as the then-governor of New Jersey, Woodrow Wilson, the New Jersey legislature amended its corporation laws in 1913 to place restrictions on the state's chartering of

13. See N.Y. CONST. art. VIII, § 1 (1846).

14. Henning, *supra* note 5, at 915.

15. *Id.* See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 135-37 (1932).

16. Law of April 21, 1896, ch. 185, 1896 N.J. Laws 120th Sess. 277. See Cary, *supra* note 6, at 664. Mr. Justice Brandeis in *Liggett Co. v. Lee*, 288 U.S. 517 (1933) (Brandeis, J., dissenting), noted that the Act of 1896 is commonly credited with attracting the incorporation of such trusts as Standard Oil. *Id.* at 562-63.

17. See R. NADER, *supra* note 4, at 45-46.

18. 118 U.S. 394 (1886). See generally H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* 111-13 (2d ed. 1970); Green, *Corporations as Persons, Citizens, and Possessors of Liberty*, 94 U. PA. L. REV. 202 (1946).

19. See Cary, *supra* note 6, at 669. But see Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1968).

[E]ven if it is held that the full faith and credit clause is applicable to the corporation statute of the state of incorporation, it is doubtful whether such a holding in itself would have the effect of inhibiting another state, which has a valid and substantial interest to safeguard, from applying its own rule of law, even if contrary to that of the incorporating state.

Id. at 447.

corporations.²⁰ As a result of this amendment and Delaware's enactment in 1915 of a more liberal incorporation statute, Delaware replaced New Jersey as the leader in the competition to charter large corporations.²¹ During the 1920's Delaware-type statutes became the national norm and offered an open-ended opportunity for promoters and management to create the kind of corporation they desired.²²

Today, Delaware continues to lead the "race to the bottom,"²³ and its popularity as a place for incorporation accounts for a significant portion of total state revenues.²⁴ Despite the enactment by other states of Delaware-type incorporation statutes,²⁵ Delaware provides a more favorable climate for corporations because of the close relationship between the legislative and judicial processes,²⁶ the judiciary's liberal interpretation of Delaware law,²⁷ and the enormous body of case law that serves as precedent for corporate planning.²⁸

20. Law of Feb. 19, 1913, chs. 13-19, 1913 N.J. Laws 137th Sess. 25. See Cary, *supra* note 6, at 664.

21. See DEL. REV. CODE ch. 65 (1915); R. NADER, *supra* note 4, at 51; Cary, *supra* note 6, at 664-65.

22. Cary, *supra* note 6, at 666 (citing J. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1789-1970*, 13-57 (liberal legislation necessary to enable corporation to perform its functional role)).

23. The "race to the bottom" concept originated in the famous dissenting opinion of Mr. Justice Brandeis in *Liggett Co. v. Lee*, 288 U.S. 517, 559 (1933) ("The race was not of diligence but of laxity."). See Jennings, *supra* note 6, at 992 n.3.

24. See Cary, *supra* note 6, at 668; Smith, *Delaware Works Hard to Stay a Corporate Home Sweet Home*, *FORTUNE*, Feb. 13, 1978, at 132 (256 of the Fortune 500 companies incorporate in Delaware. The \$58 million per year paid in franchise taxes and fees constitutes 13% of Delaware's total revenue.).

25. See, e.g., GA. CODE ANN. tit. 22 (1977); N.J. STAT. ANN. tit. 14A (West 1969); OHIO REV. CODE ANN. tit. 17 (Page 1978); PA. STAT. ANN. tit. 15 (Purdon 1967).

26. See Cary, *supra* note 6, at 690-92.

27. Professor William Cary interprets the decisions of the Delaware courts as a relaxation of fiduciary duties and standards of fairness. Cary, *supra* note 6, at 688-92. See, e.g., *Manfield Hardwood Lumber Co. v. Johnson*, 268 F.2d 317 (5th Cir.), cert. denied, 361 U.S. 885 (1959); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964); *Graham v. Allis-Chalmers Mfg. Co.*, 40 Del. Ch. 335, 182 A.2d 328 (1962), *aff'd*, 41 Del. Ch. 78, 188 A.2d 125 (1963); *American Hardware Corp. v. Savage Arms Corp.*, 37 Del. Ch. 59, 136 A.2d 690 (1957). Cary believes that these judicial decisions indicate a desire on the part of the courts to foster incorporation in Delaware. See Cary, *supra* note 6, at 690-92.

Ralph Nader also asserts the existence of a judicial bias by the Delaware courts in favor of large corporations. He claims that Delaware shareholder rights during mergers have been subverted by three conventional loopholes, one of which is judicial. See R. NADER, *supra* note 4, at 276-77.

28. See, e.g., *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964); *Graham v. Allis-Chalmers Mfg. Co.*, 40 Del. Ch. 335, 182 A.2d 328 (1962), *aff'd*, 41 Del. Ch. 78, 188 A.2d 125 (1963). See also Cary, *supra* note 6, at 670-84.

The present system of state chartering has been criticized by several groups,²⁹ including public interest associations³⁰ and consumer advocates,³¹ but foremost among the critics have been proponents of shareholder rights.³² Shareholder advocates view the state chartering system, as exemplified by the Delaware statute,³³ to be unresponsive to

One commentator, however, suggests that the recent decision of *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), which held that a controlling shareholder who causes a merger solely for the purpose of "cashing out" minority shareholders violates the fiduciary duty he owes minority shareholders, "demolished precedents," and raised questions about how reliable previous case law may be. See Smith, *supra* note 24, at 133-34. The court's decision, however, in *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977), which held that a majority shareholder did not violate its fiduciary duty by merging to facilitate long-term debt financing, may mitigate the impact of the *Singer* decision.

29. An initial consideration in any analysis of the social and economic problems inherent in the present state chartering system is whether the corporation's primary interest is to make a profit or to benefit the public. Historically, the corporation has been viewed as "an entity interwoven with public purpose." Rubin, *supra* note 12, at 268. Critics of this viewpoint argue that the sole social responsibility of business is to use society's resources in activities designed to increase its profits. See Manne, *Should Corporations Assume More Social Responsibilities?*, in *ATTACK ON CORPORATE AMERICA* 3 (M. Johnson ed. 1978); Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. Times, Sept. 13, 1970, § 6 (Magazine), at 32.

30. Public interest critics claim that the present state chartering system, as exemplified by the Delaware statute, is the cause of a number of problems: (1) the lack of disclosure about industrial pollution, see R. NADER, *supra* note 4, at 17-18, 140-45; Green, *The Corporation and the Community*, in *CORPORATE POWER IN AMERICA* 42, 52 (R. Nader & M. Green eds. 1973); (2) undesirable political influence, see R. NADER, *supra* note 4, at 20-22, 153-57; Green, *supra* at 48; see generally Crain, *Do Corporations Wield Great Political Power?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 59; (3) dependence of local communities, see R. NADER, *supra* note 4, at 23-24; see generally Leibowitz, *Do Corporations Capture Local Communities?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 63; (4) deceptive product information and advertising, see R. NADER, *supra* note 4, at 24-26, 150-53; see generally Ayanian, *Does Advertising Persuade Consumers to Buy Things They Do Not Need?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 236; (5) potentially destructive technology, see R. NADER, *supra* note 4, at 25-28; (6) concentration of wealth and power among large corporations, resulting in a lack of competition, high inflation, and unemployment, see R. NADER, *supra* note 4, at 28-30; see generally Tollison, *Is Industrial Concentration the Cause of Inflation?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 194; (7) wasteful corporate subsidies, see R. NADER, *supra* note 4, at 22-23; (8) abuses of employees (e.g., the threat of toxic substances in the work environment, discrimination against blacks and women, worker alienation, and invasions of employees' rights of privacy), see R. NADER, *supra* note 4, at 18-20, 148-50; see generally Adie, *Are Corporations Indifferent to Worker-Job Alienation?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 44; Martin, *Do Corporations Discriminate Against Minorities and Women?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 48; and (9) business crime, see R. NADER, *supra* note 4, at 30-32.

31. See R. NADER, *supra* note 4, at 16-17. But see Winter, *supra* note 9 (market forces provide substantial protection for shareholders).

32. See, e.g., Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L. J. 71, 81-84 (1976) (noting the work of shareholder advocate Gilbert).

33. For example, Delaware law permits authorization of corporate action upon receipt of the

shareholder rights.³⁴ Historically, shareholders controlled the corporation,³⁵ but Delaware law has broadened the power and prerequisites of management to subjugate shareholder rights and privileges.³⁶ The board of directors now may propose fundamental changes such as merger,³⁷ sale of corporate assets,³⁸ and charter amendments³⁹ without a vote of the shareholders. In addition, the number of votes required for shareholder approval of these changes has been reduced to fifty per-

written approval of the requisite number of shareholder votes. No meeting is required. DEL. CODE ANN. tit. 8, § 228 (1974). Reformers view this practice as a device to circumvent disclosure of corporate affairs to minority shareholders. *See* Cary, *supra* note 6, at 669; Folk, *supra* note 6, at 1042-43. Others interpret the provision as a means of reducing time and expense for meetings, which are generally viewed as mere formalities. *See* Drexler, *supra* note 9, at 376.

In addition, critics argue that disclosure is inadequate under the present system because management prints "false and misleading reports." *See* R. NADER, *supra* note 4, at 84. For example, Delaware does not have a state provision requiring disclosure of dividends declared from a source other than earned surplus. *But see* Business Corporation Act § 46 (1974), which provides that a corporation may pay dividends from any surplus and possibly mislead an investor about the financial status of the corporation.

34. The theory that the present state chartering system is unresponsive to shareholders' rights presumes that a corporation owes a duty to its stockholders to allow them to participate in the corporation's management. *See generally* R. NADER, *supra* note 4; Cary, *supra* note 6; Folk, *Some Reflections of a Corporate Draftsman*, 42 CONN. B.J. 409 (1968); Folk, *Does State Corporation Law Have a Future?*, 8 GA. ST. B.J. 311 (1972); Folk, *supra* note 6; Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?*, 50 NW. U.L. REV. 1 (1955). This premise runs counter to the view that shareholders buy stock in public companies to make money on their investment and, therefore, apart from major decisions, prefer that management control the decisionmaking. *See* Arsht, *supra* note 9; Winter, *supra* note 9.

35. The early general corporation acts established the power of the shareholders to direct the policy of the corporation. Shareholders had to unanimously approve any proposal to change the corporation's assets, share structure, capitalization, or bylaws. *See* R. NADER, *supra* note 4, at 37.

36. An examination of the 1967 Revisions explains in part why Delaware has remained the favorite of big business. Management power and prerequisites were broadened as never before by such provisions as: § 242—only directors, not shareholders, may propose amendments to the corporate charter; §§ 143 and 122(15)—plans for loans to officers, stock options, stock bonuses, and incentive compensation were authorized, but lacking procedures to avoid abuses or even disclose to shareholders the amounts involved; § 145—officers and directors could be indemnified for all court costs and settlements of criminal and civil cases without court or shareholder approval; and § 252—management was given the power to merge certain subsidiary corporations without a shareholder vote.

Id. at 58.

37. DEL. CODE ANN. tit. 8, § 251 (1974 & Supp. 1978). *See generally* F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 5.13 (1975).

38. DEL. CODE ANN. tit. 8, § 271 (1974). *See generally* F. O'NEAL, *supra* note 37, at § 5.17 (sale of corporate business, franchise, and assets).

39. DEL. CODE ANN. tit. 8, § 242 (1974 & Supp. 1978). *See generally* F. O'NEAL, *supra* note 37, at § 5.05 (charter amendment).

cent.⁴⁰ Critics also contend that Delaware's elimination of the cumulative voting requirement,⁴¹ along with its provision for the staggered election of corporate directors,⁴² has diminished the voting power of minority shareholders.⁴³ A statutory provision that denies preemptive rights⁴⁴ and permits management to issue nonvoting stock or stock with unequal rights and preferences also gives rise to objections by advocates of shareholder voting rights.⁴⁵

Paralleling this decline in shareholder power is the appearance of a panoply of director benefits, which most frequently includes the indem-

40. See sources cited in notes 37-39 *supra*. Reformers argue that the 50% rule renders shareholders powerless to effect corporate change and fails to safeguard minority rights. See Folk, *supra* note 6, at 1039. But see Arsh, *supra* note 9, at 1119 (50% rule is more democratic).

41. DEL. CODE ANN. tit. 8, § 214 (1974). Under a system of cumulative voting, each shareholder is entitled to a vote equal to his number of shares multiplied by the number of directors to be elected. The shareholder may cast his entire vote for one director-candidate or split his vote among the candidates in any manner. Delaware does not require cumulative voting in large corporations.

Thirty-two states also permit but do not require cumulative voting, but even those corporations that utilize cumulative voting have the means to subvert it. In Delaware, for example, a simple majority may repeal cumulative voting. Along with 42 other jurisdictions, Delaware allows classification of directors, which may reduce to one-third or one-quarter the number of directors required to stand for reelection annually and increase the number of votes necessary to elect a director. See R. NADER, *supra* note 4, at 88-89.

42. DEL. CODE ANN. tit. 8, § 141(d) (Supp. 1978). Corporations commonly stagger the election of board directors so that each director serves three terms before subject to a reelection vote. See H. HENN, *supra* note 18, at 410-11.

43. See *Wolfson v. Avery*, 6 Ill. 2d 78, 126 N.E. 2d 701 (1955), in which the Illinois Supreme Court held that the staggered-election provision of the Illinois Business Corporation Act violated the cumulative voting provision of the Illinois constitution. But see Arsh, *supra* note 9, at 1119-20 (cumulative voting rights in large corporations are of no practical utility to minority shareholders).

44. Most jurisdictions expressly permit the articles of incorporation to deny or limit preemptive rights. See, e.g., DEL. CODE ANN. tit. 8, § 102(b) (1974); GA. CODE ANN. tit. 22, § 22-602 (1977); H. HENN, *supra* note 18, at 215. The purpose of preemptive rights is to prevent dilution of a shareholder's percentage of ownership in a corporation by requiring a corporation making a new offering to first offer the additional shares to existing shareholders. See generally H. HENN, *supra* note 18, at 215-16.

Preemptive rights are arguably of minimal value if a shareholder of a publicly traded security has other means to increase his stock holdings. See Arsh, *supra* note 9, at 1119-20. In addition, corporations claim that mandatory preemptive rights are outmoded and geared towards close corporations, and limit the corporations' flexibility in both the timing and the size of stock issues. See Wall St. J., Mar. 20, 1975, at 1, col. 5.

45. See DEL. CODE ANN. tit. 8, § 151 (1974); R. NADER, *supra* note 4, at 89.

The New York Stock Exchange rule that prohibits the listing of nonvoting common stock and prescribes minimum voting rights for listed preferred stock eliminates this problem to a great extent. See R. NADER, *supra* note 4, at 89; Arsh, *supra* note 9, at 1122. A Delaware law, which gives nonvoting stock a class vote on charter amendments, also addresses this problem. DEL. CODE ANN. tit. 8, § 242(c)(2) (Supp. 1978).

nification or insurance of management for corporate misconduct,⁴⁶ the right to establish executive salaries and pension plans,⁴⁷ and the establishment of generous noncash benefits.⁴⁸ The increased power of directors also creates a greater potential for abuse of position and laxness in the exercise of fiduciary duties and responsibilities.⁴⁹

These criticisms, as well as others,⁵⁰ of state chartering statutes have led reformers to call for the adoption of a federal system of chartering.⁵¹ Reformers argue that a federal system would prevent a state from granting corporations special treatment to retain their presence within the state or to entice foreign corporations into the state. Advocates of federal chartering also assert that a federal system would provide a central control over multinational corporations and diffuse large concentrations of corporate power. Proponents maintain that a federal system would better protect the consumer and general public by monitoring corporate power and serving as a reminder to corporate management that they hold "their charters in trust for the public."⁵² Finally, supporters contend that a federal system could more effectively regulate violations and impose penalties when necessary.⁵³

As a result of these criticisms, proposals for a federal chartering system continue to be debated.⁵⁴ Senator Henry Jackson's Interior Com-

46. See notes 58-150 *infra* and accompanying text.

47. See, e.g., DEL. CODE ANN. tit. 8, § 141(h) (1974) (board of directors fixes the compensation of directors); DEL. CODE ANN. tit. 8, § 122(15) (1974) (directors may establish pension plans, stock bonus plans, profit sharing plans, and other incentive plans); DEL. CODE ANN. tit. 8, § 143 (1974) (loans may be made to executives).

48. Noncash benefits include life and medical insurance, free medical service, educational grants to executives' children, company apartments, country club memberships, luncheon or dinner club memberships, chauffeur-driven cars, and expense accounts. See R. NADER, *supra* note 4, at 117.

49. See R. NADER, *supra* note 4, at 118, 122. For an overview of the role of the board of directors, see H. KOONTZ, *THE BOARD OF DIRECTORS AND EFFECTIVE MANAGEMENT* (1967); M. MACE, *DIRECTORS: MYTH AND REALITY* (1971).

50. For a comprehensive study of the possible problems of minority shareholders, see F. O'NEAL, *supra* note 37.

51. For a discussion of the history of federal incorporation and licensing proposals, see L. LOSS, *supra* note 3, at 107-11; R. NADER, *supra* note 4, at 65-71; Schwartz, *supra* note 4, at 1126-27.

52. E. MCSWEENEY, *MANAGING THE MANAGERS* 131 (1978).

53. *Id.*

54. For recent discussions on the issue of federal chartering, see Hyman, *Do Lientent State Incorporation Laws Injure Minority Shareholders?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 166; Martin, *Do Corporations Have No Inherent Rights Only Government-given Privileges?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 151; Morgan, *Is Federal Chartering Necessary to Curb Corporate Power?*, in *ATTACK ON CORPORATE AMERICA*, *supra* note 29, at 158.

mittee examined federal chartering bills in 1974.⁵⁵ Representative James Stanton unsuccessfully introduced a bill in 1975 that would have required the one hundred largest corporations to obtain federal charters.⁵⁶ Senator Howard Metzenbaum most recently revived the issue in Congress before the Senate Subcommittee on Citizens and Shareholders Rights and Remedies.⁵⁷

If federal legislation is to become a reality, however, general inquiries must be abandoned for specific analyses of identified weaknesses in the present system of state chartering. Only then can a federal remedy be constructed that will garner the support of a legislative majority. The indemnification or insurance of corporate directors for corporate misbehavior offers one specific concern ripe for an alternative consistent with the philosophy of federal incorporation.

II. INDEMNIFICATION AND INDEMNITY INSURANCE FOR CORPORATE DIRECTORS

The common law of agency required a principal to indemnify its agents against third-party claims in the event an agent performed an act that, although authorized, constituted a tort or breach of contract.⁵⁸ The law of corporations, however, remained unsettled over whether corporate directors or officers could be characterized as agents of the corporation and, therefore, entitled to indemnity.⁵⁹

The first decision to focus on the director's right to indemnity came in 1906. In *Figge v. Bergenthal*⁶⁰ the Wisconsin Supreme Court exonerated individual directors of a corporation in a fraud suit and upheld

Some commentators argue that the federal securities laws have created a federal law of corporations. See, e.g., Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27 (1973); Comment, Schoenbaum v. First Brook: The "New Fraud" Expands Federal Corporation Law, 55 VA. L. REV. 1103 (1969). *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), however, may limit the role of the federal government in preventing fraud in securities transactions.

55. *Federal Charters for Energy Corporations—Selected Materials*, Senate Comm. on Interior and Insular Affairs, 93d Cong., 2d Sess. (1974).

56. *Congressional Record*, H.R. 7481, 94th Cong., 1st Sess., 121 CONG. REC. 15897 (1975).

57. *Hearings Before the Subcomm. on Citizens & Shareholders Rights and Remedies of the Comm. of the Judiciary*, 95th Cong., 1st Sess. (1977).

58. RESTATEMENT (SECOND) OF AGENCY § 439(c) (1958).

59. See Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 993, 994 (1978).

60. 130 Wis. 594, 109 N.W. 581 (1906). See G. WASHINGTON & J. BISHOP, *INDEMNIFYING THE CORPORATE EXECUTIVE* 83 (1963).

the payment of attorneys' fees out of corporate funds in defense of the action.⁶¹ Shareholder ratification of the payments, though not unanimous, may have influenced the court's holding.⁶² The Wisconsin Supreme Court again faced the issue sixteen years later in *Jesse v. Four-Wheel Drive Auto Company*.⁶³ Despite *Figge*, the court characterized *Jesse* as a case of first impression and held that a unanimous vote of the stockholders is required for a corporation to assume the costs of defense in an action for defendant-directors' alleged misrepresentations in the sale of stock.⁶⁴

Nine years later the Ohio Court of Appeals confronted the indemnification issue in *Griese v. Lang*.⁶⁵ The directors of a corporation in *Griese* successfully defended a shareholder action charging the directors with negligence in the performance of their corporate duties. The court held that the attorneys' fees of the directors could be funded from the corporate treasury only if some benefit inured to the corporation and the shareholders approved the payments.⁶⁶

In the last of the early decisions on the issue, a New York court in *New York Dock Co., Inc. v. McCollum*⁶⁷ held that the expenditure of corporate funds to indemnify a director who successfully defended a derivative action was ultra vires.⁶⁸ The court discounted the theory that a director is an agent of the corporation entitled to recover for expenditures made in the transaction of his principal's affairs.⁶⁹ The court also rejected the view that a director derives his powers from either the shareholders or the corporation so that shareholder or board approval of his acts could justify the use of corporate funds to reimburse his litigation expenses.⁷⁰ Instead, the court declared a director's status to be *sui generis* with the director; thus, any corporate expenditure to indemnify the director would exceed the corporation's scope of powers because it could derive no benefit from the director's successful defense of an action not against the corporation.⁷¹ Though the corpo-

61. 130 Wis. at 625, 109 N.W. at 592.

62. *Id.* at 609, 109 N.W. at 586.

63. 177 Wis. 627, 189 N.W. 276 (1922).

64. *Id.* at 634, 189 N.W. at 278.

65. 37 Ohio App. 553, 175 N.E. 222 (1931).

66. *Id.* at 557, 175 N.E. at 223.

67. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

68. *Id.* at 111, 16 N.Y.S.2d at 849.

69. *Id.* at 109, 16 N.Y.S.2d at 847.

70. *Id.*

71. *Id.*

ration might benefit from indemnification to the extent that it could more easily induce responsible persons to become directors, the court maintained that liability is a risk assumed by any director, responsible or irresponsible.⁷²

The *McCullum* decision triggered the passage of the nation's first indemnification statute by the New York Assembly in 1941.⁷³ Less than a year later, a New York court in *Hayman v. Morris*⁷⁴ upheld the legislature's determination that without indemnification the public would be deprived of the services of capable executives, and affirmed the fairness of corporate reimbursement of directors and officers who successfully defend their acts taken on behalf of the corporation.⁷⁵

Similar statutes and court decisions followed in other jurisdictions.⁷⁶ In *Solimine v. Hollander*⁷⁷ a New Jersey court held that a director who prevails on the merits of his alleged misconduct may be reimbursed for expenses incurred in defense of the action.⁷⁸ The court flatly rejected the *McCullum* court's view that a director assumes the risk of litigation expenses in accepting corporate office.⁷⁹ More importantly, the court recognized the argument rejected in *McCullum* that indemnification for attorneys' fees is essential to the corporation's ability to attract competent directors.⁸⁰ Echoing the decision of the *Solimine* court, the Supreme Court of Minnesota in *In re E.C. Warner Co.*⁸¹ upheld reimbursement on the ground that the inducement of responsible persons to corporate office serves the needs of public policy.⁸² The court also

72. *Id.* at 112, 16 N.Y.S.2d at 850.

73. Law of April 2, 1941, ch. 209, § 1, 1941 N.Y. Laws 164th Sess. 813; Law of April 14, 1941, ch. 350, § 1, 1941 N.Y. Laws 164th Sess. 1034 (repealed 1945).

74. 37 N.Y.S.2d 884 (Sup. Ct. 1942).

75. *Id.* at 893-94.

76. See L. LOSS, *supra* note 3, at 1829-30; Note, *Liability Insurance for Corporate Officers and Directors: The Search for a Model Enabling Statute*, 50 N.Y.U.L. REV. 1120, 1126 (1975). For examples of the legislative enactments triggered by the *McCullum* case, see CAL. CORP. CODE § 803 (West Supp. 1975); DEL. CODE ANN. tit. 8, § 145 (1974); MINN. STAT ANN. § 301.905 (1969); N.Y. BUS. CORP. LAW §§ 721-26 (McKinney 1963 & Supp. 1975); OHIO REV. CODE ANN. § 1701.13(e) (Page Supp. 1974); PA. STAT. ANN. tit. 15, § 1410 (Supp. 1975).

77. 129 N.J. Eq. 264, 19 A.2d 344 (Ch. 1941).

78. *Id.* at 265, 19 A.2d at 345.

79. *Id.* at 269-70, 19 A.2d at 346-47.

80. "It is certainly just and reasonable that corporate officers and directors who have been put to expense in successfully defending themselves against actions of this kind should be reimbursed in reasonable amounts." *Id.*

81. 232 Minn. 207, 212, 45 N.W.2d 388, 392 (1950).

82. *Id.* at 214-15, 45 N.W.2d at 393.

ruled that a director need not demonstrate a tangible benefit to the corporation to recover his expenses if he is vindicated on the merits of the action against him.⁸³

Today, all state general corporation statutes provide indemnification of directors and officers in some form.⁸⁴ The primary policy consideration in favor of indemnification is the need to attract the best people available to run American corporations. Proponents of indemnification fear that without this protection, those most qualified to serve as directors not only will be reluctant to participate on corporate boards, but will avoid service altogether.⁸⁵ This fear is particularly strong among those who advocate the presence of more outside directors on corporate boards for their special knowledge or experience, their ability to supervise or police the active management of the corporation, and their business contacts or prestige.⁸⁶ Implicit in this consideration is the desire that directors serve fearlessly in the knowledge that the corporation they serve will support their expert judgments. Recognizing

83. *Id.*

84. A 1975 commentary indicated that all but two states, Idaho and New Hampshire, have indemnification provisions. Barrett, *Mandatory Indemnification of Corporate Officers and Directors*, 29 Sw. L.J. 727, 727 (1975). Currently, Idaho and New Hampshire have indemnification provisions. See IDAHO CODE tit. 30, § 166 (Supp. 1978); N.H. REV. STAT. ANN. § 294:4 (1977).

85. Orvel Sebring, then Chairman-Elect of the ABA Section on Corporation, Banking and Business Laws, stated in 1966: "[Indemnification] is good social policy . . . because we get the best men available to run our corporations. The lifeblood of business depends upon the quality of guidance which officers and directors can give the corporations. So there is a strong case for indemnification." Sebring, *Symposium: Duties and Liabilities of Corporate Directors*, 22 Bus. Law. 29, 124 (1966).

The rise in stockholder's suits and the increasing awareness of the liabilities which may result therefrom has had the disturbing effect of deterring many able men from service as corporate directors as well as causing the resignation of some. Many who resigned or who have been deterred feared that pressures of other affairs would prevent them from being adequately informed of the company's activities and thus would increase the possibility of their liability in a suit based upon acts of which they were unaware.

Cheek, *Control of Corporate Indemnification: A Proposed Statute*, 22 VAND. L. REV. 255, 274 (1969). See M. SCHAEFTLER, *THE LIABILITIES OF OFFICE: INDEMNIFICATION AND INSURANCE OF CORPORATE OFFICERS AND DIRECTORS* 72-73 (1976); G. WASHINGTON & J. BISHOP, *supra* note 60, at 5; Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 875 (1969).

86. The threat of litigation, the annoyance of public inspection, the consumption of valuable time, and the probability of being held liable for large amounts of money frequently outweigh the benefits of the position of outside directors, and explain why many businessmen are reluctant to serve on boards and, if they do, why they insist on being protected, either by indemnification or by insurance.

M. SCHAEFTLER, *supra* note 85, at 218. See Bishop, *Sitting Ducks and Decoys: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1092-93 (1968).

the importance of this objective, courts repeatedly have upheld corporate indemnification of directors.⁸⁷

The need to attract competent persons to corporate directorships also underscores the importance of reaching an equilibrium between the compensation granted corporate directors and the risks directors assume in performance of their duties. The present-day director faces a greater risk of third-party actions for misdeeds, mismanagement, or negligence than did his predecessor,⁸⁸ and the costs of defense have correspondingly mushroomed.⁸⁹ Influenced by these developments, proponents of indemnification reason that these risks must be shifted to the corporation to reflect the modern-day reality.⁹⁰ The executive must receive either a higher salary or a promise that his expenses will be reimbursed in the event of litigation.⁹¹ Viewed as a form of compensation, indemnification may be more equitable to both the director and the corporation and its shareholders than a fixed salary increment, because indemnification occurs only when litigation arises and only in the amount of costs actually incurred by the director.⁹²

Advocates of indemnification also assert that its benefits extend to plaintiffs as well as defendants. The availability of indemnification or liability insurance assures plaintiffs a fund from which to recover on

87. See, e.g., *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 141 (Del. 1974); *Bosch v. Meeker Coop. Light & Power Ass'n*, 257 Minn. 362, 363-64, 101 N.W.2d 423, 425 (1960); *In re E.C. Warner Co.*, 232 Minn. 207, 214-15, 45 N.W.2d 388, 393 (1950); *Solimine v. Hollander*, 129 N.J. Eq. 264, 272, 19 A.2d 344, 348 (1941). *But cf.* *Galdi v. Berg*, 359 F. Supp. 698, 701 (D. Del. 1973) (indemnification disallowed for derivative action against corporation's officer dismissed without prejudice); *New York Dock Co. v. McCollum*, 173 Misc. 106, 111-12, 16 N.Y.S.2d 844, 849-50 (1939) (directors not entitled to indemnification when successful defense of derivative action did not benefit corporation).

88. Note, *supra* note 76, at 1120.

89. Had "damages in the well-known *Texas Gulf Sulphur* litigation been assessed on a restitution basis . . . their amount would have exceeded the assets of the company by some \$150 million." *Id.* at 1120 n.3.

90. See *G. WASHINGTON & J. BISHOP*, *supra* note 60, at 5.

91. *Id.*

92. See, e.g., *Sorenson v. Overland Corp.*, 142 F. Supp. 354, 354, 360 (D. Del. 1956), *aff'd*, 242 F.2d 70 (3d Cir. 1957).

The equation of indemnification or insurance with compensation for services performed, however, may not be consistent with what public policy considers acceptable compensation. See *Bishop*, *supra* note 86, at 1091. A court might find the characterization of indemnification or insurance as compensation impermissible on the grounds that it constitutes waste or lacks a reasonable relationship to the value of the director's service. See generally *Rogers v. Hill*, 289 U.S. 582 (1933); *M. SCHAEFTLER*, *supra* note 85, at 113.

judgments against corporate tortfeasors⁹³ and assures defendant-directors the resources necessary to conduct a defense on the merits of the disputed conduct.⁹⁴

Persuasive arguments also have been advanced against indemnification and indemnity provisions. Foremost is the contention that the availability of indemnification or insurance, which allows a director to escape financial liability for his wrongful acts, undermines a more important policy objective—deterrence of corporate misconduct. The paramount importance of this objective has been long established by the common-law rule that bars the issuance of insurance for intentionally inflicted harm.⁹⁵ Statutory provisions that allow a corporation to purchase insurance on behalf of its directors, officers, employees, and agents for liability arising out of their intentional wrongdoings decrease the likelihood that the threat of liability will deter breaches of the fiduciary duty directors owe to the corporation and its shareholders.⁹⁶ Critics also question whether indemnification benefits the corporation in attracting qualified directors who fear personal liability for their mistakes when these mistakes amount to willful misconduct. To protect any director who places his own interests above those of the corporation would be unwise and harmful to the corporation.⁹⁷

Aside from its adverse effect on intentional misconduct, indemnification opponents argue that indemnity for negligent actions will lower the standard of care required of directors.⁹⁸ The argument, however, is

93. See M. SCHAEFTLER, *supra* note 85, at 86, 100; Israel, *A New Look at Corporate Directorship*, 24 BUS. LAW. 727, 738 (1969); Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716, 718 (1967) [hereinafter cited as *Public Policy*]; Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648, 654 (1967) [hereinafter cited as *Corporate Executives*].

94. M. SCHAEFTLER, *supra* note 85, at 80.

95. Note, *supra* note 76, at 1123.

96. See Bishop, *supra* note 86, at 1085; Note, *supra* note 76, at 1127. Proponents of indemnification characterize the deterrent effect of personal liability as speculative because litigation expenses bear little relationship to the degree of misconduct alleged against the corporate officer. See M. SCHAEFTLER, *supra* note 85, at 80. See also de Ravel D'Esclapon, *Liability of Directors to Shareholders for Negligence Under American Law and Their Indemnification*, 16 MCGILL L.J. 323, 384 (1970).

97. M. SCHAEFTLER, *supra* note 85, at 100.

98. Some authorities believe that the threat of civil or criminal liability could deter one's negligence. The fear that one will have to pay large damages if found liable would induce him to be more careful

It is important to point out that those who believe that negligent behavior cannot be deterred would not hesitate to recommend indemnity contract, since no personal or deterrent grounds are undermined. On the other hand, those who believe that negligent

much less compelling than in the case of intentional misbehavior. Little evidence exists to support the belief that either indemnification or indemnity insurance will lead to an increase in carelessness or a decline in standards of care.⁹⁹ The widespread availability of liability insurance for ordinary negligence in connection with motor vehicles, for example, also argues for the insurability of directors for mere negligent breaches of corporate responsibility.¹⁰⁰

Another argument voiced against indemnification centers upon the "business judgment rule."¹⁰¹ These opponents assert that the need for indemnification is obsolete because the business judgment rule virtually immunizes directors from liability for judgments uninfluenced by personal considerations.¹⁰² The rule, however, does not protect a director who fails to exercise judgment on a matter that gives rise to a claim of negligence.¹⁰³ Furthermore, the business judgment rule does not shield an "outside director"¹⁰⁴ who views the directorship as "an honorary position which . . . had nothing to do with the activities of the corporation."¹⁰⁵

conduct could be deterred might be disturbed by insurance, since it could be argued that insurance alleviates the punitive and deterrent consequences of misconduct and encourages careless conduct.

Id. at 82 n.7.

99. *Id.* at 93. See *Public Policy*, *supra* note 93, at 721; *Corporate Executives*, *supra* note 93, at 667.

100. See *Public Policy*, *supra* note 93, at 723; *Corporate Executives*, *supra* note 93, at 654.

Critics note, however, that an issue inherent in these arguments against insurance and indemnification is whether negligence is, in fact, deterrable. Indemnification advocates also point to the experience in the fields of law and medicine where the existence of malpractice insurance has not resulted in a lower standard of care. See M. SCHAEFTLER, *supra* note 85, at 95; Drexler, *supra* note 9, at 376; Israels, *supra* note 93, at 738; *Public Policy*, *supra* note 93, at 724. Professional sanctions and social pressures act to deter misconduct by lawyers and physicians more so than the threat of civil liability. See M. SCHAEFTLER, *supra* note 85, at 85-86. Critics note, however, that the analogy to medical and legal malpractice is inaccurate and inappropriate because the weight of societal concern in the case of a physician whose lack of care causes physical injury is much greater than in the case of a director whose negligence results in economic loss. See *id.* at 85.

101. Under the business judgment rule, "[t]he law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than the welfare of the corporation." *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

102. See *Public Policy*, *supra* note 93, at 724-25.

103. *Id.* at 727.

104. An "outside director" is a director who does not hold an executive or other employee position in the company. *BUS. WEEK*, May 11, 1974, at 34.

105. *Platt Corp. v. Platt*, 42 Misc. 2d 640, 645, 249 N.Y.S.2d 1, 8 (Sup. Ct. 1964), *aff'd mem.*, 23 App. Div. 2d 823, 258 N.Y.S.2d 629 (App. Div. 1965), *rev'd on other grounds*, 17 N.Y.2d 234, 217 N.E.2d 134, 270 N.Y.S.2d 408 (1966).

In a final argument against indemnification, some commentators assert that indemnification and insurance statutes run contrary to the disclosure policy underlying the federal securities laws.¹⁰⁶ In *Globus v. Law Research Service, Inc.*, a New York federal district court held that a securities underwriter, who had actual knowledge of the omission of material facts from the prospectus filed with the SEC, could not enforce the indemnification provisions of the underwriting agreement with the issuer.¹⁰⁷ In support of its holding, the court cited Securities and Exchange Commission Rule 460¹⁰⁸ for the proposition that indemnification of directors and officers undermines public policy.¹⁰⁹ The language of the rule, however, reveals that "there is no public policy against indemnification of a director or officer for the expenses of a *successful* defense."¹¹⁰

In view of the aforementioned policy considerations, a substantial case can be made for the indemnification or insurance of corporate di-

106. See Barrett, *supra* note 84, at 742; Bishop, *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE L.J. 1153; Johnston, *supra* note 59, at 2008; Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of Bar-Chris and Globus*, 24 BUS. LAW. 681 (1969).

Other commentators suggest, however, that the SEC might view insurance as acceptable even if it might object to direct indemnification. See Knepper, *Officers and Directors: Indemnification and Liability Insurance—An Update*, 30 BUS. LAW. 951, 958 (1975); Note, *supra* note 76, at 1145.

107. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

108. The note to Rule 460, promulgated under the Securities Act of 1933, provides in part:

(a) Where, by reason of any charter provision, by-law, contract, arrangements, statute, or otherwise, provision is made for indemnification by the registrant of a director, officer or controlling person of the registrant against liabilities arising under the act, unless waiver is obtained from such officer, director or controlling person of the benefits of such indemnification with respect to the proposed offering or there is included in the registration statement, a brief description of the indemnification provision and an undertaking in substantially the following form:

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the act and will be governed by the final adjudication of such issue.

17 C.F.R. § 230.460 (1978) (emphasis added).

109. 418 F.2d at 1288.

110. See Johnston, *supra* note 59, at 2008-09.

rectors, at least under some circumstances. The task at hand, therefore, is to develop a federal statutory scheme that accommodates this range of competing interests and goals.¹¹¹ The strengths and weaknesses of indemnification and insurance provisions in several state codes provide an analytical springboard for this effort.

III. INDEMNIFICATION IN A FEDERAL CHARTERING SYSTEM

One of the most significant state indemnification statutes is that enacted by Delaware in 1967.¹¹² Section 145(a) of the Delaware act permits a corporation to indemnify its directors, officers, employees, and agents against third-party claims for actual and reasonable expenses, judgments, fines, and settlements, provided that the indemnified party "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."¹¹³ This type of provision, if incorporated into a federal chartering system, would protect the director who acted reasonably and in good faith and simultaneously deter willful miscon-

111. In light of the SEC policy against indemnification of officers and directors, the following analysis will encompass only those liabilities currently covered by state corporation laws. A serious question remains, however, about the impact of a federal corporation law on the SEC policy opposing indemnification.

112. See Brook, *Directors: Indemnification and Liability Insurance*, 21 N.Y.L.F. 1, 5 (1975). Because of its pervasive influence, the Delaware indemnification statute is the one most frequently analyzed by commentators. See, e.g., R. NADER, *supra* note 4, at 108; Bishop, *supra* note 86, at 1083-88; Cary, *supra* note 6, at 665; Johnston, *supra* note 59, at 1996-2000; Comment, *supra* note 85, at 874-86.

113. DEL. CODE ANN. tit. 8, § 145(a) (1974) provides:

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.

duct or abuse of power. Section 145(b) affords similar protection to corporate personnel in derivative actions, but with an additional requirement of court approval for indemnity payments.¹¹⁴

The statutory distinction between third-party and derivative actions is significant. In a third-party action, the plaintiff recovers for a personal wrong; a judgment against the director, therefore, does not imply that the director committed a wrongful act against the corporation. In a derivative action, however, the nominal plaintiff is the corporation; thus, a judgment against the director generally indicates that he breached his fiduciary duty to the corporation and should be entitled to indemnity only when someone not a party to the litigation deems it reasonable and proper.¹¹⁵

The Delaware approach, however, fails to strike an equitable balance between the corporation's need for the power to indemnify its personnel and the shareholders' right as owners of the corporation to oversee its operations. The statute fails to require the corporation to notify its stockholders of indemnification payments, or to grant the courts authority to compel shareholder notification.¹¹⁶ The "nonexclusive clause" in section 145(f) further tips the balance in favor of corporate personnel; any indemnification provided in section 145 does not preclude an indemnified party from asserting any other rights to indemnification to which he may be entitled under any bylaw, agreement, or vote of the stockholders or disinterested directors.¹¹⁷

114. DEL. CODE ANN. tit. 8, § 145(b) (1974) provides:

A corporation shall have the 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 of Chancery of 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 of such other court shall deem proper.

115. See Heyler, *Indemnification of Corporate Agents*, 23 U.C.L.A. L. REV. 1255, 1257 (1976).

116. See Bishop, *supra* note 86, at 1083.

117. DEL. CODE ANN. tit. 8, § 145(f) (1974) provides:

The indemnification provided by this section shall not be deemed exclusive of any

Section 145(g)¹¹⁸ poses an even greater threat to corporate responsibility.¹¹⁹ To assuage the fear of would-be directors over personal liability for corporate acts and to attract better corporate leadership, Delaware in 1967 became the first state to permit a corporation to purchase liability insurance on behalf of its directors and officers.¹²⁰ Under this subsection a corporation may purchase indemnity insurance for any officer or director even if it would not have the power to indemnify the official against liability under the other provisions of the section. Thus, this provision allows a corporate official to escape financial penalty for his acts regardless of whether he "acted in good faith or in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."¹²¹ Without limitations on the availability of insurance, section 145(g) effectively removes whatever deterrent effect the imposition of liability on a corporate official may have on corporate misbehavior and abuse of power.¹²² Furthermore, directors and of-

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.

The nature and scope of this subsection is not altogether clear. A drafter's comment indicates that courts should limit the provision where public policy requires. *See* Bishop, *supra* note 86, at 1085. Critics nonetheless argue that the legislature should specifically define the scope of indemnification under § 145 and make it exclusive. *See* Cary, *supra* note 6, at 702. One critic, however, has remarked that "[s]ubsection (f) may be a manifestation of reluctance to meddle with the incomprehensible rather than a deliberate effort to geld the statute." Bishop, *supra* note 86, at 1086.

118. DEL. CODE ANN. tit. 8, § 145(g) (1974) provides:

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 of 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.

119. *See* Bishop, *supra* note 86, at 1086; Comment, *supra* note 85, at 885.

120. Note, *supra* note 76, at 1121-27.

121. Bishop, *supra* note 86, at 1086. Taken literally, the subsection seems to mean that, as far as Delaware law is concerned, a corporation may insure its management against any obligation to account to the corporation for profits from any of the numerous varieties of self-dealing, from usurping the corporation's business opportunities through paying its directors excessive compensation to plain embezzlement, each of which stockholders typically allege in derivative suits. *Id.* at 1086-87.

122. Bishop, *supra* note 86, at 1086; Comment, *supra* note 85, at 885. Although most insurance companies impose limitations and conditions on their coverage, *see* Bishop, *supra* note 86, at 1088-89 (sample insurance policy exclusions), these restrictions do not appease all critics. *See* Note, *supra* note 76, at 1131. Critics also question the effectiveness of insurance exclusions, such

ficers should not be permitted to avoid the legally imposed duties of good faith and due care through the purchase of liability insurance.¹²³

Despite these criticisms, some commentators favor indemnity insurance over indemnification payments to corporate officials for its less severe burden on the corporation and its stockholders.¹²⁴ The costs of direct indemnification flow immediately from the corporate treasury to the corporation and its shareholders in the form of reduced assets for corporate operations and shareholder dividends. Insurance premiums, on the other hand, impose a less severe and more predictable expense on the corporation than do massive damage awards.

California recently enacted an indemnification statute¹²⁵ that provides a preferable model for a federal chartering or minimum standards act. Like the Delaware version, the California provisions distinguish between third-party suits brought against directors by outsiders¹²⁶ and derivative suits filed by shareholders in the name of the corporation.¹²⁷ The California provisions, however, strike a more equi-

as for intentional or reckless conduct, as a means to deter corporate misbehavior or unlawful conduct. *See id.*; *Corporate Executives*, *supra* note 93, at 655.

123. *See* Bishop, *supra* note 86, at 1091.

124. *See* Note, *supra* note 76, at 1145.

125. CAL. CORP. CODE § 317 (Deering Supp. 1979). *See generally* 16 MARSH'S CALIFORNIA PRACTICE §§ 9.35-.46 (1977).

The indemnification provisions of the California statute are discussed in Heyler, *Indemnification of Corporate Agents*, 23 U.C.L.A. L. REV. 1255 (1976); Note, *California's New General Corporation Law: Director's Liability to Corporations*, 7 PAC. L.REV. 613, 639 (1976).

126. CAL. CORP. CODE § 317(b) (Deering Supp. 1979) provides:

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 proceeding (other than an action by or in the right of the corporation to procure a judgment in its favor) by reason of the fact that such person is or was an agent of the corporation, against expenses, judgments, fines, settlements and other amounts actually and reasonably incurred in connection with such proceeding if such person acted in good faith and in a manner such person reasonably believed to be in the best interests of the corporation and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct of such person 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, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in the best interests of the corporation or that the person had reasonable cause to believe that the person's conduct was unlawful.

See also N.Y. BUS. CORP. LAW § 723(a) (McKinney Supp. 1978).

127. CAL. CORP. CODE § 317(c) (Deering Supp. 1979) provides:

A corporation shall have the 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 by or in the right of the corporation to procure a judgment in its favor by reason of the fact that such person is or was an agent of the corporation, against expenses actually and reasonably incurred by such person in connection with the defense or settlement of such action

table balance between the competing policy considerations surrounding the indemnification debate.

For third-party actions, Delaware authorizes indemnification when the director has "acted in good faith and in a manner he reasonably believed to be *or not opposed to* the best interests of the corporation."¹²⁸ Section 317(b) of the California standard, however, does not contain the "or not opposed to" language;¹²⁹ thus, it more properly restricts the availability of indemnification to cases of good faith and reasonable mistakes by directors.¹³⁰ Similarly, the California standard more satisfactorily addresses director indemnification in derivative actions. To be eligible for reimbursement under section 317(c), the director must have acted not only in a good faith and reasonable manner, as required under the Delaware law, but also "with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances."¹³¹ Under the California version, therefore, the director's actions must be objectively as well as subjectively reasonable.

Like the Delaware statute, California's indemnification statute prohibits indemnification without prior court approval for judgments rendered against the director in,¹³² or expenses incurred in settlement of,¹³³ derivative actions. The California version goes one step further,

if such person acted in good faith, in a manner such person believed to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. No indemnification shall be made under this subdivision (c):

(1) In respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation in the performance of such person's duty to the corporation, unless and only to the extent that the court in which such proceeding is or was pending shall determine upon application that, in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for the expenses which such court shall determine;

(2) Of amounts paid in settling or otherwise disposing of a threatened or pending action, with or without court approval; or

(3) Of expenses incurred in defending a threatened or pending action which is settled or otherwise disposed of without court approval.

128. DEL. CODE ANN. tit. 8, § 145(a) (1974) (emphasis added).

129. See note 114 *supra*.

130. See Heyler, *supra* note 115, at 1258.

131. CAL. CORP. CODE § 317(c) (Deering Supp. 1979). This language is similar to the New York standard that requires "good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances." N.Y. BUS. CORP. LAW §§ 717, 722(a) (McKinney Supp. 1978).

132. CAL. CORP. CODE § 317(c)(1) (Deering Supp. 1979).

133. CAL. CORP. CODE § 317(c)(3) (Deering Supp. 1979). *Accord*, N.Y. BUS. CORP. LAW § 722(b)(2) (McKinney 1963). In contrast, Delaware allows indemnification for expenses incurred

however, to forbid indemnification for judgments or amounts paid in settlement of derivative actions with or without court approval.¹³⁴ The reason for this prohibition is obvious: To permit a corporation to reimburse a director for the same sum that the director is liable to the corporation would be circular without any determination on the merits of the director's conduct.¹³⁵ A federal act clearly should adopt the California approach.

Another praiseworthy section of the California indemnification statute is section 317(e), which authorizes indemnity by majority vote of a quorum of directors not parties to the proceeding, or by majority vote of the disinterested shareholders.¹³⁶ These alternatives to judicial approval of indemnification provide greater flexibility for determining whether indemnification is appropriate in a particular case. Moreover, those persons with the greatest knowledge of an interest in the standard of care expected of directors have a role in the indemnification decision. Costly court determinations of whether the requisite standard of care has been met also may be avoided or relied upon solely as a last resort.¹³⁷

as a result of "any threatened, pending or completed action or suit." DEL. CODE ANN. tit. 8, § 145(b) (1974).

134. CAL. CORP. CODE § 317(c)(2) (Deering Supp. 1979). *Accord*, N.Y. BUS. CORP. LAW § 722(b)(1) (McKinney 1963).

135. *See* Heyler, *supra* note 115, at 1261.

136. CAL. CORP. CODE § 317(e)(1)-(2) (Deering Supp. 1979) provides:

(e) Except as provided in subdivision (d), any indemnification under this section shall be made by the corporation only if authorized in the specific case, upon a determination that indemnification of the agent is proper in the circumstances because the agent has met the applicable standard of conduct set forth in subdivision (b) or (c), by:

(1) A majority vote of a quorum consisting of directors who are not parties to such proceeding;

(2) Approval of the shareholders (Section 153), with the shares owned by the person to be indemnified not being entitled to vote thereon.

Both the Delaware and New York statutes provide for authorization of indemnification by independent legal counsel if a quorum of directors, not parties to the action, is unobtainable. DEL. CODE ANN. tit. 8, § 145(d) (1974); N.Y. BUS. CORP. LAW § 724(b)(2)(A) (McKinney 1963).

137. CAL. CORP. CODE § 317(e)(3) (Deering Supp. 1979) provides:

(e) Except as provided in subdivision (d), any indemnification under this section shall be made by the corporation only if authorized in the specific case, upon a determination that indemnification of the agent is proper in the circumstances because the agent has met the applicable standard of conduct set forth in subdivision (b) or (c), by:

...
 (3) The court in which such proceeding is or was pending upon application made by the corporation or the agent or the attorney or other person rendering services in connection with the defense, whether or not such application by the agent, attorney or other person is opposed by the corporation.

New York also provides for this alternative. N.Y. BUS. CORP. LAW § 725 (McKinney 1963).

Section 317(d) provides for mandatory indemnification of directors in either third-party or derivative suits when the director prevails on the merits of the action.¹³⁸ This provision grants the director an enforceable right to indemnification, which is essential in cases in which the director is denied reimbursement by an antagonistic board.¹³⁹ Section 317(f) further provides that a corporation, upon approval of its board of directors, may make advance payments to a director for expenses incurred in defense of any proceeding.¹⁴⁰ These guarantees of financial assistance are of major significance to a federal chartering act because they advance the objective of attracting competent persons to serve as directors without fear of oppressive risks of personal liability.

The California statute further improves upon the Delaware version through its restriction on the availability of indemnification to the terms and conditions prescribed in the statute.¹⁴¹ The Delaware statute, as previously criticized, expressly provides that indemnification under the statute does not preclude an indemnified party from asserting

138. CAL. CORP. CODE § 317(d) (Deering Supp. 1979) provides:

To the extent that an agent of a corporation has been successful on the merits in defense of any proceeding referred to in subdivision (b) or (c) or in defense of any claim, issue or matter therein, the agent shall be indemnified against expenses actually and reasonably incurred by the agent in connection therewith.

See also DEL. CODE ANN. tit. 8, § 145(c) (1974); N.Y. BUS. CORP. LAW § 724(a) (McKinney 1963).

139. *See* Heyler, *supra* note 115, at 1261.

140. CAL. CORP. CODE § 317(f) (Deering Supp. 1979) provides:

Expenses incurred in defending any proceeding may be advanced by the corporation prior to the final disposition of such proceeding upon receipt of an undertaking by or on behalf of the agent to repay such amount unless it shall be determined ultimately that the agent is entitled to be indemnified as authorized in this section.

CAL. CORP. CODE § 317(h) (Deering Supp. 1979), however, limits the scope of § 317(f):

No indemnification or advance shall be made under this section, except as provided in subdivision (d) or paragraph (3) of subdivision (e), in any circumstance where it appears:

(1) That it would be inconsistent with a provision of the articles, bylaws, a resolution of the shareholders or an agreement in effect at the time of the holders or an agreement in effect at the time of the accrual of the alleged cause of action asserted in the proceeding in which the expenses were incurred or other amounts were paid, which prohibits or otherwise limits indemnification; or

(2) That it would be inconsistent with any condition expressly imposed by a court in approving a settlement.

See also DEL. CODE ANN. tit. 8, § 145(e) (1974); N.Y. BUS. CORP. LAW § 724(c) (McKinney 1963).

141. CAL. CORP. CODE § 317(g) (Deering Supp. 1979) provides:

No provision made by a corporation to indemnify its or its subsidiary's directors or officers for the defense of any proceeding, whether contained in the articles, bylaws, a resolution of shareholders or directors, an agreement or otherwise, shall be valid unless consistent with this section. Nothing contained in this section shall affect any right to indemnification to which persons other than such directors and officers may be entitled by contract or otherwise.

The New York provision is similar. N.Y. BUS. CORP. LAW § 721 (McKinney 1963).

any other rights to indemnification to which he may be entitled under any bylaw, agreement, or vote of the stockholders or disinterested directors.¹⁴² The Delaware statute implies that any form of indemnification is permissible regardless of its scope. In enacting a model statute for a federal system, California's exclusivity provision should be adopted for its advantages of uniformity and predictability and its superior ability to effectuate public policy objectives.¹⁴³

A final consideration in the development of a federal indemnification model concerns whether a corporation should be permitted to purchase liability insurance on behalf of its directors. Following the lead of Delaware,¹⁴⁴ California grants the corporation the power "to purchase and maintain insurance on behalf of any agent of the corporation against any liability . . . whether or not the corporation would have the power to indemnify" under California law.¹⁴⁵ Commentators continue to debate whether this provision authorizes all-embracing liability coverage for directors in contravention of public policy considerations.¹⁴⁶ For

142. DEL. CODE ANN. tit. 8, § 145(f) (1974). See note 119 *supra*.

143. In addition to providing greater certainty as to the limits of permissible indemnification, the exclusive approach has several other significant advantages. First, it provides a certain amount of uniformity and predictability in the indemnification rights of corporate personnel. Any area so closely tied with public policy that courts are willing to override clear legislative intent should seek uniform application of the law. Surely a non-exclusive clause can never achieve that aim, as it encourages a diverse "bylaw by bylaw" application since each corporation is free to place in its bylaws any provision it wishes.

Second, the exclusive language is a more effective means to implement public policy. The non-exclusive language lends itself to indemnification under bylaws which grossly violate the bounds of public policy but which may never be challenged due to stockholder apathy or lack of notice. On the other hand, the exclusive statute defines the limits of public policy in the statute itself and prohibits any indemnity inconsistent with those limits.

Third, the exclusive statute need not abrogate the corporate freedom which defenders of the non-exclusive statute say can exist only if the corporation can indemnify outside the provisions of the statute. If the exclusive statute has been broadly drafted, then any provision outside its limits would be prohibited by public policy. Additionally, the corporation should still have the freedom to choose, since the statute should merely grant the power to indemnify within its limits and should not be mandatory as a whole.

Cheek, *supra* note 85, at 277 (citations omitted).

144. See DEL. CODE ANN. tit. 8, § 145(g) (1974).

145. CAL. CORP. CODE § 317(i) (Deering Supp. 1979) provides:

A corporation shall have power to purchase and maintain insurance on behalf of any agent of the corporation against any liability asserted against or incurred by the agent in such capacity or arising out of the agent's status as such whether or not the corporation would have the power to indemnify the agent against such liability under the provisions of this section.

146. See notes 123-25 *supra* and accompanying text. Other commentators, such as Samuel Arsht, argue that a literal reading is unwarranted and that these provisions do not authorize or

this reason, the ambiguity of Delaware and California statutory language should be abandoned for the clarity of the New York statute. The New York statute specifies the situations in which the corporation may purchase liability insurance and resolves the dispute over the scope of the purchased coverage.¹⁴⁷ The statute clearly restricts coverage to the cost of defense "if a judgment or final adjudication adverse

empower an insurance company to issue a policy insuring against a risk that it either could not or would not assume in the absence of such provisions.

I submit, however, that those who have criticized Section 145(g) have read more into that provision than is fairly warranted by its language and that for this reason, as well as others, the parade of horrors which has been envisioned will never come to pass. . . .

Initially, let me say that Subsection (g) does nothing more than it purports to do. It authorizes a Delaware corporation to pay the premium for directors' and officers' liability insurance. Such insurance has typically consisted of two separate policies. . . . The coverage provided under one policy reimburses the corporation for sums properly paid to the director or officer as indemnification, while the coverage under the other policy directly indemnifies the directors or officers against liability and expenses not properly indemnifiable by the corporation. These two policies are sold as a package to the corporation, and the insurance companies have traditionally refused to sell the latter policy to corporate executives individually.

As a consequence of this practice, prior to 1967, when the Delaware statute was enacted, the corporation desiring to insure itself for its obligation to indemnify its directors and officers was placed in the position of being able to obtain such insurance for itself only in conjunction with insurance for its directors and officers insuring the latter for their non-indemnifiable outlays, and then of having to apportion the premium for such dual insurance coverage between itself and its executives. These premiums were usually apportioned on a ninety-ten basis with the corporation paying the larger portion since it was felt—and properly, I think—that insuring the corporation for payments properly made by the corporation as indemnification presented a much larger risk than insuring the executives directly for their covered risks.

Nevertheless, the corporation, or, rather, its directors were faced with the possibility that a challenge to the method of apportionment could result in a finding that they were achieving indirectly what they could not achieve directly, that is, impermissible indemnification. Subsection (g) was intended to lay such fears to rest by expressly authorizing payment by the corporation of the entire insurance premium. The "whether-or-not" clause in Subsection (g) was merely intended to encompass both coverages provided in a typical D & O policy.

Professor Bishop suggests that a literal reading of Subsection (g) leads to the conclusion that it authorizes all-embracing liability insurance for directors and officers. Not so. Subsection (g) is a corporation law, not an insurance law. It does no more than authorize the corporation to pay the premiums for such insurance as it or its directors are able to obtain. It does not authorize or empower an insurance company to issue a policy insuring against a risk which it either could not or would not issue in the absence of Subsection (g). If a risk were not insurable before Subsection (g), the subsection's enactment did not make it so.

Klink, Chalif, Bishop & Arsht, *Liabilities Which Can Be Covered Under State Statutes and Corporate By-Laws*, 27 BUS. LAW. 109, 126-27 (Feb. 1972).

147. N.Y. BUS. CORP. LAW § 727 (McKinney Supp. 1978) provides:

(a) Subject to paragraph (b), a corporation shall have power to purchase and maintain insurance:

(1) To indemnify the corporation for any obligation which it incurs as a result of the indemnification of directors and officers under the provisions of this article, and

to the insured director or officer establishes that his acts of active and deliberate dishonesty were material to the cause of action adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled."¹⁴⁸ This restriction will satisfy the advocates of federal chartering who realize the need for insurance in the corporate setting, but demand that indemnification and insurance be strictly prescribed to encourage high standards of corporate responsibility.

IV. CONCLUSION

The need to attract competent persons to corporate directorships provides a compelling justification for a system of director indemnification. The present-day director faces a significantly greater risk of liability for his actions, which may cause those most qualified to serve as directors to be reluctant to participate on corporate boards or to decline service altogether. At the same time, a real concern exists that indemnification will lower the standard of care required of directors or allow directors to escape liability for intentional misconduct.

A balance between attracting competent directors and deterring misconduct may be achieved if reasonable indemnification standards are

(2) To indemnify directors and officers in instances in which they may be indemnified by the corporation under the provisions of this article, and

(3) To indemnify directors and officers in instances in which they may not otherwise be indemnified by the corporation under the provisions of this article provided the contract of insurance covering such directors and officers provides, in a manner acceptable to the superintendent of insurance, for a retention amount and for co-insurance.

(b) No insurance under paragraph (a) may provide for any payment, other than cost of defense, to or on behalf of any director or officer.

(1) if a judgment or other final adjudication adverse to the insured director or officer establishes that his acts of active and deliberate dishonesty were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled, or

(2) in relation to any risk the insurance of which is prohibited under the insurance law of this state.

(c) Insurance under any or all subparagraphs of paragraph (a) may be included in a single contract or supplement thereto. Retrospective rated contracts are prohibited.

(d) The corporation shall, within the time and to the persons provided in paragraph (c) of section 726 (Other provisions affecting indemnification of directors or officers), mail a statement in respect of any insurance it has purchased or renewed under this section, specifying the insurance carrier, date of the contract, cost of the insurance, corporate positions insured, and a statement explaining all sums, not previously reported in a statement to shareholders, paid under any indemnification insurance contract.

(e) This section is the public policy of this state to spread the risk of corporate management, notwithstanding any other general or special law of this state or of any other jurisdiction including the federal government.

148. N.Y. BUS. CORP. LAW § 727(b)(1) (McKinney Supp. 1978).

established. Left to their own initiative, the individual states seem unlikely to strike an appropriate balance. The states remain willing to grant corporations special treatment to retain their presence within the state or to entice foreign corporations into the state. At best, state efforts to regulate director indemnification will lack the uniformity a federal system could provide. From the Constitutional Convention of 1786 to the congressional debates of today, calls for a federal chartering system continue to be voiced. The indemnification of corporate directors for corporate misconduct is a controversy well-suited to a federal alternative.

