Comment

CORPORATIONS: RIGHT TO ATTORNEYS' FEES IN SHAREHOLDERS' DERIVATIVE SUITS.

The shareholders' derivative suit affords an individual shareholder his only effective remedy for attacking the abuse of managerial power, the taking of secret profits, and the exploitation of a corporation by its officers, directors and controlling shareholders.¹ Thus, though its misuse has aroused much discussion,² "It is clear that the stockholder's derivative suit is an absolutely necessary arm of equity jurisdiction and that, when used with justice and restraint, it has both public and private value."³


³ Carson, op. cit. supra note 1, at 1127. See also Hornstein, The Counsel Fee in Stockholder's Derivative Suits (1939) 39 Col. L. Rev. 784, 786.
A liberal allowance of attorneys' fees to the plaintiff, if successful, is the life blood of the derivative suit. Since the holdings of the average shareholder are often infinitesimal, the proportion of the corporate recovery which will accrue to his benefit is generally much less than the burden and expense he will incur. Without an allowance of fees and expenses there would be no incentive for the average shareholder to initiate and maintain suit on behalf of his corporation. It should be noted in this connection that the allowance of liberal fees gives no encouragement to groundless suits by the "striker", since such awards are made only to a successful suitor.

In general, successful litigants have to pay their own attorneys' fees. However, attorneys' fees are allowed against property or a fund increased or protected in a class, representative, or derivative suit. For example, allowance is made for services rendered in protection of a trust fund or an estate and in actions on behalf of creditors. Recently, the Supreme Court extended the rule even further, holding that where a plaintiff suing solely in an individual capacity, incidentally, through the operation of stare decisis, establishes the right of other parties similarly situated to certain benefits, it is within the power of a court of equity to allow such plaintiff his attorneys' fees and litigation expenses to be paid out of the benefits thus made available.

Attorneys' fees will be allowed in a derivative action only where the suit succeeds. This does not mean, however, that the complainant must gain everything prayed for before he is entitled to his attorneys' fees. It requires only that the litigation result in some actual benefit to the corporation. Such benefit may take the form of money damages, the cancellation of an ultra vires contract, or the nullification of a fraudulent conveyance. The award of attorneys' fees

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4 Estate of Marré (1941) 18 Cal. (2d) 191, 114 P. (2d) 591.
6 14 Am. Jur. §§73-76.
7 Sprague v. Ticonic Bank (1939) 307 U. S. 161. Plaintiff, by establishing her right to a lien on the proceeds of certain ear-marked bonds held by an insolvent bank, established by the operation of stare decisis rights of recovery in relation to fourteen trusts situated similarly to her own.
9 The degree of success will have a direct bearing on the amount which will be awarded as attorneys' fees. See note 19, infra.
10 Hornstein, op. cit. supra note 3, at 799; 14 Am. Jur. §76.
should not take the form of a personal judgment against the corporation, but should limit the attorney to a rateable share of what is actually received by the corporation upon execution of the judgment in its behalf. There is some disagreement as to whether attorneys' fees should be allowed in suits which are non-derivative in character, but which, nevertheless, are representative and benefit all the shareholders. Examples are actions to enjoin a fraud upon the corporation or for the appointment of a receiver for a solvent corporation, without further relief. Where the action is neither derivative nor representative of all the shareholders, attorneys' fees will not be awarded. Thus it has been held that one bringing a class action for a declaratory judgment as to the rights of preferred shareholders as opposed to those of common shareholders is not entitled to an allowance of attorneys' fees.

In addition to having attained success, a representative or derivative action must also have been necessary to entitle the plaintiff to an allowance of fees. Contest of the suit is, in general, sufficient proof of necessity. A suit is not necessary if there was pending at the time of its inauguration a prior action embracing the same cause and brought in good faith either by the corporation itself or another minority shareholder. An intervener is entitled to compensation only if his intervention was necessary to a bona fide and successful prosecution of the suit. Examples are where the suit was collusive or where the original complainant attempted to withdraw from the action. Where otherwise merited, attorneys' fees have been awarded upon application by the attorney either at the time of entry of final judgment, or in a separate action.

Since the allowance of attorneys' fees is quasi-contractual in character, the amount of compensation is limited to the reasonable value of the services rendered to the corporation. Consequently, any contract which may have been made between the plaintiff-shareholder and his attorney at the institution of the action should have no bear-

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12 Hornstein, op. cit. supra note 3, at 800.
14 County of Tulare v. City of Dinuba (1928) 205 Cal. 111, 270 Pac. 201.
15 Hornstein, op. cit. supra note 3, at 802.
16 Mann v. Superior Court, supra note 11.
18 13 FLETTER, loc. cit. supra note 8; Hornstein, op. cit. supra note 3, at 807. After judgment has become final, the trial court cannot modify it by an award of attorneys' fees. Wickersham v. Crittenden (1894) 103 Cal. 582, 37 Pac. 513.
ing on the amount which may be recovered against the corporation as attorney's fees. Determination of the fee to be allowed involves a question of fact. Hornstein lists the elements to be considered as: "... (1) the amount and character of the services rendered, the skill and experience called for in the performance of the services, and the professional standing of the attorney; (2) the value of the property affected by the controversy, and the results secured; and (3) whether the fee is absolute or contingent. ..."10 It is questionable whether the fact that the attorney took the case on a contingent fee basis should be considered in the evaluation. The attorney in a derivative suit has a contract in regard to his services only with the plaintiff. As to the corporation he is a pure volunteer and any compensation he may receive from it is conditioned on benefit. In this sense the attorney's fees are always contingent in this type of suit. However, they "... find their true analogue in salvage causes on a pure salvage basis of no cure no pay, wherein maritime law conditions any recovery on success and fixes the quantum of recovery on the basis of the efforts required and of benefit to the salved ship, cargo and freight, or their owners."20 Under this view the generally recognized rule that an attorney may properly charge a much larger fee when it is contingent than when it is not seems inapplicable.

Regardless of their views on this point, the courts have not ordinarily been niggardly in their allowances of attorney's fees.21 This is as it should be. Aside from the natural inertia of shareholders, there are so many obstacles in the path of one who seeks to bring corporate officers or directors to account that the importance of adequate compensation as an incentive cannot be overemphasized.22

INDEMNITY OF DIRECTORS

A review of the cases indicates that the derivative suit is well supported so far as allowance of the complainant's attorneys' fees are concerned. A minority shareholder and his attorneys and ac-

10 Hornstein, op. cit. supra note 3, at 810. See also (1939) 6 U. OF CHI. L. REV. 484, discussing the factors to be considered in determining reasonable attorneys' fees.


21 Mason v. Drug Inc. (1939) 31 Cal. App. (2d) 697, 88 P. (2d) 929 (approving an award of $30,000); Mann v. Hearst, infra note 32 (award of $60,000). For an interesting tabulation of cases and the fees awarded in connection therewith, see Hornstein, op. cit. supra note 3, at 814.

countants have reasonable assurance that if their efforts prove successful they will not be out-of-pocket for their pains. But what of the innocent corporate director who has successfully defended himself against an ill-founded shareholder’s suit? Public policy requires that erring executives be brought to account. It would seem equally to demand that honest corporate officials be made whole for moneys expended in contesting “strike” suits and other unfounded derivative actions brought against them by minority shareholders. The first portion of this comment has stressed the importance of encouraging bona fide shareholders’ suits. It must be recognized, however, that not all, or perhaps not even most, shareholders’ derivative actions are instituted in absolute good faith. They may be grossly abused. Consequently, corporate directors are not infrequently called upon to defend their official acts in groundless litigation brought against them by chiseling shareholders. The question as to how far, if at all, directors should be reimbursed for the expenses of defending such suits has been very much agitated of late and is still in the process of solution.

Several factors have combined to make corporate directorships more burdensome than they formerly were. They may involve responsibility for corporate giants and industrial empires worth millions of dollars. Higher standards of conduct are now imposed, accompanied by a greater possibility of being subjected to shareholders’ suits. In most instances the compensation of directors as such is still purely nominal. Therefore, there exists little enough inducement for capable men to serve diligently as directors, without imposing the additional hazard of expending large sums of combating strike suits charging misconduct in office, no matter how faithful their efforts as directors may have been.

If it be conceded that the reimbursement of honest directors for attorneys’ fees is highly desirable in many instances, there still remains a question as to the legal basis for such corporate expenditures. As Professor Washington has pointed out, the problem is twofold: First, may the director demand reimbursement as a matter of legal right? And, second, if the corporation is under no legal duty to

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24 Washington, op. cit. supra note 8, at 325; Ballantine and Sterling, Upsetting Mergers and Consolidations: Alternative Remedies of Dissenting Shareholders in California (1939) 27 Calif. L. Rev. 644, 648; Note (1934) 34 Col. L. Rev. 1308.


26 Washington, op. cit. supra note 8, at 151.
reimburse, may the management, in the absence of prior contract, grant an allowance in its discretion.\textsuperscript{27}

The cases dealing with the right to reimbursement are few in number. It has been suggested that "... the right of the vindicated director to an allowance for counsel fees is seldom litigated either because no claim for reimbursement is usually asserted or because an appropriation is made by the corporation for that purpose without persistent objection from stockholders."\textsuperscript{28} In any event the wrongdoing director whose defense has been unsuccessful is ordinarily not entitled to reimbursement.\textsuperscript{29}

The recent cases on the director's right to reimbursement after a successful defense of an action based on mismanagement and dereliction of duty are in conflict. In \textit{New York Dock Co. v. McCollom}\textsuperscript{30} any obligation on the part of the corporation to reimburse the directors for expenses incurred was denied in the absence of some definite corporation benefit arising from the defense. In \textit{Solimine v. Hollander},\textsuperscript{31} on the other hand, the New Jersey court found a right of reimbursement from the corporation for reasonable and necessary litigation expenses, analogous to the fees granted to complaining shareholders in derivative actions and to trustees and other fiduciaries subjected to suit on unjust charges. In finding this right to apply for counsel fees against the corporate defendant in behalf of the directors who had been vindicated on the merits in a derivative suit, irrespective of any direct benefit to the corporation, the New Jersey court rejected the contention that defense of unsuccessful shareholders' suits is an accepted risk of the office. The court found it to be not only the right but the official duty of a director to his beneficiaries to stand his ground and defend himself from unjust attack.

The only California case which has dealt with the problem of reimbursement of a director for his costs and attorneys' fees incidental to his defense of a shareholder's suit was not appealed. In an unreported opinion, the superior court considered the question to be

\textsuperscript{27} \textit{Ibid.} at 334.
\textsuperscript{28} Note (1940) 25 \textit{Corn. L. Q.} 437, 438.
\textsuperscript{29} \textit{Hollander v. Breeze Corps.} (N. J. Eq. 1941) 26 A. (2d) 507, 514. See also authorities cited \textit{supra} note 8. However, where corporate interests are deemed to be sufficiently involved, unsuccessful directors are allowed reasonable attorneys' fees. Albrecht, Maguire & Co. v. General Plastics (1939) 256 App. Div. 134, 9 N. Y. S. (2d) 415, aff'd, \textit{(1939) 280 N. Y. 840}, 21 N. E. (2d) 887; \textit{Kanneberg v. Evangelical Creed Congregation} (1911) 146 Wis. 610, 131 N. W. 353; \textit{Washington}, \textit{op. cit. supra} note 8, at 338-339; \textit{(1941) 26 Minn. L. Rev.} 119.
\textsuperscript{31} \textit{(1941) 129 N. J. Eq.} 264, 19 A. (2d) 344, \textit{(1941) 26 Minn. L. Rev.} 119; see also \textit{Washington}, \textit{op. cit. supra} note 8, at 343.
not whether the corporation was under a duty to reimburse, but rather, whether it might properly do so. The court declared the problem to be one relating to management, hence not appropriate for judicial consideration in the first instance. In the court’s view, it is within the province of the directors to determine, in the exercise of their business judgment, whether or not the successful defense of a derivative action by an officer or director sufficiently benefited the corporation to warrant reimbursement of the individual for the expense incident thereto, and, if so, in what amount. In accordance with this theory, the court should treat a refusal by the directors to reimburse as final, while it should sustain the directors’ decision to reimburse “... if the proof were such as to show that the directors believed and had reasonable grounds for believing that the corporation had received substantial benefit.” As a key to what is meant by “substantial benefit” the opinion states that mere vindication of a director’s conduct of corporate affairs is not enough to warrant reimbursement. There must have been “direct and tangible” benefit to the corporation.

In the instant case the court found it impracticable for the directors to pass on the claim for reimbursement, since all had been named as defendants in the action. Faced with this situation, the court itself passed upon the claim as it assumed a board of directors, acting independently in the matter, would have done. It found that had the complaining shareholders prevailed, receivership and perhaps bankruptcy would have ensued. It also found that a vigorous defense against charges of fraud “... the establishment of [which] ... would have had a disastrous effect upon the newspaper organization ... was of distinct advantage to the corporation.” Since the benefit to the corporation was thus established, the court allowed the director (who was also an attorney) $60,000 to be paid to his assisting counsel. Nothing was allowed for his own extensive efforts as an attorney in the suit. However, the director’s necessary out-of-pocket expenses in connection with the defense of the suit were allowed.

32 Mann v. Hearst (Sept. 1941) L. A. Co. Sup. Ct. No. 432,229 (Shinn, J.). This was a shareholder’s derivative suit to recover certain unfair profits made in violation of fiduciary duties at the expense of Hearst Consolidated Publications, Inc. A judgment for $1,771,859.21 was rendered in favor of Consolidated against Hearst and certain holding companies controlled by him. None of the individual defendants except Hearst was held liable, although only part of them were wholly vindicated. There were stipulations waiving the right of appeal and to new trial except on the matter of the allocation of attorneys’ fees. Action of the district court of appeal on a writ of certiorari taken with respect to this matter is reported in Mann v. Superior Court, supra note 11.

33 Mann v. Hearst, supra note 32. (Memo. opinion re attorney’s fees for John Francis Neylan, at 1.)

34 Ibid. at 2.

35 Ibid. at 3.
LEGISLATION OR BY-LAWS AS TO INDEMNITY

The scarcity and lack of uniformity in the case law on the subject leaves the directors' right to reimbursement in a highly uncertain state. In view of this uncertainty, three possibilities present themselves. Protection of the directors' interests may be sought through legislation, adoption of a corporate by-law, or the insertion of a clause in the director's individual contract. The procedure most generally resorted to has been the adoption of a corporate by-law.36 At first, the proposed by-laws were limited in scope, seeking only to protect directors from financial loss incident to the defense of unwarranted suits on the theory that unless reimbursement in such cases was assured responsible and able men would hesitate to serve. However, as one large corporation after another submitted proposals to its shareholders, the by-laws, drafted at the instance of the management, became extremely broad in many cases and sought to provide the directors and officers with every conceivable protection. For example, some proposals sponsored by managements have provided for reimbursement not only for counsel fees, but also for indemnity against judgment and settlement liability. In such cases the shareholders' assent has been readily obtained by the use of the proxy system. Such by-laws involve a change in the standards of fiduciary duty and of liability for misconduct in office normally imposed upon directors and may well be nullified by the courts as contrary to public policy.37 Apparently directors have not explored the possibilities of guaranteeing themselves reimbursement through individual contracts with the corporation, whereby reimbursement would be offered as compensation for their services, but such contracts seem open to the same objections and abuses as does the device of the corporate by-law.

Thus legislation presents itself as the only adequate means of adjusting the conflicting interests of the corporation, its shareholders, and its management. New York has been the first state to take steps in this direction. Recently added to the General Corporation Law was section 27-a, definitely legalizing indemnity agreements with respect to derivative actions where the director has not been found

36 For forms of indemnity agreements and by-laws, see Washington, op. cit. supra note 8, at 478. For an excellent article based on a study of 169 such by-laws proposed to stockholders within the past three years, see Bates and Zuckert, supra note 25. See also Jervis, Corporate Agreements to Pay Directors' Expenses in Stockholders' Suits (1940) 40 Col. L. Rev. 1192. For the validity of such agreements under federal securities legislation, see Washington, The S. E. C. and Directors' Indemnity: Recent Developments (1940) 40 Col. L. Rev. 1206.
37 Washington, op. cit. supra note 8, at 369 et seq.
"liable for negligence or misconduct".\textsuperscript{38} Following the adoption of this provision, section 61-a was added providing for reimbursement (in the discretion of the court) of the "successful or partially successful party" in an action brought on behalf of a corporation.\textsuperscript{39} This latter provision would seemingly permit reimbursement of directors even in case of private settlement, but since the allowance is to be made only with the court's approval, this does not appear open to serious criticism. Circumstances are conceivable in which it would be good business practice for a director to settle, even though the charges upon which the suit against him were based, were unfounded. Unfortunately, section 27-a has no such check upon its operation as the requirement of court approval. It "... permits an advance grant of indemnity by the stockholders without any control except that liability for negligence or misconduct shall not be established by final judgment."\textsuperscript{40} Nothing on the face of its negative phraseology would preclude indemnity where the director chose to settle with the plaintiff out of court. Thus "... the section might permit the absurd result that the director could, because there was no judgment, receive back not only his expenses but the amount he paid in settlement."\textsuperscript{41} However, as Professor Washington has pointed out, courts have narrowed broad statutory privileges before, and it is not unlikely that indemnity agreements entered into under section 27-a will be subjected to the equitable test of good faith and fair dealing.\textsuperscript{42} Nevertheless, the New York law leaves much to be desired. Because bargaining between management and stockholders and the judicial enforcement of equitable claims are treated as wholly unrelated, there is danger that the effects of judicial supervision will be largely nullified.

What seems to be needed is legislation which will extend a uniform degree of protection to all directors. The right to reimbursement should not turn on the existence of an individual contract or a corporation by-law. Nor should the right to reimbursement lie in the managerial discretion of the directors, as the California superior court has suggested.\textsuperscript{43} The allowance or denial of attorneys' fees and costs is properly a matter for the court to decide. Only the judge is in a position fairly to determine the merits of the cause and the value

\textsuperscript{38} (Cum. Supp. 1942).
\textsuperscript{39} For a good critical discussion of this section, see WASHINGTON, \textit{op. cit. supra} note 8, at 410 \textit{et seq.} The danger of subjecting a corporation to large liability for statutory costs at the suit of the holder of a few shares tends to stimulate the courts to protect the corporation against unfounded suits in their early stages. Corash v. Texas Co. (App. Div. June 5, 1942) 35 N. Y. S. (2d) 334; Weinberger v. Quinn, \textit{supra} note 23.
\textsuperscript{40} Bates and Zuckert, \textit{op. cit. supra} note 25, at 250.
\textsuperscript{41} \textit{Ibid.}
\textsuperscript{42} WASHINGTON, \textit{op. cit. supra} note 8, at 423.
\textsuperscript{43} Mann v. Hearst, \textit{supra} note 32.
of the attorneys' services rendered therein. More often than not, the association of the members of a board of directors with a fellow director will be too intimate to permit an unbiased consideration of his claim for reimbursement, even where the board is possessed of the facts necessary to a just decision.

The California court seems also to err in suggesting that the right to reimbursement should rest upon benefit to the corporation. A better rationale would seem to be that the vindicated director should be reimbursed for a loss suffered as a result of his position as a corporate fiduciary. As suggested in the Solimine case, there should be recognition of a right in directors analogous to that in trustees entitling them to reimbursement for attorneys' fees when subjected to suit on unjust charges. Similarly, it would seem that where the director is also an attorney his claim to reimbursement for personal efforts expended in his own behalf should be disposed of by ascertaining the law applicable to a trustee in such circumstances.

It is to be hoped that legislation embodying these principles may soon be forthcoming so that the legitimate interests of directors may be protected without subjecting shareholders to the manifold abuses which are likely to stem from the current flood of management-sponsored corporate by-laws.

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44 Supra note 31.
45 On the theory that the trustee should not profit from his trust the English Chancery, at an early date, denied compensation to trustees employing themselves to perform legal or other services. While there are still authorities adhering to this doctrine, "...it is believed that the recent tendency is in favor of making allowances to the trustee for special services, where their rendition, necessity, and value are clearly proved." 3 BOGERT, TRUSTS (1935) 1546.