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Expert Analysis

Statutory Indemnification of Officers And Directors: Foresight Is Power

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In New York, directors and officers sued for actions or inactions taken in connection with their corporate post have another avenue to seek relief from litigation costs if their corporation denies them indemnification. Pursuant to the Business Corporation Law (BCL) and the Not-For-Profit Corporation Law (N-PCL), courts have authority to award an advancement of litigation expenses or indemnification to directors and officers of for-profit and not-for-profit corporations (collectively, "corporations").[1] The court's authority extends not just to instances in which third parties sue directors and officers, but also to those situations where the corporation itself has brought suit.

This article focuses on the standard for directors and officers to obtain an advancement of fees and indemnification under the BCL or N-PCL and provides practical insights for corporations interested in affecting the scope of the court's authority to award such an advancement.[2]

Pendente Lite

Under BCL §724(c) or N-PCL §724(c), directors and officers may obtain a court-ordered advancement from their employer to finance their defense costs. In particular, the statute provides:

> Where indemnification is sought by judicial action, the court may allow a person such reasonable expenses, including attorneys' fees, during the pendency of the litigation as are necessary in connection with his defense therein, if the court shall find that the defendant has by his pleadings or during the course of the litigation raised genuine issues of fact or law.

As a result of the New York Nonprofit Revitalization Act of 2013, directors and officers who seek advancement of fees from a not-for-profit corporation under N-PCL §724(c) must copy the New York Attorney General on their application to the court.[3]

Here, the statute uses a seeming misnomer when it references "indemnification" to signify an advancement of fees. Case law qualifies this term by referring to "indemnification pendente lite."[4] Courts have held that the statute's "genuine issues of fact or law" requirement is a lesser standard than that required to defeat summary judgment.[5] Indeed, defendants have met this standard by denying the allegations against them and asserting that they acted in good-faith for a purpose reasonably believed to be in the best interests of the organization.[6]

> Courts have authority to award an advancement of litigation expenses or indemnification to directors and officers of for-profit and not-for-profit corporations.

Our research has uncovered only one case in which a court denied advancement of fees on the grounds that "no genuine issues of fact or law" existed. In *Vacco v. Diamandopoulos*, the state court refused to award an advancement of fees to former trustees of a not-for-profit university in an action brought by the New York State Attorney General.[7] The court's decision, however, was premised upon the fact that prior to that action, the university had paid for the defendant trustees' defense during a 27-day hearing conducted by the Board of Regents.[8] A three-member panel concluded that the former trustees had severely violated their duties, and the Board of Regents ordered the immediate removal of the trustees from their post.[9] Recognizing the length of the prior hearing and "the scope of the findings of neglect of duty by the Regents," the court in *Vacco* held an advancement of fees was unwarranted.[10]

In addition to showing that "genuine issues of fact or law" exist, directors and officers must also show that they were sued in their corporate (rather than individual) capacity (i.e., that the suit concerns actions or inactions taken while they were corporate employees and acting within the scope of their employment responsibilities).[11] For those defendants sued both in their corporate and individual capacities, the court may limit an award for advancement of fees to the defense of those claims that concern the defendant's corporate conduct.[12]

Defendants may obtain an advancement of fees to defend against claims brought by third parties and by the entity responsible for paying the advancement.[13] In making such an application, defendants should be careful to seek an advancement of fees under the correct provision of the BCL or N-PCL because failure to rely upon the appropriate provision may result in a denial of the request.[14] The court possesses the discretion to award reimbursement of expenses incurred prior to the filing of the motion or, alternatively, to limit an award to future expenses.[15]

If defendants are successful in obtaining an advancement of fees, it is important to note that this is a preliminary award only. Pursuant to BCL §725(a) or N-PCL §725(a), a defendant must repay the advancement to the paying entity if, at the conclusion of the action, the defendant is found liable for the claim alleged.

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After Resolution of Action

In addition to advancement of fees, BCL §724(a) and N-PCL §724(a) offer indemnification to directors or officers of corporations, provided notice for such an application is given to the New York Attorney General. New York courts have construed an advancement of fees and indemnification to be "two distinct corporate obligations"; whereas an advancement concerns interim relief during the pendency of the action, indemnification is available only after resolution of the action and only if the defendant is found not liable for the claim alleged.[16] Unlike advancement of fees, however, indemnification under Section 724(a) is mandatory if defendants meet the applicable standards. This is true even when the entity has refused to indemnify the defendant. In particular, Section 724(a) provides:

> Notwithstanding the failure of a corporation to provide indemnification, and despite any contrary resolution of the board or of the shareholders in the specific case under section 723 (Payment of indemnification other than by court award), indemnification shall be awarded by a court to the extent authorized under section 722 (Authorization for indemnification of directors and officers), and paragraph (a) of section 723.

In other words, under section 724(a), directors and officers must be awarded indemnification when they "ha[ve] been successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding" if they are found to have "acted, in good faith, for a purpose which [they] reasonably believed to be in, or…not opposed to, the best interests of the corporation and, in criminal actions and proceedings, in addition, had no reasonable cause to believe that [their] conduct was unlawful."[17] In cases where directors and officers are sued by the corporation to which they serve, courts are not required to—but may after considering all of the circumstances—award indemnification to directors and officers if (a) the action, actual or threatened, was settled or otherwise disposed of, or (b) they are adjudged to be liable to the corporation for any claim, issue, or matter unless the court in which the action was brought, or any court of competent jurisdiction if no action was brought, concludes that they are entitled to indemnification.[18]

The request for indemnification must be made either (1) in the civil action or proceeding in which defendants incurred the expenses or (2) in a separate proceeding brought in New York Supreme Court. If the latter option is pursued, then the defendants must set forth (a) the disposition of any prior application for indemnification, and (b) reasonable cause why they did not seek indemnification in the action or proceeding in which they incurred the expenses. The failure to establish reasonable cause for seeking indemnification in a separate action could result in a denial of the application.[19]

Court's Authority: Limitations

While Section 724 provides courts with authority to award an advancement of fees or indemnification, Section 725(b) sets forth limitations upon that authority. In particular, courts cannot award an advancement of fees or indemnification if such an award would be inconsistent or contrary to (a) the laws of the jurisdiction in which a (foreign) corporation was incorporated;[20] (b) "the certificate of incorporation, a by-law, a resolution of the board or the members, an agreement or other proper corporate action, in effect at the time of the accrual of the alleged cause of action asserted in the threatened or pending action or proceeding in which the expenses were incurred or other amounts were paid";[21] or (c) the terms of a court-approved settlement agreement.[22] Thus, any corporation seeking to limit the circumstances in which a court may order advancement or indemnification should do so by amending its bylaws, adopting a resolution, or executing an agreement that expressly defines the parameters for any advancement or indemnification. Courts will not construe the absence of language permitting certain forms of indemnification as an indication that the corporation meant to preclude them.[23] Nonetheless, to be safe, directors and officers would be wise to obtain by contract a warranty that any efforts by the company to opt out of its statutory indemnification obligations shall not apply to them.

Conclusion

The provisions providing for court-ordered advancement of fees or indemnification under the BCL or N-PCL operate on a separate track from any indemnification rights a for-profit or a not-for-profit entity may wish to bestow upon its directors and officers. If an entity wishes to limit the authority of a court to compel it to pay a particular type of indemnification to an officer or director (e.g., advancement of legal fees), then it must expressly limit its exposure to court-ordered indemnification by amendment to its certificate of incorporation, bylaws, through corporate resolution, or via contract with its directors and officers before the right to indemnification has accrued.

New York courts have construed an advancement of fees and indemnification to be "two distinct corporate obligations"; whereas an advancement concerns interim relief during the pendency of the action, indemnification is available only after resolution of the action and only if the defendant is found not liable for the claim alleged.

Conversely, prudent directors and officers should obtain contractual protection expressly affording them statutory indemnification notwithstanding anything stated to the contrary in the company's bylaws or elsewhere. Of course, any for-profit or not-for-profit entity may offer broader indemnification than that provided by statute so long as the directors or officers are not found to have acted in bad faith or with active or deliberate dishonesty or to have personally gained a financial profit or advantage to which they were not entitled.[24]

1. See BCL §721 and N-PCL §721.
2. In this article, we rely on authorities analyzing the BCL because there is a dearth of case law concerning the provisions for indemnification under the N-PCL and the language and purposes of the BCL and N-PCL are aligned. See Practice Commentaries by Rose Mary Bailly, William Josephson, and Peter J. Kiernan for N-PCL §724 n.2.
3. N-PCL §724(a).
4. See, e.g., *Tilden of New Jersey v. Regency Leasing Sys.*, 237 A.D.2d 431 (2d Dept. 1997).
5. *Booth Oil Site Admin. Grp. v. Safety-Kleen*, 137 F.Supp.2d 228, 237 (W.D.N.Y. 2000) ("The standard by which a genuine issue of fact or law has been raised, thereby entitling a defendant to an advance award of litigation fees under N.Y. Bus. Corp. Law §724(c) is 'a far less demanding standard' than that necessary on a motion for summary judgment.") (quoting *Sequa Corp. v. Gelmin*, 828 F.Supp. 203, 206 (S.D.N.Y. 1993)).
6. *Sequa Corp.*, 828 F.Supp. at 206-07 (awarding advancement of fees under BCL §724(c) to former executive who met standard by providing affidavit denying corporation's fraud allegations); *Happy Kids v. Glasgow*, No. 01 Civ. 6434 (GEL), 2002 WL 72937, at *2 (S.D.N.Y. Jan. 17, 2002) (relying on defendant's answer and motion to dismiss to hold he was entitled to advancement under BCL §724(c)).
7. 185 Misc.2d 724 (N.Y. Sup. Ct. 1998).
8. Id. at 725-26.
9. Id. at 726, 729.
10. Id. at 729.
11. See, e.g., *Bensen v. Am. Ultramar*, No. 92 Civ. 4420 (KMW) (NRB), 1996 WL 435039, at *2-3 (S.D.N.Y. Aug. 2, 1996) (denying advancement of fees where director was sued in personal capacity for engaging in wrongful conduct during negotiations for his compensation); *Tilden of New Jersey*, 237 A.D.2d 431 (affirming denial of advancement because defendant was sued based on a personal guaranty).
12. *Booth Oil Site Administrative Group*, 137 F.Supp.2d at 238 (apportioning advancement to preclude years in which defendant did not serve as a company director).
13. *Sierra Rutile v. Katz*, No. 90 Civ. 4913 (JFK), 1997 WL 431119, at *1 (S.D.N.Y. July 31, 1997).
14. *Qantel v. Niemuller*, 771 F.Supp. 1372, 1374-75 (S.D.N.Y. 1991) (denying request for advancement of fees, without prejudice, because director brought motion under BCL §§722 and 723 instead of BCL §724(c)).
15. Compare *United States v. Weissman*, No. S2 94 CR. 760 (CSH), 1997 WL 334966, at *15-16 (S.D.N.Y. June 16, 1997), supplemented by 1997 WL 539774 (S.D.N.Y. Aug. 28, 1997) (requiring company to pay legal expenses already incurred by defendant), with *Sequa Corp.*, 828 F.Supp. 203 (granting advancement of expenses on a prospective basis).
16. *Booth Oil Site Administrative Group,* 137 F.Supp.2d at 236.
17. BCL §§722(a) and 723(a); N-PCL §§722(a) and 723(a).
18. BCL §722(c).
19. See *Wasitowski v. Pali Holdings*, No. 09 Civ. 8243 (PKC), 2010 WL 1459767, at *5-6, (S.D.N.Y. April 8, 2010).
20. See, e.g., *Bear, Stearns v. D.F. King & Co.*, 243 A.D.2d 252, 253-54 (2d Dept. 1997) (reversing award of advancement of fees against a Delaware corporation because Delaware law does not provide for court-ordered interim fees).
21. See *Booth Oil Site Administrative Group*, 137 F.Supp.2d at 233-34 (defining "accrual of the alleged cause of action" in BCL §725(b)(2) to mean "when a suit may be maintained thereon").
22. BCL §725(b)(1)-(3); N-PCL §725(b)(1)-(3).
23. See *Happy Kids,* 2002 WL 72937, at *4 (awarding advancement to former director under BCL §724(c) after rejecting argument that indemnification would be inconsistent with bylaws, where bylaws did not expressly prohibit indemnification); *Crossroads ABL v. Canaras Capital Mgmt.*, 105 A.D.3d 645, 645-46 (3d Dept. 2013) (concluding that agreement did not preclude indemnification of intra-party claims where the agreement lacked any limiting language).
24. BCL §721; N-PCL §721.