

“Fees on Fees”— Can Directors and Officers Recover Attorneys' Fees to Enforce Corporate Indemnities?

By William G. Passannante and Alex D. Hardiman¹

Should directors and officers be permitted to recover attorneys' fees when they attempt to recover attorneys' fees? No, that is not a typographical error.

Many directors and officers are entitled to indemnification from the corporations that they serve either under corporate bylaws or under statute. This may mean that a corporation has an obligation to pay attorneys' fees in defending a civil law suit, a criminal prosecution, or a governmental investigation. If the corporation resists paying the fees and expenses associated with such actions, the officer or director may be forced to sue to enforce his or her indemnity rights. Are the attorneys' fees expended in enforcing those indemnity rights recoverable under the corporate indemnity?

Two recent cases take differing views on the “fees on fees” issue.

In *Baker v. Health Management Systems, Inc.* (New York 2002) the Court of Appeals of New York answered a certified question from the United States Court of Appeals for the Second Circuit. The Court of Appeals of New York held that a corporate officer was not entitled to indemnification from the corporation for attorneys' fees incurred in pursuing indemnification of his attorneys' fees and expenses. The case against the corporate officer involved an alleged securities fraud class action and the corporation denied the officer's request for indemnification for fees paid to his attorney. The corporation refused because, in the corporation's view, the officer did not require separate counsel.

New York's Chief Judge states, in a separate dissenting opinion, that “[t]here is a good reason why these fees should be reimbursable, as we believe the Legislature provided. The majority's conclusion puts a finger on the scale in favor of a corporation and its controlling directors in cases where an individual director or a minority group of directors, may have a legitimate independent legal position at odds with what the corporation would wish to portray as a common defense.” The Chief Judge continues in the dissent to state, “we certainly join the majority's concluding observation that directors would do well to provide for such indemnification in bylaws, employment contracts and insurance, if they can. Otherwise, individuals would be well advised to decline board service which, this case shows, may be personally expensive.”

The *Baker* decision may have profound negative consequences for corpo-

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rate directors and officers under New York law. Corporations may well be harmed by a smaller pool of individuals willing to serve.

The Supreme Court of Delaware reached the opposite conclusion in *Stifel Financial Corporation v. Cochran* (Delaware 2002).

In *Stifel*, an officer was terminated after an SEC investigation resulted in both civil and criminal fraud proceedings. After his conviction was reversed on appeal, the officer sought indemnification from the corporation for his defense costs. The officer was required to sue to recover these defense costs in an indemnity action. The Delaware Supreme Court held that indemnification statutes encourage qualified persons to serve and should be interpreted broadly.

The Court noted that §145 of the Delaware Corporation Law which permits indemnification to a party "in any action" can be read literally to encompass the indemnification action itself. The Court further noted "the indemnification statute should be broadly interpreted to further the goals it was enacted to achieve." The Court observed that the "larger purpose" of the statute is to encourage capable persons to serve as corporate directors, "secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve."

Delaware has taken a decidedly different tack in *Stifel* than New York has in *Baker*. The effect upon New York's competitiveness as a corporate domicile remains to be seen.

These two cases show that directors and officers in certain states, New York included, may need specifically to address the "fees on fees" issue through corporate bylaws, employment contracts or insurance policies.

(For a national survey regarding a related issue, the recovery of attorneys' fees generally in insurance coverage actions, see the article by Diana Shafter and William G. Passannante, "Paying by the Rules," *The John Liner Review* (December 2002).) ■

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