# Indemnification of Corporate Executives Who Have Been Convicted of Crimes: An Assessment and Proposal

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Payments to indemnify corporate executives[1] convicted of crimes, though ostensibly forbidden by state incorporation codes and Directors and Officers (D&O) Liability Insurance policies,[2] can actually occur routinely, and quietly. This system of corporate indemnification is both excessive and overly restrictive — excessive because corporations' ability to fully indemnify executives convicted of criminal offenses is potentially unlimited, yet overly restrictive because executives who perform in good faith and are virtually vindicated by criminal proceedings[3] have no

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1. In this Article, the term "corporate executives" refers to directors, officers, employees, and agents unless otherwise noted. Some incorporation statutes distinguish between these positions when discussing indemnification. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT, §§ 8.50-8.58 (1984) [hereinafter RMBCA]. A greater number do not. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145 (1983 & Supp. 1988). Generally, Directors and Officers (D&O) liability insurance policies treat directors and officers equally. *See, e.g.*, Stewart Smith D&O Insurance Form, in J. BISHOP, LAW OF CORPORATE OFFICERS AND DIRECTORS, INDEMNIFICATION AND INSURANCE (1981 with annual supplements) at ¶ 8.04 (1990) [hereinafter INDEMNIFICATION AND INSURANCE].

2. State incorporation codes give corporations the power to indemnify for costs arising from "civil, criminal, administrative or investigative" matters but indemnification for criminal matters is permitted only if the executive meets certain conditions, including having "no reasonable cause to believe his conduct was unlawful." *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1988). Intuitively, it would appear that a person convicted of unlawful behavior would not meet this condition, and therefore, that the indemnification statute forbids indemnification to a convicted executive.

D&O insurance policies specifically exclude from coverage "fines or penalties . . . charges or expenses of grand jury or criminal proceedings" and claims "arising from, brought about or contributed to by the dishonest, fraudulent or criminal acts of any [executive]." P. RICHTER, INDEMNIFICATION OF DIRECTORS AND OFFICERS app. at 2-6 and 2-8 (Securities Law Series 1989-1990) (reprinting sample D&O policies).

At common law reimbursement to convicted executives was disallowed. See *infra* notes 158-97 and accompanying text for a discussion of this common law and its development.

3. "Virtually vindicated by criminal proceedings" refers to the situation where a defendant is acquitted, or secures a dismissal, of all of the serious charges filed against him but is convicted on a single, or few, minor offenses. *See infra* notes 36-53 and accompanying text.

statutory right to reimbursement. This odd result exists, in part, because indemnification developed in the context of civil liability[4] and was extended to the criminal arena simply by tacking a few words about criminal liability onto existing indemnification statutes.[5] Unfortunately, this extension was unaccompanied by a thorough analysis of the practicalities and unique policy concerns of the criminal law.[6]

If convicted, it is likely that corporate executives will be assessed fines and penalties. They will undoubtedly incur attorneys fees for their unsuccessful defense. If acquitted or if the charges are dismissed, the executive will not be assessed fines or penalties but will have incurred attorneys fees. Currently, there are two major avenues through which corporate executives may seek reimbursement for these costs. The first is from the corporation, which receives power to indemnify its executives from state incorporation statutes or from internal sources such as bylaws or contracts. The second avenue is the D&O insurer. Executives turn to a D&O insurer when their corporation is either unwilling to indemnify, as in the case of a hostile take-over, or is unable to indemnify, as in the case of insolvency.

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4. Schwarz v. General Airline & Film Corp., 305 N.Y. 395, 113 N.E.2d 533, 535 (1953) (discussing historical development of New York's indemnification statute); *Note, Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, 76 HARV. L. REV. 1403 (1963) [hereinafter *Indemnification of Directors*] ("State indemnification law has largely developed in the context of shareholders' derivative actions . . . ."); *id.* at 1405 (discussing how the "breach of duty" standard in indemnification statutes has no applicability to third party (including criminal) actions).

5. In 1953 the New York Court of Appeals held that the New York indemnification statute, as passed in 1945, did not apply to criminal actions, despite the statutory language indicating that corporations were empowered to indemnify for costs arising from "any action, suit, or proceeding." *Schwarz*, 305 N.Y. at 403, 113 N.E.2d at 535-36 (interpreting 1945 N.Y. LAWS ch. 869). Thereafter in 1961, the New York legislature passed section 723 of chapter 855, which explicitly empowered corporations to indemnify directors and officers in any "action or proceeding . . . whether civil or criminal." 1961 N.Y. LAWS ch. 855, § 723.

It was not until 1968 that the Delaware statute was amended to cover criminal actions. It did so merely by adding the following language to the existing standards for permissive indemnification: "[W]ith respect to any criminal action or proceeding, [the executive seeking indemnification] had no reasonable cause to believe his conduct was unlawful." DEL. CODE ANN. tit. 8, § 145(a) (1968).

*See, e.g.*, Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1407 (discussing this development in the Model Business Corporation Act); Note, *Indemnifying Corporate Officials for Williams Act Violations*, 50 IND. L.J. 826, 827-833 (1975) (discussing the historical development of indemnification).

6. Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitations and Indemnification*, 43 BUS. LAW 1207, 1231-1234 (1988) [hereinafter *Evaluating Recent Legislation*]; Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1408.

Part One of this Article addresses the first avenue and surveys the full panoply of opportunities corporations have to willingly, even eagerly,[7] indemnify corporate executives who have been convicted of crimes. This survey also covers the few odd occasions when deserving executives have no rights to indemnification. Part Two describes the additional reimbursement opportunities presented by D&O insurance which, as noted, is an executive's surrogate for indemnification when the corporation is unwilling or unable to indemnify. Part Three provides a summary and assessment of indemnification and D&O insurance, suggesting that our current approach poorly serves the public interest.[8] Appendix A contains a proposed indemnification statute that better accommodates the public

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7. The Fruehauf Corporation, a truck manufacturer in Detroit with $2 billion in annual sales, provides an apt example. In 1975, Fruehauf, its President and CEO, Robert D. Rowan, and its Chairman of the Board, William E. Grace, were convicted on a federal felony charge of conspiracy to evade more than $12.3 million in corporate federal excise taxes. Nathan, *Coddled Criminals*, HARPER's 30 (Jan. 1980). Fruehauf not only kept Rowan on the payroll (at an annual salary of $500,000) during the trial and three years of appeals, but paid all legal fees the men incurred during the trial and the appeals. When a Fruehauf shareholder filed suit to recover the legal fees paid to Rowan and Grace, the Board of Directors fought the shareholder *after* passing resolutions indemnifying themselves for legal expenses they might incur fighting the shareholder. *Id.* at 31.

For other examples of corporations "eagerly" indemnifying their executives, see Koster v. Warren, 176 F. Supp. 459, 460 (N.D. Cal. 1959), *aff'd*, 297 F.2d 418 (9th Cir. 1961) (corporation paid $75,000 fine assessed against its former President after his plea of nolo contendere to criminal antitrust charges); Simon v. Socony - Vacuum Oil Co., Inc., 38 N.Y.2d 270, 274-275 (N.Y. Sup. Ct. 1942), *aff'd*, 267 A.D. 890, 47 N.Y.S.2d 589 (N.Y. App. Div. 1944) (corporation paid defense costs and fines assessed against directors after directors pled nolo contendere to criminal antitrust charges).

8. Scholars who have addressed the policy concerns raised by corporate indemnification and D&O insurance for both civil and criminal liability include: Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 BUS. LAW at 1207; Oesterle, *Limits on a Corporation's Protection of Its Directors and Officers From Personal Liability*, 1983 WIS. L. REV. 513 (1983) [hereinafter *Personal Liability Protection]*; Pillai & Tractenberg, *Corporate Indemnification of Directors and Officers: Time for a Reappraisal*, 15 U. MICH. J.L. REF. 101 (1981); Coffee, *"No Soul to Damn, No Body to Kick": An Unscandalized Inquiry Into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386 (1981) [hereinafter *No Soul to Damn*]; Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 (1980) [hereinafter *Enterprise Liability*]; Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW 1993 (1978) [hereinafter *Indemnification and Insurance*]; Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968) [hereinafter *Sitting Ducks and Decoy Ducks*]; Note, *Practical Aspects of Directors and Officers Liability Insurance - Allocating and Advancing Legal Fees and the Duty to Defend*, 32 UCLA L. REV. 690 (1985) [hereinafter *Practical Aspects of D&O Insurance*]; Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716 (1967); Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648 (1967) [hereinafter *Insurance for Executives*]; Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. 1403.

interest while also preserving the important, and needed, protection indemnification should provide.

## I. Indemnification By the Corporation

### *A. OVERVIEW*

Corporations are empowered to indemnify their directors and officers through four possible sources: statutes in force in the jurisdiction of incorporation,[9] bylaws, corporate resolutions, or contracts negotiated with individual directors.[10]

As part of its incorporation statute, each state has enacted provisions dealing with indemnification of corporate executives for costs associated with their corporate duties.[11] Currently, the most influential statutes are

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9. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶ 6.03[5]. *See, e.g.,* Wisener v. Air Exp. Intern. Corp., 583 F.2d 579, 581 (2d Cir. 1978); B. & B. Investment Club v. Kleinert's Inc., 472 F. Supp. 787, 789 (E.D. Pa. 1979); Gross v. Texas Plastics, Inc., 344 F. Supp. 564, 565-66 (D.N.J. 1972).

10. J. Bishop, Indemnification and Insurance, *supra* note 1, at ¶¶ 6.02, 7.01, 7.05 (Supp. 1985 & 1988); *cf.* Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 Wis. L. Rev. at 553-555 (discussing how waiver by a corporation of judgments awarded to it against an executive is another way of effectively indemnifying executives).

11. Ala. Code § 10-2A-21 (1987); Alaska Stat. § 10.06.490 (1989); Ariz. Rev. Stat. Ann. § 10-005 (1990); Ark. Stat. Ann. § 4-26-814 (1987); Cal. Corp. Code § 317 (West 1977 & Supp. 1990); Colo. Rev. Stat. § 7-3-101.5 (1990); Conn. Gen. Stat. Ann. § 33-320a (West 1987); Del. Code Ann. tit. 8, § 145 (1983 & Supp. 1988); Fla. Stat. Ann. § 607.014 (West 1986 & Supp. 1989); Ga. Code Ann. §§ 14-2-850 to -859 (1989); Haw. Rev. Stat. § 415-5 (1985 & Supp. 1989); Idaho Code § 30-1-5 (1980 & Supp. 1989); Ill. Ann. Stat. ch. 32, para. 8.75 (Smith-Hurd 1985 & Supp. 1990); Ind. Code Ann. §§ 23-1-37-1 to -15 (West 1989); Iowa Code Ann. § 496 A.4A (West Supp. 1990); Kan. Stat. Ann. § 17-6305 (1988); Ky. Rev. Stat. Ann. §§ 271 B.8-500 to -580 (Michie/Bobbs - Merrill 1989); La. Rev. Stat. Ann. § 12.83 (West 1969 & Supp. 1990); Me. Rev. Stat. Ann. tit. 13A, § 719 (1981 & Supp. 1989); Md. Corps & Ass'ns Code Ann. § 2-418 (1985 & Supp. 1989); Mass. Gen. Laws Ann. ch. 156B, § 67 (West 1970 & Supp. 1990); Mich. Comp. Laws Ann. § 450-1561 (West 1990); Minn. Stat. Ann. § 302 A.521. (West 1985 & Supp. 1990); Miss. Code Ann. §§ 79-4-8.50 to -8.58 (1972 & Supp. 1988); Mo. Ann. Stat. § 351.355 (Vernon 1966 & Supp. 1990); Mont. Code Ann. § 35-1-414 (1989); Neb. Rev. Stat. § 21-2004(15) (1987); Nev. Rev. Stat. Ann. § 78.751 (Michie 1987); N.H. Rev. Stat. Ann. § 293-A:5 (1987); N.J. Stat. Ann. § 14A:3-5 (West 1969 & Supp. 1990); N.M. Stat. Ann. § 53-11-4.1 (1983 & Supp. 1989); N.Y. Bus. Corp. Law §§ 721-727 (McKinney 1986 & Supp. 1990); N.C. Gen. Stat. §§ 55.8-50 to .8-58 (1990); N.D. Cent. Code § 10-19.1-91 (1985); Ohio Rev. Code Ann. § 1701.13(e) (Baldwin 1986 & Supp. 1990); Okla. Stat. Ann. tit. 18, § 1031 (West 1986 & Supp. 1990); Or. Rev. Stat. §§ 60.387 to .414 (1988); 15 Pa. Cons. Stat. Ann. § 1741 to 1750 (Purdon 1990); R.I. Gen. Laws § 7-1.1-1-4.1 (1985 & Supp. 1989); S.C. Code Ann. §§ 33-8-500 to -580 (Law. Co-op. 1990); S.D. Codified Laws Ann. §§ 47-2-58 to -58.7 (1983 & Supp. 1990); Tenn. Code Ann. §§ 48-18-501 to -509 (1988 & Supp. 1989); Texas Bus. Corp.

the Delaware statute[12] and the 1984 Revised Model Business Corporation Act (RMBCA).[13]

The first indemnification statute was passed by New York in 1941[14] in response to *New York Dock Co., Inc. v. McCollom*,[15] decided two years earlier. In *New York Dock*, the New York court of appeals held that a corporation did not have the power to pay the expenses of directors sued in a derivative suit who had successfully defended themselves on the merits.[16] This decision was contrary to the generally accepted common law view that corporations had power to reimburse successful executives.[17] Alarmed over this decision, business interests quickly rallied state legislatures to pass statutes empowering corporations to indemnify executives who incurred legal liability in the exercise of their corporate duties.[18] As new generations of indemnification statutes developed, more sophisticated features were added such as mandatory indemnification for the successful executive; indemnification for costs incurred in ERISA, criminal, administrative, and legislative actions; indemnification for threatened actions that never culminated in actual "claims" but which may have generated attorney fees; and, indemnification for costs incurred in compromise settlements.[19]

Since the mid-1980s, the trend in the states has been to statutorily expand the power of corporations to indemnify their executives.[20] Whereas the most dramatic expansion has been with regard to shareholder derivative lawsuits,[21] the expansion of exclusivity[22] and advancement of

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ACT ANN. art. 2.02-1 (Vernon 1980 & Supp. 1990); UTAH CODE ANN. § 16-10-4 (1987 & Supp. 1990); VT. STAT. ANN. tit. 11, § 1852(15) (1984); VA. CODE ANN. §§ 13.1-696 to -704 (1989); WASH. REV. CODE ANN. § 23A.08.025, 23B.08.500 (Supp. 1990); W. VA. CODE § 31-1-9 (1988); WIS. STAT. ANN. §§ 180.04 to .059 (West Supp. 1990); WYO. STAT. §§ 17-16-850 to -858 (1989).

12. DEL. CODE ANN. tit. 8, § 145 (1983 & Supp. 1988).

13. RMBCA, *supra* note 1, at §§ 8.50-.58.

14. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 6.02 (1981 & Supp. 1985).

15. 173 Misc. 106, 16 N.Y.S.2d 844 (1939).

16. *Id.*

17. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 5.08 (1981 & Supp. 1990).

18. *Id.* at ¶ 6.02.

19. *Id.* at ¶ 6.03[2], [3].

20. Hazen, *Corporate Directors' Accountability: The Race To The Bottom - The Second Lap*, 66 N.C.L. REV. 171, 177 (1987) [hereinafter *The Race To The Bottom*]; *cf.* Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 BUS. LAW at 1221-1227; Heyler, *Indemnification of Corporate Agents*, 23 UCLA L. REV. 1255, 1255 (1976) (referring primarily to the early development of indemnification in California); Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1081.

21. Until recently, indemnification in shareholder derivative lawsuits was limited

expense[23] provisions directly affects executives who face criminal liability.

Virtually all indemnification statutes follow the same general pattern: they require corporations to indemnify directors in some instances but permit indemnification in other instances as long as certain standards of conduct are met.[24] All of the statutes set forth a procedure for authorizing indemnification and indicate whether the statute is the exclusive mechanism for providing indemnification.

Thirty statutes are purely nonexclusive, and thus allow corporations to indemnify executives in circumstances other than those set forth in the statute.[25] No statutes are truly exclusive but two, those of Minnesota and North Dakota, come close. Although these statutes give corporations the authority to limit the indemnification provided in the statute, they

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to expenses of a successful defense and was not available for judgments. North Carolina, Virginia, Indiana and Wisconsin all exemplify the trend of allowing indemnification for settlements or even judgments in derivative lawsuits. For a discussion of this trend see Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 BUS. LAW at 1221-24.

22. *See, e.g.*, Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 BUS. LAW at 1224-27; Note, *Protecting Corporate Directors and Officers: Indemnification*, 40 VAND. L. REV. 737, 758 (1987); *cf.* Heyler, *supra* note 20, 23 UCLA L. REV. at 1266 (referring primarily to the early development of indemnification law in California).

23. *Cf.* Heyler, *supra* note 20, 23 UCLA L. REV. at 1263-64 (referring primarily to the early development of indemnification law in California).

24. There are a few exceptions to this pattern. The Connecticut, Minnesota, North Dakota, and Wisconsin statutes provide only for mandatory indemnification. CONN. GEN. STAT. ANN. §§ 33-320a(b) and (c) (West 1987); MINN. STAT. ANN. § 302A.521 (West 1985 & Supp. 1990); N.D. CENT. CODE § 10-19.1-19.(2) (1985); WIS. STAT. ANN. § 180.042 (West Supp. 1990). The Massachusetts and Vermont statutes provide only for permissive indemnification. MASS. GEN. LAWS ANN ch. 156B, § 67 (West 1990 & Supp. 1990); VT. STAT. ANN. tit. 11, § 1852(15) (1984).

25. ALA. CODE § 10-2A-21(f) (1987); ALASKA STAT. § 10.06.490(a) (1989); ARIZ. REV. STAT. ANN. § 10.005(F) (1990); ARK. STAT. ANN. § 4-26-814(F) (1987); CAL. CORP. CODE § 317(g) (West 1987 & Supp. 1990); DEL. CODE ANN. tit. 8, § 154(f) (1983 & Supp. 1988); HAW. REV. STAT. § 415-5(g) (1985 & Supp. 1989); IDAHO CODE § 30-1-5(f) (1980 & Supp. 1989); ILL. ANN. STAT. ch. 32, para. 8.75(f) (Smith-Hurd 1985 & Supp. 1989); IND. CODE ANN. § 23-1-37-15(a) (West 1989); KAN. STAT. ANN. § 17-6305(f) (1988); KY. REV. STAT. ANN. § 271B.8-580 (Michie/Bobbs-Merrill, 1989); LA. REV. STAT. ANN. § 12:83(E) (West 1969 & Supp. 1990); ME. REV. STAT. ANN. tit. 13A, § 719(5) (1981 & Supp. 1989); MD. CORPS & ASS'NS CODE ANN. § 2-418(g) (1985 & Supp. 1989); MASS. GEN. LAWS ANN. ch. 156B, § 67 (West 1970 & Supp. 1990); MICH. COMP. LAWS ANN. § 450.1565 (West 1990); MO. ANN. STAT. § 351.355 subd. 6 (Vernon 1966 & Supp. 1990); N.H. REV. STAT. ANN. § 293-A:5(VI) (Supp. 1987); N.J. STAT. ANN. § 14A:3-5(8) (West 1969 & Supp. 1990); N.M. STAT. § 53-11-4.1(B) (1983 & Supp. 1989); OHIO REV. CODE ANN. § 1701.13(E)(6) (Baldwin 1986 & Supp. 1989); OKLA. STAT. ANN. tit. 18, § 1031(F) (West 1986 & Supp. 1990); OR. REV. STAT. § 60.414(1) (1988); S.D. CODIFIED LAWS ANN. § 47-2-58.6 (1983 & Supp. 1990); UTAH CODE ANN. § 16-10-4(f) (1987 & Supp. 1990); VT. STAT. ANN. tit. 11, § 1852(15) (1984); WASH. REV. CODE ANN. § 23B.08.560(2) (Supp. 1990). *But see infra* note 26; W. VA. CODE § 31-1-9(f) (1988); WYO. STAT. § 17-16-858 (1989).

do not allow corporations to expand indemnification rights beyond those set forth in the statute.[26] A few statutes present a hybrid approach on the exclusivity issue. Nine of the statutes professing to be nonexclusive appear to place some restrictions on indemnification made outside the statute.[27] Another nine statutes,[28] following the RMBCA,[29] prohibit in-

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26. The pertinent language in these two statutes is identical: "The articles or bylaws either may prohibit indemnification or advances of expenses otherwise required by this section or may impose conditions on indemnification or advances of expenses in addition to the conditions [imposed by this statute] . . . ." MINN. STAT. ANN. § 302A.521 subd. 4 (West 1985 & Supp. 1990); N.D. CENT. CODE, § 10-19.1-91.(5) (1985).

27. For example, New York's incorporation statute provides that

> [t]he indemnification and advancement of expenses granted pursuant to, or provided by, this article shall not be deemed exclusive of any other rights . . . contained in the certificate of incorporation or the by-laws, or . . . a resolution of shareholders, . . . a resolution of directors, or . . . an agreement . . . provided that no indemnification may be made . . . if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated.

N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1990). The following state incorporation codes also purport to be exclusive but impose similar restrictions: FLA. STAT. ANN. § 607.014(6) (West 1986 & Supp. 1989); IOWA CODE ANN. § 496A.4A(7) (West Supp. 1990); MISS. CODE ANN. § 79-4-8-8.58 (1972 & Supp. 1988); NEV. REV. STAT. § 78.751(6) (Michie 1987); 15 PA. CONS. STAT. ANN. § 1746(b) (Purdon 1990); TENN. CODE ANN. § 48-18-509 (1988 & Supp. 1989); VA. CODE ANN. § 13.1-704 (1989); and WIS. STAT. ANN. § 180.049 (West & Supp. 1990).

The Washington incorporation statute uses this approach when the indemnification at issue is authorized by the articles of incorporation, bylaws or a resolution adopted or ratified by the shareholders. In these situations a corporation is not limited by the indemnification statute except that no indemnity is available to a director whose acts or omissions have been "finally adjudged to be intentional misconduct or a knowing violation of law," or were regarding "unlawful distributions," or any transaction in which it was finally adjudged that such director personally received a benefit to which he was not entitled. WASH. REV. CODE ANN. § 23B.08.560(1) (Supp. 1990). However, when the corporation grants indemnification through a mechanism other than the articles of incorporation, bylaws or a resolution adopted or ratified by shareholders, Washington's statute is nonexclusive and corporations are not bound by it. WASH. REV. CODE ANN. § 23B.08.560(2) (Supp. 1990). Thus, for example, it would appear that a corporation would not be bound by the limits in the incorporation statute when it negotiated a contract with an executive for indemnification.

28. COLO. REV. STAT. § 7-3-101.5 (1990); CONN. GEN. STAT. ANN. § 33-320(g) (West 1987); GA. CODE ANN. § 14-2-859 (1989); MONT. CODE ANN. § 35-1-414(7) (1989); NEB. REV. STAT. § 21-2004(15)(f) (1987); N.C. GEN. STAT. § 55-8-58 (1990); R.I. GEN. LAWS § 7-1.1-4.1.(g) (1985 & Supp. 1989); S.C. CODE ANN. § 33-8-580(a) (Law. Co-op. 1990); TEX. BUS. CORP. ACT ANN. art. 2.02-1.(M) (Vernon 1980 & Supp. 1990). Some of these statutes impose requirements additional to the consistency requirement which may affect the convicted executive. For example, North Carolina further provides that corporations may not indemnify any person for "activities which were at the time taken

demnification that is "not consistent with" the provisions of the statute.[30]

Virtually all of the statutes address two additional issues, advancement of attorneys fees and purchase of D&O insurance. All statutes, except Vermont's,[31] specifically allow corporations to advance funds to pay attorneys fees as those fees are incurred, rather than after judgment. Every state indemnification statute, except Vermont's, specifically authorizes corporations to procure D&O liability insurance without regard to whether the corporation has the power to indemnify.[32]

In states where the indemnification statute is nonexclusive, corporations may pass bylaws or corporate resolutions or negotiate contracts with individual executives allowing indemnification. These bylaws, resolutions or contracts may allow indemnification beyond that permitted in the statute. Bylaws and corporate resolutions tend to favor corporate executives.[33] Most seek to expand the benefits of indemnification to directors and officers in "new and unexpected ways."[34] As might be

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known or believed . . . to be clearly in conflict with the best interests of the corporation." N.C. GEN STAT. § 55-8-57) (1990).

29. RMBCA, *supra* note 1, at § 8.58(a).

30. Section 8.58(a) of the RMBCA provides that

> [a] provision treating a corporation's indemnification of or advance for expenses to *directors* that is contained in its articles of incorporation, bylaws, a resolution of its shareholders or board of directors, or in a contract or otherwise, is valid only if and to the extent the provision is consistent with this subchapter. If articles of incorporation limit indemnification or advance for expenses, indemnification and advance for expenses are valid only to the extent consistent with the articles.

*Id.* (emphasis added). As can be seen, the above provision governs corporations' extra-statutorial powers to indemnify directors.

Section 8.56(3) governs corporations' extra-statutorial powers to indemnify officers, employees and agents who are not directors. It provides that a corporation may indemnify these individuals through its articles of incorporation, bylaws, general or specific action of its board of directors, or contracts that are "consistent with public policy." *Id.* § 8.56(3).

31. VT. STAT. ANN. tit. 11, § 1852(15) (1984).

32. *Id.*

33. For example, Delaware's statute provides in full:

> 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 provision of this section.

DEL. CODE ANN. tit. 8, § 145(g) (1983 & Supp. 1988). The provisions of most other state statutes mirror Delaware's provision.

34. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 7.06 (1981 & Supp. 1988); *id.* at ¶ 7.03.

imagined, ad hoc agreements negotiated between corporations and individual executives allow for the broadest discretion to negotiate terms of full indemnification. To date, the only requirement imposed by the courts on such contracts is that new and independent consideration must support the agreement. Courts have liberally construed what suffices as "new and independent" consideration.[35]

## *B. THE INDEMNIFICATION STATUTES*

### *1. Mandatory Indemnification*

All but six state incorporation statutes make indemnification mandatory when an executive has been successful in defending against criminal charges,[36] but these statutes differ in their description of "success." California's statute requires that the executive must be "successful on the merits."[37] Twenty-eight state statutes require that the executive be "successful on the merits or otherwise,"[38] while fifteen statutes require that the executive be "wholly successful on the merits or otherwise."[39]

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35. The only requirement the courts have imposed thus far on such agreements is that new and independent consideration to that already negotiated between the parties support the agreement. *See, e.g.*, Koster v. Warren, 176 F. Supp. 459, 461-462 (N.D. Calif. 1959), *aff'd*, 297 F.2d 418 (9th Cir. 1961) (and cases cited therein); Choate, Hall & Stewart v. SCA Services, Inc., 22 Mass. App. 522, 495 N.E.2d 562, 565 n.7 (1986); Mooney v. Willys-Overland Motors, 204 F.2d 888, 891 (3d Cir. 1953).

36. Of these six, Massachusetts and Vermont provide only for permissive indemnification. MASS. GEN LAWS ANN. ch. 156B, § 67 (West 1970 & Supp. 1990); VT. STAT. ANN. tit. 11, § 1852 (15) (1984). Connecticut, Minnesota, North Dakota, and Wisconsin, statutes which provide for mandatory indemnification only, use as their standards for mandatory indemnification what most statutes use as standards for permissive indemnification. CONN. GEN. STAT. ANN. § 33-320a(b) and (c) (West 1987); MINN. STAT. ANN. § 302A.521 (West 1985 & Supp. 1990); N.D. CENT. CODE § 10-19.1-9.1(2) (1985); WIS. STAT. ANN. § 180.042 (West & Supp. 1990).

37. CAL. CORP. CODE § 317(d) (West 1977 & Supp. 1990).

38. The incorporation statutes of the following states use the "successful on the merits" standards for mandatory indemnification: Alabama, Alaska, Arizona, Arkansas, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Kansas, Louisiana, Maine, Maryland, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, South Dakota, Utah, West Virginia, Wisconsin. *See supra* note 11 for state statutory citations.

39. Following the lead of the RMBCA, the incorporation statutes of the following states use the "wholly successful on the merits or otherwise" standard for mandatory indemnification: Colorado, Indiana, Iowa, Kentucky, Mississippi, Montana, New Mexico, North Carolina, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Washington, Wyoming. *See* RMBCA, *supra* note 1, at § 8.52. *See supra* note 11 for state statutory citations.

Virginia uses different language but to the same effect. Virginia's statute provides that "[u]nless limited by its articles of incorporation, a corporation shall indemnify a

The decision in *Merritt-Chapman & Scott Corp. v. Wolfson*[40] highlights the significance of the "wholly successful" requirement. An executive of Merritt-Chapman pled guilty to filing false annual reports with the SEC and New York Stock Exchange. In return, the government agreed to dismiss the remaining charges pending against him. Another Merritt-Chapman executive, who was convicted of perjury before the SEC, promised not to appeal his conviction in exchange for dismissal of other charges pending against him.[41] The two executives sought and received pro rata reimbursement for the attorneys fees associated with the dismissed charges. The trial court approved this reimbursement, reasoning that "in a criminal action, any result other than conviction must be considered a success."[42]

After the *Merritt-Chapman* decision, the RMBCA added the word "wholly" to its standard for mandatory indemnification. The Official Comments to the RMBCA indicate that this change was made "to avoid the argument accepted in *Merritt-Chapman* . . . that a defendant may be entitled to partial mandatory indemnification if he succeeded by plea bargaining or otherwise to obtain a dismissal of some but not all counts of an indictment."[43] Thus, to qualify for mandatory indemnification in states using the "wholly successful" language, the executive must secure an acquittal or dismissal of *all* charges.

Whether a statute mandates indemnification when one has been successful "on the merits" or "on the merits or otherwise" depends upon how the drafters felt about victories on procedural grounds. Those drafters who believed that executives should not be forced to forego a viable procedural defense simply to collect indemnification, included the language "on the merits or otherwise."[44] In these states a dismissal of charges for reasons wholly unrelated to guilt or innocence still entitles the executive to indemnification. The drafters of the California Code which requires "success on the merits" before one qualifies for mandatory indemnification, did not specifically address this rationale but generally indicated their belief that the "success on the merits" standard properly balanced the need for indemnification while also protecting the shareholders.[45]

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director who entirely prevails in the defense of any proceeding . . . ." VA. CODE ANN. § 13.1-698 (1989). The Official Comments to the Virginian statute state that this change in language from the RMBCA was not intended to alter the result under the RMBCA. *Id.*

40. 321 A.2d 138 (Del. Super. Ct. 1974).
41. *Id.* at 140.
42. *Id.* at 141.
43. RMBCA, *supra* note 1, at § 8.52 (Official Comment).
44. *Id.*
45. *Cf.* CAL. CORP. CODE § 317 (West 1977) (Legislative Committee Comment (1975)).

It is not clear how much sense these standards for mandatory indemnification make when applied. For example, the requirement that an executive be "wholly successful" overlooks the discretion and variation in how identical offenses are charged, and negotiated.[46] Mail fraud[47] demonstrates why this is so. The first count in most mail fraud indictments details the alleged scheme to defraud and the defendant's role in it. Subsequent counts of the indictment incorporate, by reference, all allegations in the first count and simply allege that the defendant caused a different mailing in furtherance of the scheme to defraud.[48] Every count in the indictment carries a possible maximum term of imprisonment of five years, a possible maximum fine of $250,000, or both.[49] In most mail fraud cases, there are many mailings, often hundreds, that could be included as separate counts in the indictment.

Prosecutors vary tremendously in how they charge mail fraud, and in how they negotiate plea agreements with defendants.[50] One prosecutor may charge five counts in a mail fraud indictment and agree to dismiss three counts in return for a plea of guilty on two counts. This convicted executive would be entitled to sixty percent indemnification in a jurisdiction not imposing the "wholly successful" requirement, because the executive was "successful" on sixty percent of the charges. Another prosecutor may charge the same mail fraud scheme in twenty counts and agree to dismissal of nineteen counts; under the same indemnification statute, the convicted executive would now be entitled to ninety-five percent indemnification. Still another prosecutor may charge the same mail fraud scheme in one count and dismiss nothing; in this instance, again under the same indemnification statute, the convicted executive is not entitled to any indemnification. In each of these hypothetical cases, the evidence of fraud and the defendant's culpability are the same but, because of the different practices of prosecutors, the convicted executives are entitled to widely varying amounts of indemnification.

The requirement that one be "wholly successful" also presents the major example of when indemnification is not, but should be, allowed. Assume there is an indictment against a single corporate executive charg-

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46. For sources discussing the discretion accorded prosecutors in charging offenses and negotiating plea agreements see, e.g., Rakoff, *The Exercise of Prosecutorial Discretion in Federal Business Fraud Prosecutions*, in CORRIGIBLE CORPORATIONS AND UNRULY LAW 173 (Fisse & French ed. 1985); Vorenberg, *Decent Restraint of Prosecutorial Discretion*, 94 HARV. L. REV. 1521 (1981); LaFave, *The Prosecutor's Discretion in the United States*, 18 AM. J. COMP. L. 532 (1970).

47. 18 U.S.C. § 1341 (1984 & Supp. 1990).

48. United States Attorneys' Manual § 43.410 (1988).

49. 18 U.S.C. § 1341 (1984 & Supp. 1990) (regarding term of imprisonment); 18 U.S.C. § 3571(a)(3) and (e) (Supp. 1990) (regarding fine).

50. *See supra* note 46.

ing the executive with RICO, mail fraud, and tax offenses. RICO is a felony which carries a possible maximum fine of $250,000, a possible maximum term of prison of twenty years, and mandatory forfeiture of all assets acquired or maintained in violation of the RICO statute.[51] As noted, mail fraud, also a felony, carries a possible maximum term of imprisonment of five years and a possible maximum fine of $250,000 or both.[52] The tax offense is a misdemeanor and carries a possible maximum term of imprisonment of one year, a possible maximum fine of $10,000, or both.[53] Assume that the jury acquits the executive on the more serious RICO and mail fraud charges but convicts on the misdemeanor tax offense. Because the executive has escaped potential imprisonment of twenty-five years, fines of $500,000 and forfeiture of assets, most observers would agree that such a result is a virtual vindication. Despite the fact that the attorneys fees are no doubt enormous after a complex trial on three such charges, if the defendant is in a jurisdiction that requires one to be "wholly successful" to receive indemnification, the executive will not qualify for mandatory indemnification, even on a pro-rata basis. By comparison, if the defendant is in a jurisdiction that simply requires "success," it is likely he would qualify for almost total mandatory indemnification.

The addition of "or otherwise" in the standard, "successful on the merits or otherwise," appropriately recognizes that it makes no sense to force an executive charged with criminal offenses to forego a successful procedural defense, simply to qualify for mandatory indemnification. However, trying to apply the "on the merits" or the "on the merits or otherwise" standards can be difficult. It is not at all clear what qualifies, or should qualify, as prevailing "on the merits." Most observers would agree that pretrial dismissals for expired statute of limitations, lack of venue, double jeopardy, or improper pleading of charges are procedural and therefore not victories "on the merits." However, dismissals for prosecutorial misconduct, government's refusal to reveal an informant's identity or other discoverable information, arguably are "on the merits" and should qualify for mandatory indemnification.

When the corporate officials charged with authorizing indemnification are friendly to the executive seeking indemnification, it will not matter to the executive whether or not the executive qualifies for mandatory indemnification. The friendly authorizing individuals have several ways by which they can award their colleague indemnification: they can con-

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51. Racketeer-Influenced and Corrupt Organizations (RICO), 18 U.S.C. § 1963 (Supp. 1990) (regarding forfeiture and imprisonment); Alternative Fine Provision, 18 U.S.C. § 3571(a)(3) and (e) (Supp. 1990) (regarding fine).

52. *See supra* note 49.

53. Fraudulent Returns, Statements, or Other Documents, 26 U.S.C. § 7207 (1989).

strue the statutory standard for mandatory indemnification generously; they can find that their colleague qualifies under the statutory permissive standard; if the statute is nonexclusive, they can indemnify their fallen comrade pursuant to bylaws, resolutions or contracts, none of which are bound by the statutory standards. Qualifying for mandatory indemnification will be vital, however, when the authorizing officials are hostile to the executive or otherwise unwilling to construe the statute in the executive's favor. The need for statutory clarity in such circumstances is evident. As presently drafted, however, these standards are not clear, and because they fail to account for the way the criminal law is actually administered, they have the potential to operate unfairly.

*2. Permissive Indemnification*

For those executives who have been convicted on criminal charges and do not qualify for mandatory indemnification, indemnification may still be available if these executives can qualify for permissive indemnification.[54] There are potentially eight different provisions in the various incorporation statutes that determine whether a corporation is permitted to indemnify a convicted executive. Although no incorporation statute directly permits reimbursement for criminal fines, penalties, or attorneys fees incurred in the unsuccessful defense of the criminal charges, the combination of these provisions makes it quite possible for a corporation to indemnify convicted executives. The following five provisions are included in almost every state's incorporation statute: (1) a standard for permissive indemnification (2) a procedure for authorizing indemnification, (3) a provision addressing the exclusivity of the statutory standards, (4) a statement regarding the authority to advance expenses, and (5) a statement of the significance to be accorded a conviction or plea of nolo contendere. Additionally, the following three provisions are variously included in some state incorporation statutes: (1) power given a court to indemnify executives who have not met the statutory standards for indemnification, (2) shareholder disclosure requirements, and (3) miscellaneous restrictions.

*a. The standard for permissive indemnification*

Forty-four incorporation statutes contain essentially the same three criteria that a convicted corporate executive must meet before a cor-

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54. In some states, corporate executives will have still other avenues for obtaining indemnification when they do not qualify for mandatory indemnification. *See infra* text accompanying the following notes: notes 54-131 (permissive indemnification), notes 143-198 (avenues outside the incorporation statute when the statute is nonexclusive), notes 199-209 (advancing of expenses), notes 214-215 (power given courts to order indemnification when statutory standards are not met).

poration may indemnify this executive for attorneys fees, fines or penalties.[55] The first criterion, shared by all forty-four states, requires that the executive "acted in good faith." There is a slight variation among the states as to the second criterion. California's statute requires that the person seeking indemnification "acted in a manner the person reasonably believed to be in the best interests of the corporation."[56] Twenty-six statutes broaden this second criterion by requiring only that the executive "acted in a manner he reasonably believed to be in or not opposed to the best interest of the corporation."[57] Some states retain California's version when the executive was acting "in his official capacity with the corporation" but allow a variation of the latter version[58] "in all other cases."[59] "All other cases" includes situations such as requests by the indemnifying corporation that its executive serve as a director for a related or charitable corporation. Two states, Georgia and Virginia, have altered this second criterion by deleting the reasonableness requirement.[60] Thus, in these two states the executive must simply show that he truly believed that his conduct was in the best interests of the corporation; the executive does not have to show that his belief was reasonable. The third criterion is imposed only when the executive is seeking indemnification for costs arising from a criminal proceeding. Forty-three statutes allow indemnification to a convicted executive if the executive "had no reasonable cause to believe that his conduct was unlawful."[61]

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55. The six statutes that do not use these general criteria for permissive indemnification are Massachusetts, Vermont, Connecticut, Minnesota, North Dakota and Wisconsin. To some extent, however, the *mandatory* standards of Connecticut, Minnesota, North Dakota and Wisconsin incorporate some or all of the three criteria used by the other forty-four states for *permissive* indemnification. *See supra* note 11 for statutory citations.

56. CAL. CORP. CODE § 317(b) (West 1977 & Supp. 1990).

57. Alabama, Alaska, Arizona, Arkansas, Delaware, Florida, Hawaii, Idaho, Illinois, Kansas, Louisiana, Maine, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Utah, West Virginia, Wyoming. *See supra* note 11 for statutory citations.

58. *See, e.g.*, RMBCA § 8.51(a)(2) (1984). Instead of using the language "reasonably believed to be in or not opposed to the best interests of the corporation," the RMBCA uses "reasonably believed was in [or] was *at least* not opposed to [the] best interests [of the corporation]." *Id.* (emphasis supplied). The Official Comments to this section state that this change was made to "make it clear that this test is an outer limit for conduct." 2 MODEL BUSINESS CORP. ACT ANN., at 1114 (3d ed. & Supp. 1988).

59. Colorado, Indiana, Iowa, Kentucky, Maryland, Mississippi, Montana, New Mexico, New York, North Carolina, Rhode Island, South Carolina, Tennessee, Texas, Washington, Virginia. *See supra* note 11 for statutory citations.

60. GA. CODE ANN. § 14-2-851(a) (1989); VA. CODE ANN. § 13.1-697(a) (1989).

61. The states using this criterion for permissive indemnification are Alabama,

It will not be difficult for a corporation that wants to indemnify its executives who have been convicted of crimes to find that these criteria are met, despite the convictions. To understand why, it is necessary to turn from corporate to criminal law. With some crimes there is a gray area between legal and illegal conduct.[62] The jurisprudence of white collar crime, in particular, is littered with examples of courts and legislatures struggling to clarify what is or is not a crime. RICO[63] cases present the most stunning example, for the federal courts have continuously disagreed with each other over what constitutes legal and illegal conduct under the RICO statute.[64] The Supreme Court's decisions in

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Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wyoming. *See supra* note 11 for statutory citations. Indiana phrases this criterion as follows:

> the individual [seeking indemnification costs related to a criminal proceeding] either:
>
> (A) had reasonable cause to believe the individual's conduct was lawful; or
>
> (B) had no reasonable cause to believe the individual's conduct was unlawful.

IND. CODE ANN. § 23-1-37-8(a)(3) (West 1989).

62. For discussions of this "gray area" see *White Collar Crime: Hearing Before the Senate Comm. on the Judiciary*, 99th Cong., 2d Sess. 192 (Part I) [hereinafter *White Collar Crime Hearing*] (testimony of Kenneth E. Carlson) ("With a white collar crime it is often hard to tell whether a particular action is a crime."); A REISS & A. BIDERMAN, DATA SOURCES ON WHITE-COLLAR LAW BREAKING 2 (1980) ("There is little justification . . . for distinguishing between civil and criminal fraud on grounds of culpability or seriousness of sanctions," because the only real differences between criminal and civil actions are in the "standards and procedures by which violations are determined and sanctions imposed.").

63. Racketeer Influenced and Corrupt Organizations (RICO), 18 U.S.C. §§ 1961-68 (1984 & Supp. 1990).

64. The Supreme Court's decision in H. J., Inc. v. Northwestern Bell Telephone Co., ____U.S. ____, 109 S. Ct. 2893, 106 L. Ed. 2d 195 (1989) laid to rest one such disagreement among the courts. At issue was the meaning of "pattern of racketeering activity," which is an element that must be proven in any RICO case. Until this decision the United States Court of Appeals for the Eighth Circuit enforced a narrow interpretation of this element, construing it to mean that two counts (i.e., two mailings) in a mail fraud scheme were so closely related that they constituted only one "racketeering activity," not a "pattern of racketeering activity." All of the other federal courts of appeals had rejected this interpretation (*see, e.g.*, United States v. Indelicato, 865 F.2d 1370 (2d Cir. 1989)), when the Supreme Court also rejected it in *H. J., Inc.* Until the Supreme Court resolved this controversy, RICO plaintiffs who intended to allege mail fraud as the "racketeering activity" were uncertain as to whether they could plead a sufficient "pattern of racketeering activity."

The federal courts are still in disagreement over other fundamental issues in RICO law such as, what suffices to prove an "enterprise," *compare* United States v. Bledsoe,

the fraud cases of *United States v. McNally*[65] and *Williams v. United States*[66] also present dramatic examples. In both cases the Supreme Court reversed convictions and held that conduct considered to be criminal (and successfully prosecuted) for many years was not criminal.[67] Payments between health care providers is another glaring example. The federal courts of appeal have continuously disagreed over whether certain long-standing payment practices between providers are illegal under kickback statutes.[68] If the courts cannot agree among themselves, or with legislatures, as to whether the line between legal and illegal conduct has been crossed, it is certainly understandable that corporate officials who must determine eligibility for indemnification could find that a corporate executive had no "reasonable cause to believe that his conduct was unlawful."[69]

A second reason it will not be difficult for a corporation to find that a convicted corporate executive has met the standards for permissive indemnification, is the increasingly wide latitude allowed the government in proving the mens rea element, especially in white collar criminal cases. It is commonly assumed that proof of intention to violate the law distinguishes a criminal from a civil matter.[70] If proof of such intent

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674 F.2d 647, 663-65 (8th Cir.), *cert. denied sub nom.* Phillips v. United States, 459 U.S. 1040 (1982) *with* United States v. Bagnariol, 665 F.2d 877, 890-91 (9th Cir. 1981), *cert. denied*, 456 U.S. 962 (1982), and whether an "enterprise" may also be a "person" under RICO, *compare* United States v. Hartley, 678 F.2d 961, 988 (11th Cir. 1982), *cert. denied*, 459 U.S. 1170 (1983) *with* Bennett v. United States Trust Co. of New York, 770 F.2d 308, 315 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986).

65. 483 U.S. 350, 107 S. Ct. 2875, 97 L. Ed. 2d 292 (1987).

66. 458 U.S. 279, 102 S. Ct. 3088, 73 L. Ed. 2d 767 (1982).

67. *McNally*, 483 U.S. at 361, 107 S. Ct. at 2882, 97 L. Ed. 2d at 303; *Williams*, 458 U.S. at 284, 102 S. Ct. at 3091; 73 L. Ed. 2d at 773.

68. *See* Bucy, *Fraud by Fright: White Collar Crime By Health Care Providers*, 67 N.C.L. REV. 855, 915-916 (1989) and cases cited therein.

69. In fact, Indiana explicitly cited this "gray area" between legal and illegal conduct when it passed standards for permissive indemnification that make it even easier for convicted corporate executives to qualify for permissive indemnification. Indiana's incorporation statute now provides that a convicted executive qualifies for permissive indemnification if he "either . . . had reasonable cause to believe [his] conduct was lawful; or had no reasonable cause to believe [his] conduct was unlawful." IND. CODE ANN. § 23-1-37-8(a)(3) (West 1989).

The Official Comment to Indiana's provision explains that this change was intended to favor the executive. The Comment notes that in complex modern corporate and securities transactions "a corporate director or officer . . . may well have reasonable cause to believe his action is 'lawful' even though he cannot categorically say, given the 'gray areas' in a particular statute or regulation, that he has 'no reasonable cause' to believe that the action may finally be determined to be 'unlawful.'" IND. CODE ANN. § 23-1-37-8 Official Comment (West 1989).

70. H.L.A. HART, PUNISHMENT AND RESPONSIBILITY 187 (1968) ("In all advanced

was literally required to convict corporate executives, such executives would rarely qualify for permissive indemnification, even under the friendliest application of these standards. However, if a defendant is found guilty under a strict liability standard, which requires no proof of mens rea,[71] or under a negligence or recklessness mens rea standard, it is not particularly difficult for corporate officials who want to indemnify convicted colleagues to find that their colleagues acted in "good faith," reasonably believing their conduct was in the "best interest of the corporation" (or in some states, "at least not opposed to the best interests"), and "had no reason to believe [their] conduct was unlawful."

In recent years, prosecution of strict liability offenses involving corporate executives has increased. Strict liability offenses were created in response to the danger to health and safety posed by the industrial revolution.[72] As the potential dangers from corporate action have increased, courts and legislatures have expanded strict liability offenses.[73] Congress has passed the Federal Food, Drug, and Cosmetic Act,[74] the Refuse Act,[75] and the Public Health Service Act,[76] all of which impose

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legal systems liability to conviction for serious crimes is made dependent, not only on the offender having done those outward acts which the law forbids, but on his having done them in a certain frame of mind or with a certain will . . . . Lawyers of the Anglo-American tradition use the Latin phrase *mens rea* (a guilty mind) as a comprehensive name for those necessary mental elements . . . ."). *See also* J. HALL, GENERAL PRINCIPLES OF CRIMINAL LAW 11-13 (1947); Lee, *Corporate Criminal Liability*, 28 COLUM. L. REV. 1 (1928). Considerable efforts have been devoted to defining "intent" or "mens rea." *See, e.g.*, H.L.A. HART, PUNISHMENT AND RESPONSIBILITY, *supra*, at 136-157; 1 BISHOP, CRIMINAL LAW § 287 (9th ed. 1930). For purposes of this Article, mens rea is used to signify "the mental element necessary to convict for any crime." Sayre, *Mens Rea*, 45 HARV. L. REV. 974 n.1 (1932).

71. With strict liability offenses, criminality is based only upon external behavior and irrespective of intent. Sayre, *Public Welfare Offenses*, 33 COLUM. L. REV. 55 (1933).

72. Morissette v. United States, 342 U.S. 246, 253-255, 72 S. Ct. 240, 96 L. Ed. 2d 288 (1952); Sayre, *Public Welfare Offenses*, *supra* note 71, 33 COLUM. L. REV. at 68.

73. Weiss-Malik, *Imposing Penal Sanctions on the Unwary Corporate Executive: The Unveiled Corporate Criminal*, 17 U. TOL. L. REV. 383, 387 (1986); McCormack, *The Tightening White Collar: Expanding Theories of Criminal Liability for Corporate Executives, Directors, and Attorneys*, 49 TEX. B.J. 494, 499 (1986); Metzger, *Corporate Criminal Liability for Defective Products: Policies, Problems, and Prospects*, 73 GEO. L.J. 1, 2-3 (1984); Brickey, *Criminal Liability of Corporate Officers for Strict Liability Offenses - Another View*, 35 VAND. L. REV. 1337, 1337-1338 (1982). *But see* Abrams, *Criminal Liability of Corporate Officers For Strict Liability Offenses - A Comment on Dotterweich and Park*, 28 UCLA L. REV. 463 (1981) (suggesting that criminal liability in these cases is based upon a finding of culpability, not strict liability).

74. 21 U.S.C. §§ 301-392 (1972 & Supp. 1990).

75. 33 U.S.C. § 407 (1986).

76. 42 U.S.C. §§ 261, 262 (1982 & Supp. 1990).

strict liability for criminal offenses. Since the Supreme Court's 1943 decision in *United States v. Dotterweich*,[77] courts also have been increasingly willing to hold corporate executives strictly liable for acts of their agents, even though the executives did not participate in the acts or have personal knowledge of them.[78]

*United States v. Park*[79] is perhaps the premiere decision demonstrating this expansive liability of corporate executives. Park was the Chief Executive Officer of ACME, a large national retail food chain with 36,000 employees, 16 warehouses, and 874 retail outlets.[80] ACME and Park were convicted for violations of the Food, Drug, and Cosmetic Act (FDCA) because of unsanitary conditions in one of the company warehouses.[81] The evidence indicated that Park was aware of the unsanitary conditions but had delegated the responsibility for remedying the situation to a corporate vice-president.[82] Convicted by a jury, Park secured a reversal from the court of appeals[83] only to see the Supreme Court reinstate his conviction.[84] The Supreme Court noted that "'[i]n the interest of the larger good,'"[85] the FDCA dispensed with the "'conventional requirement for criminal conduct—awareness of some wrongdoing.'"[86] It did so by imposing a duty on corporate executives to seek out and remedy violations, and to "implement measures that will insure that violations will not occur."[87] In affirming Park's conviction, the Supreme Court relied upon a long line of cases that approved criminal liability of managerial officers who had no knowledge of, or personal participation in, criminal acts, but who had a sufficient relationship to the corporation that they "had the power to prevent the act complained of."[88]

In addition to increased use of strict liability offenses, there is another trend in the criminal law, especially with regard to white collar prosecutions, that should make it easy to find that a convicted executive has met the standard for permissive indemnification. The courts have become increasingly receptive to allowing an inference of criminal mens

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77. 320 U.S. 277, 64 S. Ct. 134, 88 L. Ed 492 (1943).
78. *Id.* at 280-81, 64 S. Ct. at 136, 88 L. Ed at 51-52.
79. 421 U.S. 658, 95 S. Ct. 1903, 44 L. Ed. 2d 489 (1975).
80. *Id.* at 660, 95 S. Ct. at 1905, 44 L. Ed. 2d at 494.
81. *Id.* at 662-66, 95 S. Ct. at 1906-1908, 44 L. Ed. 2d at 495-97.
82. *Id.* at 663-64, 95 S. Ct. at 1907-1908, 44 L. Ed. 2d at 496.
83. *Id.* at 666, 95 S. Ct. at 1908, 44 L. Ed. 2d at 497.
84. *Id.* at 667, 95 S. Ct. at 1909, 44 L. Ed. 2d at 498.
85. United States v. Park, 421 U.S. 658, 668, 95 S. Ct. 1903, 1909-10, 44 L. Ed. 2d 489, 498-99. (1975) (quoting United States v. Dotterweich, 320 U.S. 277, 280-81 (1943)).
86. 421 U.S. at 668, 95 S. Ct. at 1909, 44 L. Ed. 2d at 498.
87. *Id.* at 672, 95 S. Ct. at 1911-12, 44 L. Ed. 2d at 501.
88. *Id.* at 671, 95 S. Ct. at 1911, 44 L. Ed. 2d at 500.

rea from reckless behavior by defendants. It should be noted, at the outset, that courts have cautioned that by permitting such an inference they are not allowing a conviction for recklessness,[89] but one wonders if this difference is lost when corporate officials are making an indemnification decision. The courts' increased willingness to allow inferences of criminal mens rea from recklessness can be seen by examining the evolution of the following four jury instructions that define various issues of intent: (1) specific intent,[90] (2) willfulness,[91] (3) guilty knowledge,[92] and (4) false and fraudulent.[93]

Until recently, most major crimes and certainly most white collar crimes have been viewed as "specific intent" crimes, requiring proof of specific intent to violate the law before one can be convicted.[94] In such cases, the jury is instructed that "specific intent . . . means more than the general intent to commit the act"[95] and that to prove specific intent, the government must demonstrate that "the defendant knowingly did an act which the law forbids, . . . purposely intending to violate the law."[96] The heavy burden this instruction places on the government becomes more obvious when one examines the jury instruction given when the crime is only a "general intent" crime. In "general intent" cases, the jury is instructed that the "law assumes that every person intends the natural consequences of his voluntary acts;" that this general intent may be "inferred from defendant's voluntary commission of the act forbidden by law . . . ;" and, that "it is not necessary to establish that the defendant knew that his act . . . was a violation of law."[97]

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89. *Cf.* United States v. Massa, 740 F.2d 629, 643 (8th Cir. 1984), *cert. denied*, 471 U.S. 1115, 105 S. Ct. 2357, 86 L. Ed. 2d 258 (1985) (In approving this jury instruction, the court rejected Massa's argument that the instruction allowed conviction on an objective or "should have known" theory, rather than on an assessment of Massa's subjective knowledge. The court noted that the jury was repeatedly told that it must find that Massa specifically intended his actions and that the jury was only allowed to infer this intent from Massa's "deliberate indifference.").

90. E. DEVITT & C. BLACKMAR, FEDERAL JURY PRACTICE AND INSTRUCTIONS, § 14.03 (3d ed. 1977).

91. *Id.* § 14.06.

92. *Id.* § 14.09.

93. *Id.* § 47.04 (Supp. 1990).

94. *See, e.g.*, United States v. Bohonus, 628 F.2d 1167, 1172 (9th Cir.), *cert. denied*, 447 U.S. 928, 100 S. Ct. 3026, 65 L. Ed. 2d 1122 (1980) (and cases cited therein) (holding that mail fraud, 18 U.S.C. § 1341, is a specific intent crime); United States v. Lange, 528 F.2d 1280, 1288 (5th Cir. 1976) (and cases cited therein) (holding that making a false statement to the government, 18 U.S.C. § 1001, is a specific intent crime).

95. E. DEVITT & C. BLACKMAR, *supra* note 90, § 14.03.

96. *Id.*

97. SEVENTH CIRCUIT JUDICIAL CONFERENCE COMMITTEE ON JURY INSTRUCTIONS, MANUAL ON JURY INSTRUCTIONS IN FEDERAL CRIMINAL CASES, 33 F.R.D. 523, 549-50 (1963).

By the 1970s, some of the federal courts openly criticized the distinction between general and specific intent crimes as obtuse and arcane. For example, in 1979 the United States Court of Appeals for the Seventh Circuit noted that "the labels 'specific intent' and 'general intent' . . . are not enlightening to juries."[98] By 1980 the United States Supreme Court had agreed that the distinction between general intent and specific intent "has been the source of a good deal of confusion."[99] In response, the United States Courts of Appeals for the Seventh,[100] Eighth,[101] and Ninth Circuits,[102] have recommended discontinuing the distinction between general intent and specific intent crimes. They recommend, instead, that "instructions be given which define the precise mental state required by the particular offense charged."[103]

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It is interesting to consider the historical and policy significance of the general and specific intent instructions. Sayre, *Mens Rea*, *supra* note 70, 45 HARV. L. REV. 974 (1932) provides a good background for doing so. In tracing the historical development of the notion of intent, Sayre suggests that gradations of intent (such as "specific intent") developed during the thirteenth to seventeenth centuries but may not be useful in our more modern criminal justice system. *Id.* at 1016-1017.

98. United States v. Arambasich, 597 F.2d 609, 611-613 (7th Cir. 1979) (footnotes & citations omitted):

> We are inclined to agree with the district judge . . . that the labels "specific intent" and "general intent". . . are not enlightening to juries . . . . The stock "specific intent" instructions tendered by [the defendant] are based upon decided cases and have been approved in countless others. Yet they illustrate if not the "variety" or "disparity," the confusion of [judicial] definitions of the requisite but elusive mental element . . . . It is not very helpful to speak of a defendant's purpose to violate the law, as do these stock instructions. Use of the phrase "purposely intending to violate the law" may be erroneously interpreted by jurors, for example, to require that the defendant know his act violates a criminal statute, which is ordinarily unnecessary.

*See also* COMMITTEE ON FEDERAL CRIMINAL JURY INSTRUCTIONS, FEDERAL CRIMINAL JURY INSTRUCTIONS OF THE SEVENTH CIRCUIT, § 6.02 (1980) [hereinafter SEVENTH CIRCUIT PATTERN INSTRUCTIONS]; MANUAL OF MODERN CRIMINAL JURY INSTRUCTIONS FOR THE NINTH CIRCUIT, comments to § 5.04 (1989) [hereinafter NINTH CIRCUIT PATTERN INSTRUCTIONS]; MODEL PENAL CODE § 2.02 comment, at 125 (Tent. Draft No. 4, 1955) (specific intent is an "awkward term").

99. United States v. Bailey, 444 U.S. 394, 398-414, 100 S. Ct. 624, 628-636, 62 L. Ed. 2d 575, 583-593 (1980), on remand 675 F.2d 1292 (D.C. Cir.), *cert. denied sub nom.* Walker v. United States, 459 U.S. 853, 103 S. Ct. 119, 74 L. Ed. 2d 104 (1982).

100. SEVENTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, § 6.02 ("The Committee recommends avoiding instructions that distinguish between 'specific intent' and 'general intent.'").

101. MANUAL OF MODEL CRIMINAL JURY INSTRUCTIONS FOR THE DISTRICT COURTS OF THE EIGHTH CIRCUIT § 7.01 (1989) [hereinafter EIGHTH CIRCUIT PATTERN INSTRUCTIONS].

102. NINTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, at 72. ("The Committee recommends avoiding instructions that distinguish between 'specific intent' and 'general intent.'").

103. *Id.* at 74. *See also* SEVENTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98,

The demise of the specific intent instruction has been accompanied by erosion of another instruction that heretofore imposed a heavy mens rea burden on the government. Historically, juries in most criminal cases have been instructed that the government must prove that the defendant acted "willfully," even if "willfully" is not included in the offense charged.[104] Traditionally, "willfully" has been defined as acting "voluntarily and intentionally, and with the specific intent to do something the law forbids; that is to say, with bad purpose either to disobey or to disregard the law."[105] Recently, courts have condemned the "frequent" practice of including willfully in indictments and of instructing juries on willfulness, when this language is not a statutory element.[106] Furthermore, when giving an instruction on willfulness, some courts are using a definition of willfully that omits the strident specific intent language and defines willfully instead, as "intentional disobedience of [the law] *or reckless disregard* of its requirements."[107]

The Supreme Court has suggested a way of determining when this reduced definition of willfully should be used: for "offenses involving moral turpitude," the more stringent definition should be given, but for offenses "denouncing acts not in themselves wrong" the reckless disregard definition should be given.[108] Even this distinction may not wear well, however, for it is in the criminal tax offenses, which are typical malum prohibitum offenses, that the more stringent willfulness definition is still given.[109] Perhaps the only clear thing that can be said about the term

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§ 6.02; EIGHTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 101, § 7.01. Although Devitt and Blackmar, leading authorities on federal jury instructions, agree with many of the criticisms of the distinction between general and specific intent, they caution the practitioner against discarding the specific intent instruction altogether. ("The authors feel that there is great merit in the suggestions, and will attempt to report instructions applying the Seventh Circuit approach [of discontinuing use of the specific intent instruction] as they appear. There, of course is a danger in discarding established formulation, especially when specific requests are made.") E. DEVITT & C. BLACKMAR, *supra* note 90, § 14.03 notes (Supp. 1990).

104. For reference to this trend see SEVENTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, at § 6.03; NINTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, at 76.

105. E. DEVITT & C. BLACKMAR, *supra*, note 90, § 14.06; United States v. Patrick, 542 F.2d 381 (7th Cir. 1976), *cert. denied*, 430 U.S. 931, 97 S. Ct. 1551, 51 L.Ed.2d 775 (1977).

106. SEVENTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, § 6.03; NINTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, at 76.

107. United States v. Jones, 735 F.2d 785, 789 (4th Cir.) (emphasis added) (and cases cited therein), *cert. denied*, 469 U.S. 918, 105 S. Ct. 297, 83 L. Ed. 2d 232 (1984).

108. United States v. Illinois Central Railroad Co., 303 U.S. 239, 242-43, 58 S. Ct. 533, 535, 82 L. Ed. 773, 776-777 (1938)

109. For example, tax evasion (26 U.S.C. § 7201 (1989)), making a false tax return (26 U.S.C. § 7206(1) (1989)), and disclosing a false tax return (26 U.S.C. § 7207 (1989))

"willfulness," is that its meaning is not clear.[110] To the extent however, that courts are being admonished to give this instruction less often and are allowed to provide a diluted version of it in at least some cases, the strident version of this instruction may be one less hurdle the government must overcome in proving criminal mens rea.

The erosion of the strongly worded "specific intent" and "willfulness" instructions has been accompanied by increasing usage, at least in white collar criminal cases, of two instructions that make it easier to infer criminal mens rea from recklessness. The "guilty knowledge" instruction,[111] developed in the early 1970s from mens rea definitions in the Model Penal Code (MPC)[112] allows the jury[113] to infer that the defendant had actual knowledge of facts from "proof that a defendant deliberately closed his eyes to what would otherwise have been obvious to him."[114] A common definition of recklessness is "consciously disregard[ing] a substantial and unjustifiable risk."[115] Using this definition,

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all include "willfully" as an element. The "longstanding interpretation" of willfully in these cases is "bad faith or evil intent, . . . evil motive and want of justification in view of all the financial circumstances of the taxpayer." United States v. Bishop, 412 U.S. 346, 360, 93 S. Ct. 2008, 2017, 36 L. Ed. 2d 941, 951 (1973); *see also* United States v. Pomponio, 429 U.S. 10, 12, 97 S. Ct. 22, 23-24, 50 L. Ed. 2d 12, 15-16 (1976).

110. In part, the recommendation of the United States Court of Appeals for the Seventh Circuit not to give this instruction unless specifically included in the offense is because of the inconsistent application of it. SEVENTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, at 85.

111. E. DEVITT & C. BLACKMAR, *supra* note 90, § 14.09; NINTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, § 5.07.

112. MODEL PENAL CODE § 2.02 (Proposed Official Draft 1962). *See* United States v. Jacobs, 475 F.2d 270, 287 (2d Cir. 1973), *cert. denied sub. nom.* Thaler v. United States, 414 U.S. 821, 94 S. Ct. 116, 38 L. Ed. 2d 53 (1973) for a history of the development of this instruction and cases approving its use.

113. United States v. Picciandra, 788 F.2d 39, 46 (1st Cir.), *cert. denied*, 479 U.S. 847, 107 S. Ct. 166, 93 L. Ed. 2d 104 (1986).

114. E. DEVITT & C. BLACKMAR, *supra* note 90, § 14.09. There are various formulations of this instruction, *see, e.g.*, NINTH CIRCUIT PATTERN INSTRUCTIONS, *supra* note 98, § 5.07 ("You may find that the defendant acted knowingly if you find beyond a reasonable doubt that the defendant was aware of a high probability that [the facts relevant to the offense] and deliberately avoided learning the truth."); United States v. Gabriel, 597 F.2d 95, 100 (7th Cir.), *cert. denied*, 444 U.S. 858, 100 S. Ct. 120, 72 L. Ed. 2d 78 (1979) ("Knowledge may be proven by defendant's conduct, and by all the facts and circumstances surrounding the case. No person can intentionally avoid knowledge by closing his eyes to facts which should prompt him to investigate."); United States v. Dozier, 522 F.2d 224, 226 (2d Cir.), *cert. denied*, 423 U.S. 1021, 96 S. Ct. 461, 46 L. Ed. 2d 394 (1975) ("If you find from all the evidence beyond a reasonable doubt . . . that [the defendant] had a conscious purpose to avoid finding out the identity of the substance so as to close her eyes to the facts, you could find sufficient evidence to find her guilty beyond a reasonable doubt.").

115. MODEL PENAL CODE § 2.02(2)(c) (Proposed Official Draft 1962). The Model

deliberately closing one's eyes to what would otherwise be obvious is behaving "recklessly." First given in a bank fraud case in 1899,[116] this "guilty knowledge" instruction was not included in the standard criminal jury instructions until the mid-1970s.[117] Since then, its use has increased dramatically, especially in white collar criminal cases.[118] Defendants have opposed this instruction on the ground that it allows a conviction for negligence[119] and for recklessness.[120] The courts have rejected such arguments, reasoning that this instruction merely allows the jury to draw an inference of knowledge from the defendant's "deliberate avoidance" of essential facts.[121]

Significantly, this instruction is not deemed to be appropriate in all criminal cases, but only in cases in which a defendant claims a lack of knowledge of the crime and the facts suggest a conscious course of ignorance.[122] Although this factual predicate will not exist in every criminal case, it will exist in many, if not most, white collar criminal cases.

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Penal Code defines recklessly as:

> [C]onsciously disregard[ing] a substantial and unjustifiable risk that the material element [of the offense] exists or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.

*Id.*

116. Spurr v. United States, 174 U.S. 728, 735, 19 S. Ct. 812, 815, 43 L. Ed. 1150, 1153 (1899).

117. This instruction was not included in the second edition, published in 1970, of E. DEVITT & C. BLACKMAR, FEDERAL JURY PRACTICE AND INSTRUCTIONS (2d ed. 1970). By 1977, when the third edition was published, this instruction was included. E. DEVITT & C. BLACKMAR, *supra* note 90, § 14.09. This instruction is based upon United States v. Brawer, 482 F.2d 117, 128-30 (2d Cir. 1973), *on remand*, 367 F. Supp. 156, *appeal after remand*, 496 F.2d 703, *cert. denied*, 419 U.S. 1051, 95 S. Ct. 628, 42 L. Ed. 2d 646 (1974)

118. In FEDERAL JURY PRACTICE AND INSTRUCTIONS, Devitt and Blackmar assemble many of the significant citations regarding the jury instructions. A review of the annotations following the "guilty knowledge" instruction reveals that the newer cases are increasingly white collar criminal cases. (*See* "Notes" following Instruction 14.09 in E. DEVITT & C. BLACKMAR, *supra* note 90 (3d ed. 1977 and Supp. 1990).

119. *Massa*, 740 F.2d at 642-43; United States v. Natelli, 527 F.2d 311, 322 (2d Cir. 1975), *cert. denied*, 425 U.S. 934, 96 S. Ct. 1663, 48 L. Ed. 2d 175 (1976).

120. *Cf.* United States v. Evans, 559 F.2d 244, 246 (5th Cir. 1977), *cert. denied*, 434 U.S. 1015, 98 S. Ct. 731, 54 L. Ed. 2d 759 (1978). (The defendant argued that by focusing on reckless disregard, this instruction did not require proof of knowledge. The court rejected Evans' argument.)

121. *See, e.g.*, United States v. Cincotta, 689 F.2d 238, 243 n.2 (1st Cir.), *cert. denied sub nom.* Zero v. United States, 459 U.S. 991, 103 S. Ct. 347, 74 L. Ed. 2d 387 (1982); United States v. Ciampaglia, 628 F.2d 632, 642 (1st Cir.), *cert. denied*, 449 U.S. 956, 101 S. Ct. 365, 66 L. Ed. 2d 221 (1980).

122. *See, e.g., Picciandra*, 788 F.2d at 46; *Ciampaglia*, 628 F.2d at 642-43.

In these cases the criminal acts are usually fully documented in a paper trail, thus a white collar defendant can rarely deny that the alleged conduct occurred. Instead, the more common defense is to claim lack of knowledge. Because white collar criminal cases are often complex and involve voluminous documents and numerous regulations, such a claim of ignorance may be credible even when asserted by proficient business executives. Once a defendant claims such a lack of knowledge he has laid part of the factual predicate for this "guilty knowledge" instruction. Predictably, the government then attempts to prove that if the defendant was as unaware as he claims, he was "deliberately ignorant." This "counter-attack" by the government supplies the remaining factual predicate needed to make this instruction appropriate (facts that suggest a conscious course of ignorance). In this manner, the "guilty knowledge" instruction becomes appropriate in most white collar criminal cases.

The last instruction that demonstrates the trend of according the government greater latitude in proving criminal mens rea is the definition of "false or fraudulent," which is used almost exclusively in white collar criminal cases.[123] This instruction allows the jury to infer criminal mens rea from a defendant's recklessness by defining a "false or fraudulent" representation as "[a] representation . . . known to be untrue, or made with reckless indifference as to its truth or falsity, . . . ."[124] The "reckless indifference" language was added in the 1970s because, in the words of one court, "reckless indifference for the truth can be fraudulent."[125]

*Irwin v. United States*[126] demonstrates the applicability of this definition. The defendants, Irwin and Kerns, were indicted on mail fraud charges stemming from allegedly false representations that they made regarding the profitability of franchises they were selling.[127] Kerns argued that Irwin gave him the information in question and that he (Kerns) had no actual knowledge of any falsity in the representations when he repeated them. The Court rejected Kerns' argument and affirmed his conviction stating that at a minimum, "Kerns acted with reckless disregard

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123. This definition is given as part of the instructions for mail fraud, 18 U.S.C. § 1341 (1984 & Supp. 1990). *See* E. DEVITT & C. BLACKMAR, *supra* note 90, § 47.04.

124. E. DEVITT & C. BLACKMAR, *supra* note 90, § 47.04 (Supp. 1990).

125. United States v. Frick, 588 F.2d 531, 536 (5th Cir.,) *cert. denied*, 441 U.S. 913, 99 S. Ct. 2013, 60 L. Ed. 2d 385 (1979). E. Devitt and C. Blackmar indicate that they added "reckless indifference" to the definition of falsity in their second edition of FEDERAL JURY PRACTICE AND INSTRUCTIONS, published in 1970. E. DEVITT & C. BLACKMAR, *supra* note 90, at 305 (3d ed. 1977).

126. 338 F.2d 770 (9th Cir. 1964), *cert. denied*, 381 U.S. 911, 85 S. Ct. 1530, 14 L. Ed. 2d 433 (1965).

127. *Id.* at 772.

as to whether the representations he made were true or false."[128] According to the court, "the purpose [of this instruction] is to prevent an individual . . . from circumventing criminal sanctions merely by deliberately closing his eyes to the obvious risk he is engaging in unlawful conduct. . . ."[129] Notably, this instruction has been approved even when the indictment appeared to charge a higher level of mens rea, namely, that the defendant made the allegedly false statements "well knowing" they were false.[130]

In summary, the changes in these four criminal intent instructions reflect a trend toward diluting the government's burden of proving criminal intent. The "specific intent" instruction, with its emphasis on "purposely intending to violate the law," is being phased out. The "willfulness" instruction's reference to "specific intent to do something the law forbids" appears to be fading and is being replaced with a diluted version of "willfully" that equates willfulness with "reckless disregard of the law." Simultaneously, at least in the white collar criminal cases, there is increasing use of the "guilty knowledge" instruction which allows a jury to infer knowledge of facts from evidence that the defendant deliberately closed his eyes to what was obvious. To the extent that deliberately closing one's eyes to the obvious is behaving "recklessly," this instruction arguably allows an inference of criminal mens rea from recklessness. The definition of "false or fraudulent representation" further facilitates inferences of criminal mens rea from recklessness by defining a false or fraudulent representation as one made with reckless disregard for truth or falsity.

Whether the combined effect of these changes in intent instructions improperly reduces the government's burden of proving intent or properly acknowledges the unusual nuances of white collar crimes, is not the subject of this Article. Rather, the relevant issue is the impact these instructions have on permissive indemnification. The typical criminal case is concluded with a simple verdict of guilty or not guilty; no findings of fact are issued that shed additional light on whether or not the defendant meets the standards for permissive indemnification[131] despite her conviction. To assess whether a convicted corporate executive meets these standards, those making the indemnification decision will have to

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128. *Id.* at 774.

129. United States v. Sarantos, 445 F.2d 887, 881 (2d Cir. 1972).

130. *See, e.g.*, United States v. Love, 535 F.2d 1152, 1157-1158 (9th Cir.), *cert. denied*, 429 U.S. 847, 97 S. Ct. 130, 50 L. Ed. 2d 119 (1976).

131. Generally, the only time in which specific findings of fact are issued in a criminal case is after a bench trial when the court lists its specific findings. Even in this situation, the written findings may not directly address the exact inquiry necessary to assess an executive's qualification for indemnification.

look beyond the simple verdict to the charges, to the evidence and to the applicable law on mens rea. When these individuals do so and observe a strict liability offense or the use of jury instructions that allow an inference of criminal mens rea from recklessness, it is possible, perhaps inevitable, that they will determine that the convicted executive meets all qualifications for permissive indemnification. Moreover, such a determination is even more likely if those making it are sympathetic to the executive seeking indemnification. This potential sympathy leads to the next issue — the procedure for authorizing permissive indemnification.

### *b. Procedure for authorizing permissive indemnification*

All but four states[132] provide that at least the following three types of individuals can authorize indemnification: directors who were not parties to the proceeding in question,[133] legal counsel, and shareholders.[134]

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132. Neither Massachusetts' nor Vermont's incorporation statutes specify the procedure for authorizing indemnification. MASS. GEN LAWS ANN. ch. 156B, § 67 (West 1970 & Supp. 1990); VT. STAT. ANN. tit. 11, § 1852(15) (1984). Utah provides for only two of the three authorizing options provided in the other statutes. UTAH CODE ANN. § 16-10-4(d) (1987 & Supp. 1990). California does not include legal counsel as an authorizing official. Its statute provides that directors, shareholders, or the court before whom the proceeding is pending may authorize the indemnification. CAL. CORP. CODE § 317(e) (West 1977 and Supp. 1990).

133. Twenty state statutes provide another mechanism by which a committee of at least two directors who are not parties to the proceeding in question but are chosen by the other directors, including those who are or were parties, may authorize indemnification. This committee is appointed only if a quorum of directors who were not parties to the action suit or proceeding is unavailable. The RMBCA's provision, followed by all twenty states, provides:

> [I]f a quorum cannot be obtained . . ., by majority vote of a committee duly designated by the board of directors (in which designation directors who are parties may participate), consisting solely of two or more directors not at the time parties to the proceeding . . . . [may authorize indemnification].

RMBCA § 8.55(b)(2) (1984). The States including this option are Florida, Georgia, Indiana, Kentucky, Maryland, Michigan, Minnesota, Mississippi, Montana, New Mexico, North Carolina, North Dakota, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Virginia, Washington, and Wyoming. *See supra* note 11 for statutory citations.

134. The Delaware statute provides typical phrasing of these options:

> Any indemnification [under this chapter and unless ordered by a court] shall be made by the corporation only as authorized in the specific case upon a determination that indemnification . . . is proper in the circumstances because he has met the applicable standard of conduct [set forth in the statute]. Such determination shall be made (1) by the board of directors by a majority vote of a quorum, consisting of directors who were not parties to such action, suit or proceeding, or (2) if such a quorum is not obtainable, or, even if obtainable a quorum of disinterested directors so directs, by independent legal counsel in

Seven state codes also provide that the court before whom the proceeding is pending may authorize indemnification.[135]

If directors are to determine the propriety of allowing permissive indemnification, most statutes require that there be a majority vote of a quorum of directors who were not parties in the proceedings. It is questionable whether it is humanly possible, even for directors not involved in the proceedings, to be objective in authorizing indemnification for one of their peers. Not only are these directors likely to be friends and colleagues of those seeking indemnification,[136] but they may believe it to be in their self-interest to create a favorable precedent of generous indemnification.

Designating legal counsel as an authorizing official when disinterested directors are not available does not avoid the possibility of bias. Admittedly the indemnification statutes specify that legal counsel should be "independent"[137] or "special," but beyond this very general ad-

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a written opinion, or (3) by the stockholders.

DEL. CODE ANN. § 145(d) (1983 & Supp. 1988).

It should be noted that there are a few additional variations to the three-part option generally provided. Alabama provides that the directors authorizing indemnification cannot be parties to the proceeding or parties who "have been 'wholly successful on the merits or otherwise' with respect to . . . such claim, action, suit or proceeding . . . ." ALA. CODE § 10-2A-21(d)(1) (1987). Connecticut provides that if the executive seeking indemnification is an employee or agent who is not an officer or director of the corporation, the corporation's general counsel may authorize the indemnification. CONN. GEN. STAT. ANN. § 33-320a(d)(3) (West 1987). Wisconsin provides the following option:

> [A] panel of 3 arbitrators consisting of one arbitrator selected by [disinterested directors], one arbitrator selected by the director or officer seeking indemnification and one arbitrator selected by the 2 arbitrators previously selected.

WIS. STAT. ANN. § 180.046(3) (West Supp. 1990).

135. California's provision is typical:

> [I]ndemnification . . . shall be made by the corporation . . . upon a determination that . . . the [executive seeking indemnification] has met the applicable standard of conduct set forth in [the statute] by . . . [t]he court in which such proceeding is or was pending . . . .

CAL. CORP. CODE § 317(e) (West 1977 & Supp. 1990). The other states allowing some version of this option are Arizona, Colorado, Hawaii, Minnesota, North Dakota, and Ohio. *See supra* note 11 for statutory citations.

136. Herman, CORPORATE CONTROL, CORPORATE POWER 194-195 (1981); Modic, *CEOs Prefer CEOs*, INDUSTRY WK 28 (May 2, 1988); *cf.* Arnold & O'Callaghan, *The New Board of Directors: A Survey of Canadian Chief Executive Officer's*, BUS. Q. 77, 79 (Summer 1988) (One CEO of a Canadian financial institution stated, "There are about 250 experienced Canadian directors and on this small group falls all of the demands for board skill and constituency representation.").

137. The following twenty-eight states declare that the counsel making this determination must be "independent legal counsel: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Kansas, Louisiana, Maine, Michigan, Nebraska, Nevada, New Hampshire, New York, Ohio, Okla-

monition all but two of the indemnification statutes are silent.[138] Ohio specifies that the "independent legal counsel" shall be "other than an attorney, or a firm having associated with it an attorney, who has been retained by or who has performed services for the corporation or any person to be indemnified within the past five years."[139] Minnesota's provision also refers to past contact with the corporation or its executives. It provides that "special legal counsel" is "counsel who has not represented the corporation or [a person] whose indemnification is in issue."[140] While commendable, these restrictions are still too narrow. They focus only on past relationships to a corporation or its executives; they fail to acknowledge the temptation of future business. In almost every instance,[141] directors choose the attorney who is to make the indemnification determination. Even the most noble attorneys among us would have difficulty resisting the lure of new corporate business by failing to satisfy the directors who retained our services. When it is apparent that these directors believe indemnification is proper, one suspects that few attorneys, however "independent" or "special," would disallow indemnification.[142]

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homa, Pennsylvania, South Dakota, Tennessee, West Virginia, Wisconsin. *See supra* note 11 for statutory citations.

138. The following eighteen states declare that counsel must be "special legal counsel": Georgia, Indiana, Iowa, Kentucky, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Carolina, North Dakota, Oregon, Rhode Island, South Carolina, Texas, Washington, Wyoming, Virginia. *See supra* note 11 for statutory citations.

Although the provisions for the RMBCA do not elaborate on what is meant by "special legal counsel" the comments to § 8.55 provide that "'special legal counsel' should normally be counsel having no prior professional relationship with those seeking indemnification, should be retained for the specific occasion, and should not be either inside counsel or regular outside counsel." RMBCA Official Comments to § 8.55, 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 58, at 1130.

To the extent this comment addresses more than past relationships, it is an improvement over both the Ohio and Minnesota statutory explanations, (*see infra* text accompanying notes 139 and 140) but because this restriction is in the comment, rather than the statute itself, it is not as binding on courts as if it was part of the statute. Moreover, its reference to bias from present or future business is quite narrow and attorneys other than "inside counsel or regular outside counsel" may succumb, again even subconsciously, to the lure of new business. Lastly, this entire admonition may be neutralized by the next sentence in the comments: "It is important that the selection process be sufficiently flexible to permit selection of counsel in light of the particular circumstances and so that unnecessary expense may be avoided." *Id.*

139. OHIO REV. CODE ANN. 1701.13(E)(4)(b) (Baldwin 1986 & Supp. 1990).

140. MINN. STAT. ANN. § 302A.521 subd. 1(e) (West 1985 & Supp. 1990).

141. The incorporation statutes of forty states (all states except Alabama, Alaska, California, Hawaii, Massachusetts, Nebraska, New Hampshire, Utah, and Vermont) specifically state that the directors may choose the "independent" or "special" legal counsel who is to make the indemnification decision. *See supra* note 11 for statutory citations.

142. Bishop refers to the "uncertainty" in the "independence" of "independent

*c. The exclusivity provision*

It is with the exclusivity provision that the "patchwork"[143] nature of corporate indemnification begins to become apparent. Even if directors, legal counsel, shareholders or a court determine that a convicted executive does not qualify for indemnification pursuant to the statutory standards for mandatory and permissive indemnification, all is not lost for the convicted executive. In the jurisdictions governed by a nonexclusive statute, the corporation may still indemnify the convicted executive pursuant to bylaws, corporate resolutions, or contracts negotiated with the executive. Moreover, none of these options must comply with the restrictions for indemnification set forth in the statute. Almost three-fifths of the states have followed Delaware's lead of opting for the most expansive indemnification possible by passing the following provision: "The indemnification authorized by this [statute] shall not be exclusive of, and shall be in addition to, any other rights granted to those seeking indemnification under the articles or regulations or any agreement, vote of shareholders or disinterested directors, or otherwise. . . ."[144] As noted, only two states, Minnesota and North Dakota, have limited the power of corporations to grant indemnification that exceeds the restrictions in the statute.[145]

The RMBCA has pioneered an approach on indemnification that has been followed in nine states.[146] In 1980 the RMBCA amended its exclusivity provision by substituting its broad, Delaware-like statement[147]

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legal counsel":

> No one need question the honesty of these darlings of corporate draftsmen: the problem rather is that those who choose them are pretty sure to favor a lawyer who has acquired in the course of a corporate practice a sympathetic understanding of the problems of corporate management. It is not easy for even a lawyer of the most rugged integrity to be harsh to people who were responsible for his retainer. But in fact counsel may well be a regular associate and friend of the defendants: "independent" may turn out to mean nothing more than he is not an employee of the corporation.

Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1079-80.

143. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 WIS. L. REV. at 517 (referring to indemnification of directors and officers, in general, as "a patchwork of state corporation and insurance codes, court and agency interpretations of various federal securities statutes, and federal and state doctrines of contractual waiver.")

144. *See supra* note 25.

145. *See supra* note 26.

146. *See supra* notes 28-30 and accompanying text.

147. The Model Business Corporation Act provides as follows:

> The indemnification provided by this section shall not be deemed exclusive of any other rights to which those indemnified may be entitled under any by-law, agreement, vote of shareholders or disinterested directors.

§ 5(f) (1971).

on nonexclusivity for a provision that allows corporations to indemnify directors outside the statute "only if and to the extent [such] provision is consistent with this subchapter."[148] Under the RMBCA, therefore, corporations may still indemnify convicted directors outside the statute if such indemnification is "consistent with" the statutory requirements for indemnification. Indemnification will be "consistent with" the statute if the executive is found to have acted "in good faith," with the reasonable belief "that his conduct was in the best interests of the corporation,"[149] and with "no reasonable cause to believe his conduct was unlawful."

The Official Comments to the RMBCA explain that this change was made to more accurately reflect the fact that "nonstatutory conceptions of public policy limit the power of a corporation to indemnify or to contract to indemnify directors, officers, employees or agents."[150] Although it is encouraging to see attention given to public policy as a restriction on indemnification, there are two major problems with the RMBCA revision, in the context of criminal convictions. First, it is not clear how this provision applies to the criminally convicted executive. The Official Comments explain that "[i]t is important to recognize that 'to the extent it is consistent with' is not synonymous with 'exclusive.'"[151] If the "consistent with" language is meant to establish a minimum limit, prohibiting corporations from adopting indemnification policies less generous than the RMBCA, this language is fairly clear and most likely prevents corporations from executing bylaws, resolutions, or contracts that categorically disallow indemnification for executives convicted of criminal offenses. Such a bylaw, resolution or contract would be less generous than the statute since, as we have seen, both the standards and procedures for allowing permissive indemnification leave plenty of room for a convicted executive to qualify for indemnification.

However, to the extent the "consistent with" language establishes a maximum limit prohibiting corporations from adopting an indemnification policy that exceeds the indemnification in the statute, the meaning of this provision becomes murky. Although the Comments state that there are "situations" that "may well develop . . . in which indemnification is permissible under [the consistent with provision] but would be precluded if all portions of [the indemnification statute] were viewed

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148. *See supra* note 30 for the full text of this statutory provision and its comparison to a similar provision regarding corporative executives who are not directors.

149. RMBCA § 8.51 (1984).

150. RMBCA Official Comments to § 8.58, 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 58, at 1139.

151. *Id.*

as exclusive,"[152] it is difficult to imagine any criminal situations that would so qualify without substantial skill at doublespeak. If a convicted executive cannot meet the standards of the RMBCA for indemnification (i.e., the mandatory or permissive standards) and thus the statute precludes indemnification to him, it is hard to see how this executive could still qualify for indemnification under any circumstance that is still consistent with the RMBCA's standards. The confusion is compounded by section 8.54(2) of the RMBCA which allows a court to grant indemnification if a director is "fairly and reasonably entitled to indemnification in view of all relevant circumstances," even though the director may not have met the mandatory or permissive standards.[153] If the "consistent with" requirement of section 8.58 governs all provisions of the indemnification subchapter, including section 8.54(2), it would appear that court-ordered indemnification to an executive who cannot meet the statutory standards is not "consistent with" the RMBCA, regardless of how "fair and reasonable" indemnification may seem. On the other hand, if section 8.58 is inapplicable to section 8.54(2) and a court is not obliged to order only indemnification that is consistent with the RMBCA, then the RMBCA ends up being nonexclusive, but only when a court, rather than the corporation, exceeds the statute. If this latter interpretation of the "consistent with" language in section 8.58 is correct and if the executive can find a court that believes indemnification to him is "fair and reasonable," section 8.54(2) provides a small window of opportunity for the convicted executive who fails to meet the RMBCA's statutory standards to obtain indemnification.

Looking further for the possible meaning of the "consistent with" language in the context of criminal convictions, it is possible that the "consistency" requirement pertains only to procedural matters rather than to substantive consistency with the mandatory and permissible standards. The Official Comments lend support to this view. They state that the consistency requirement "does not preclude provisions in articles of incorporation, by-laws, resolutions, or contracts designed to provide procedural machinery different from that [in the statute]."[154] This tautology tells us little, for unless the procedure is identical to that in the statute, it is by definition different. The real question is how different the procedure may be and still be "consistent with" the RMBCA. For example, the RMBCA requires that the directors who authorize the indemnification must be a majority of a quorum of directors who were

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152. RMBCA Official Comments to § 8.58, 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 58, at 1139.

153. RMBCA § 8.54(2) (1984).

154. RMBCA Official Comments to § 8.58, 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 58, at 1140.

not parties to the proceeding in question. One wonders: is it "consistent with" the RMBCA if less than a majority of disinterested directors authorize indemnification? Or, is it sufficient if the authorizing directors are the individuals seeking indemnification? One would think that neither of these procedural deviations would be allowed, but neither the exclusivity provision itself nor the Comments provide guidance.

If, in fact, the RMBCA drafters simply intended for the "consistent with" language to highlight the fact that principles of public policy restrict any indemnification, it seems that the following provision, adopted by the RMBCA for officers, is more to the point:

> A corporation may also indemnify and advance expenses. . . .to the extent, *consistent with public policy*, that may be provided by its articles of incorporation, bylaws, general or specific action of its board of directors, or contract.[155]

In addition to its lack of clarity, the other major problem with the RMBCA's exclusivity provision is that it erroneously assumes that principles of public policy, as applied by the courts, are an effective limitation on indemnification. Such an assumption is questionable for two reasons. First, courts may not get the opportunity to exercise supervision over indemnification awards. The primary mechanism for challenging the propriety of a particular indemnification award in the courts is a shareholder derivative suit alleging that use of corporate assets to pay such indemnification is improper.[156] However, if the shareholders do not know of the indemnification they cannot challenge it. As discussed infra,[157] under current indemnification statutes and practices, shareholders usually do not know when a corporation has indemnified its executives, even when those executives have been convicted of crimes. The second reason that the courts' application of principles of public policy is an ineffective check on improper indemnification is that the courts' interpretation and application of these principles has been erratic.[158]

The idea that public policy considerations should limit a corporation's power to indemnify directors and officers grew out of insurance law.[159]

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155. RMBCA § 8.56(3) (1984) (emphasis supplied).

156. Note, *Insurance for Executives*, *supra* note 8, 80 HARV. L. REV. at 667-68 and 665.

157. *See infra* notes 216-20 and accompanying text.

158. *See, e.g.*, Johnston, *Indemnification and Insurance*, *supra* note 8, 33 BUS. LAW. at 2024-29 (discussing the inconsistent way courts have applied principles of public policy regarding insurance coverage for intentional acts).

159. McNeely, *Illegality As A Factor in Liability Insurance*, 41 COLUM. L. REV. 26 (1941). "Throughout its history the insurance device has been alternately hailed as a promoter of communal welfare and damned as a generator of evil." *Id.* This fascinating

As early as 1837, courts refused to allow insurance coverage for willful acts.[160] However, the courts' transference of this principle of insurance law to corporate indemnification has been inconsistent. Some courts strictly maintain that such indemnification for willful acts is against public policy. *Globus v. Law Research Service, Inc.*[161] demonstrates this approach. Noting that one cannot insure himself against his own reckless, willful, or criminal misconduct,"[162] the United States Court of Appeals for the Second Circuit held that "it would be against the public policy"[163] to allow a party who had actual knowledge of material misstatements to receive corporate indemnification.[164] *Associated Milk Producers, Inc. (AMPI) v. Parr*[165] further demonstrates the application of this principle in the criminal context. Parr, an officer of AMPI, sought indemnification from AMPI for $12,500.00 in criminal fines and $36,620.60 in legal fees and expenses which he incurred in unsuccessfully defending himself against federal conspiracy bribery charges.[166] Parr argued that he qualified for indemnification under an AMPI bylaw that required indemnification for "any loss for any matters performed for or on behalf of the Association in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the Association."[167] The court found that Parr genuinely believed that the political contributions at issue were "in the best interest of AMPI or at least not opposed to these interests" and that the officers and at least some directors of AMPI shared this belief. However, the court refused to find that Parr

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article chronicles several striking examples of this fact, to wit, life insurance was originally banned in many countries "as gambling on lives and encouraging murders," and fire insurance was condemned because it "was a temptation to commit arson or, at the least, to speculate." *Id.*

For sources discussing the common law rule that indemnification and insurance are not available for fraudulent or willful misconduct, see Johnston, *Indemnification and Insurance*, *supra* note 8, 33 BUS. LAW at 2006; Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1414-15.

160. Waters v. Merchants Louisville Ins. Co., 11 Pet. 213 (U.S. 1837); *see, e.g.*, COUCH, 9 COUCH ON INSURANCE § 39:15 (2d ed. 1985); 1B APPLEMAN, INSURANCE LAW & PRACTICE § 451 (1981).

161. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913, 90 S. Ct. 913, 25 L. Ed. 2d 93 (1970).

162. *Id.* at 1288.

163. *Id.* (quoting the trial court decision in this case, Globus v. Law Research Service, Inc., 287 F. Supp. 188, 199 (S.D.N.Y. 1968)).

164. For other cases taking this position, *see, e.g.*, Odette v. Shearson, Hammill & Co., 387 F. Supp. 163, 168 (D. Del. 1974); Gould v. American-Hawaiian Steamship Co., 394 F. Supp. 946, 957 (S.D.N.Y. 1975).

165. 528 F. Supp. 7 (E.D. Ark. 1979).

166. *Id.* at 7-8.

167. *Id.* at 7.

acted in "good faith" because he "deliberately violate[d] federal criminal law" and, by definition, "such conduct cannot be 'in good faith.'"[168]

Most of the courts that have applied principles of public policy and disallowed indemnification for intentional, reckless or criminal acts have focused on the deterrent effect of the statutes violated by those seeking indemnification.[169] Commentators who oppose indemnification for such acts have focused on the need for deterrence,[170] as well as on the damage such indemnification does to our system of justice[171] and to a viable system of insurance.[172]

Other courts, while acknowledging the importance of these public policy concerns, find that they are outweighed by competing public interests such as the need to attract qualified executives. Indemnification grew out of the belief that the promise of such reimbursement was necessary if corporations were to attract qualified corporate executives.[173] And, in fact, as the risk of liability to executives has increased in recent years, courts, legislatures, and commentators have responded by expanding the rights to indemnification.[174] The opinion of the United States Court of Appeals for the Third Circuit in *Mooney v. Willys-Overland Motors, Inc.*[175] is an often cited example of a court that allowed in-

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168. *Id.* at 8.

169. *See, e.g., Odette*, 394 F. Supp. at 954 ("Indemnification in such circumstances ["involving actual knowledge of false and misleading statements or omissions and wanton indifference to its obligations . . ."] would reduce the deterrent effect of the securities laws, and [is] therefore against public policy."). Interestingly, the *Odette* court continued to hold that, for the same reason, indemnification where reckless disregard is shown is also against public policy. *Id.* at 955. *See also Gould*, 387 F. Supp. at 168 ("To allow indemnity to those who have breached responsibilities squarely placed upon them by the statute would vitiate the remedial purposes of § 14(a) [of The Securities Act of 1934 prohibiting misstatements in proxy solicitations]. Only a realistic possibility of liability for damages will encourage due diligence by those who solicit proxies and will protect the interest of informed corporate suffrage.").

170. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 WIS. L. REV. at 514, 532 and 582; Coffee, *No Soul to Damn*, *supra* note 8, 79 MICH. L. REV. at 407-11; Note, *Insurance for Executives*, *supra* note 8, 80 HARV. L. REV. at 655; *cf.* Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1087 (arguing that indemnification to executives found to have committed deliberate misfeasance and held civilly liable is not appropriate when the purpose of the civil liability is deterrence.)

171. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 WIS. L. REV. at 535, 577-78; Stone, *Enterprise Liability*, *supra* note 8, 90 YALE L.J. at 55.

172. Oesterle, *Personal Liability Protection*, *supra* note 8, 1983 WIS. L. REV. at 523; Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1088; Note, *Insurance for Executives*, *supra* note 8, 80 HARV. L. REV. at 655.

173. *Mooney*, 204 F.2d at 898; *Merritt-Chapman*, 321 A.2d at 141; RMBCA, Introductory Comment to Subchapter E (Indemnification), 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 58, at 1081.

174. *See supra* notes 18-23 and accompanying text.

175. 204 F.2d 888 (3d Cir. 1953).

demnification for this reason. In affirming indemnification to the former president and director of Willys-Overland for costs incurred in civil litigation, the court noted that the purpose of indemnification "is to encourage capable men to serve as corporate directors."[176] The Third Circuit's approach finds support in other types of insurance cases. In *Colson v. Lloyd's of London*,[177] the Missouri Court of Appeals held that Lloyd's liability policy covered compensatory and punitive damages assessed against the insured, a sheriff, for false arrest.[178] Lloyd's argued that coverage of punitive damages, which are imposed for "wanton, reckless, or willful acts would be contrary to public policy."[179] The court rejected Lloyd's argument, noting that qualified persons may be discouraged from entering law enforcement if such coverage is not provided.[180]

Indemnification for attorneys fees raises the additional public policy concern of providing counsel to those accused of crimes. For example, Lloyd's lost again in *Flintkote Co. v. Lloyd's Underwriters*[181] when it argued against the insurability of attorneys fees incurred by an executive convicted on antitrust charges. Lloyd's argued that because such fees were incurred after a finding of guilt in a criminal matter, it was against public policy to insure them. The court disagreed, finding that public policy was served by having counsel available to represent the Flintkote's executive.[182] *Little v. MGIC Indemnity Corp.*[183] provides another example of this particular balancing of competing policy concerns. At issue in *Little* was whether a D&O insurance policy obligated the insurer to pay legal fees as those fees were incurred by Little, a bank officer named as defendant in five civil actions alleging that he committed fraud.[184] Finding that the pertinent policy language was ambiguous, the court resolved the ambiguity against the insurer and ordered the insurer to advance the costs of attorney fees.[185] Significantly, the court also held that even if the policy language did not obligate the insurer to pay the attorneys fees as those fees were incurred, holding otherwise "would be unconscionable" because the directors and officers "would be forced to

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176. *Id.* at 898.
177. 435 S.W.2d 42 (Mo. Ct. App. 1968).
178. *Id.* at 43, 47.
179. *Id.* at 47.
180. *Id.*
181. 176 N.Y.L.J., July 27, 1976, at 6 (N.Y. Sup. Ct.), *aff'd*, 56 A.D.2d 743, 391 N.Y.S.2d 1005 (1977).
182. *Id.*
183. 649 F. Supp. 1460 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).
184. *Id.* at 1462.
185. *Id.* at 1466-68.

advance all their defense expenditures, which are likely to be staggering."[186]

Still other courts have simply disregarded public policy concerns and allowed full indemnification to convicted corporate executives without discussion of any public policy rationales. *Choate, Hall, Stewart v. SCA Services, Inc.*[187] provides an example. In this case the Massachusetts Court of Appeals explicitly noted that "an agreement to indemnify . . . must be able to withstand an attack on grounds of policy or basic equity."[188] Yet, the court held that an SCA director who pled guilty to securities fraud was, nevertheless, properly indemnified.[189] Apparently disregarding the fact that the director was now a convicted criminal, the court stated that there was no evidence that the director "intentionally or willfully violated any fiduciary duty owed to SCA" or "aided or abetted in any wrongdoing."[190] The court never addressed the question of whether or how public policy was served by indemnifying a criminal.

*Koster v. Warren*[191] provides another example of apparent disregard of the significance of a criminal conviction. Safeway shareholders brought a derivative suit challenging Safeway's $75,000 indemnification to a former officer for fines the officer paid after being convicted on antitrust charges.[192] The shareholder suit alleged that this indemnification was a waste of corporate assets and a breach of the fiduciary obligation owed to the shareholders.[193] The court never addressed any issue of public policy, analyzing the case instead as a simple matter of contract law. It found that because the executive changed his plea from "not guilty" to "nolo contendere," Safeway received consideration in return for its payment of the executive's fine.[194] Without explanation, this court apparently considered full indemnification to be proper reciprocal consideration for the switch to the nolo contendere plea. Similarly, in *Simon v. Socony-Vacuum Oil Co.*,[195] the Supreme Court of New York held that the Socony-Vacuum Oil Company properly paid defense costs and fines incurred by directors who were convicted of antitrust violations because, by the directors' plea of nolo contendere, "valuable consideration moved from the [directors] to the corporation, and the corporation

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186. *Id.* at 1468.
187. 22 Mass. App. Ct. 522, 495 N.E.2d 562 (1986).
188. *Id.* at 529, 495 N.E.2d at 566.
189. *Id.* at 529-32, 495 N.E.2d at 567-68.
190. *Id.* at 531, 495 N.E.2d at 567.
191. 176 F. Supp. 459 (N.D. Cal. 1959), *aff'd*, 297 F.2d 418 (9th Cir. 1961).
192. *Id.* at 460.
193. *Id.*
194. *Id.* at 461-62.
195. 179 Misc. 202, 38 N.Y.S.2d 270 (N.Y. Sup. Ct. 1942), *aff'd*, 267 A.D. 890, 47 N.Y.S.2d 589 (1944).

clearly benefited thereby."[196] There was no mention or discussion of whether public policy was served by such indemnification.[197]

Without a doubt the courts' application of public policy to reimbursement of convicted executives, whether by corporations or insurers, is erratic. Some courts aggressively disallow indemnification of convicted executives on the ground that such indemnification threatens the public interest. Other courts are just as likely to find that the public's interest is better served by allowing indemnification because it helps corporations attract talented executives and, when the need arises, assures that they have an effective defense. Still other courts order indemnification to convicted executives without addressing any of the public policy concerns presented by the executive's criminal liability.

To conclude: The nonexclusivity provision in most incorporation statutes allows the greatest opportunity for full indemnification of convicted executives by permitting corporations to indemnify their convicted executives even when it is clear that these executives do not meet the statutory standards for indemnification. The only limitation on such indemnification is that which may be imposed by the courts as they apply common law notions of public policy. Because the courts so erratically apply these principles of law, however, their oversight is not an effective or reliable check on inappropriate indemnification of corporate executives. It is significant to note that the recent trend in state incorporation statutes is toward broader nonexclusivity provisions.[198] Al-

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196. *Id.* at 206, 38 N.Y.S.2d at 275.

197. *Id.* at 205-06, 38 N.Y.S.2d at 274-75. Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1425-26 (attacking the reasoning of Simon v. Socony-Vacuum Oil Co. and Koster v. Warren for utilizing the "conceptual nicety" of contract analysis while ignoring the policy problem posed when indemnification negates the "punitive sanction which the federal government has determined to impose").

This approach may have developed from insurance law. There are examples of courts holding that insurance is available for "willful and felonious" action. For example, in New Amsterdam Casualty Co. v. Jones, 135 F.2d 191 (1943), the United States Court of Appeals for the Sixth Circuit held that insurance covered a willful and felonious assault inflicted by the insured. The court addressed the argument that it is against public policy to insure against one's own intentional, illegal acts, *id.* at 193, but noted that "[p]ublic policy is a changing concept," *id.* at 194. The court found that the prospect that insurance would cover any judgment obtained for an assault was a "vague possibility of benefit" and insufficient to void the insurance contract. *Id.* at 195.

198. For example, until recently, New York and New Mexico used the RMBCA approach on the exclusivity issue, that is, indemnification outside the statute was permitted as long as it was "consistent with" the indemnification provided in the incorporation statute. N.Y. BUS. CORP. LAW § 721 (McKinney 1986) (repealed 1986); N.M. STAT. ANN. § 53-11-4.1(G) (1983) (repealed 1983).

Now, both statutes use the broader (and clearer) rule that indemnification authorized by the statute shall not be deemed exclusive of any other rights under the articles of

though the RMBCA represents a rejection of this trend, because of its vagueness and its similar reliance on the largely erratic notions of public policy, it too, fails to serve as an effective limit on corporations' unbridled power to indemnify.

*d. Advancing expenses*

Even if it becomes clear after an executive has been convicted that he is ineligible for indemnification, it may be too late to deny him indemnification because he has already received it in the form of "advances" to cover the attorneys fees and other costs he has incurred. Forty-nine states explicitly grant corporations the power to advance attorney fees before there has been a judgment of guilt or innocence.[199]

Granting advances is not necessarily a problem; the practice becomes a problem only when an advance is not recovered from an executive who ultimately is determined to be ineligible for indemnification. How often this occurs depends upon the corporation's initiative in recovering advanced funds after it becomes clear that the executive does not qualify for indemnification. The incorporation statutes impose no meaningful requirement or mechanism for reclaiming such advances and without a statutory requirement, it is questionable how aggressively corporations will seek repayment. This is especially true given the secrecy in which the advances were likely made and the friendly relationship that may exist between the convicted executive and his corporate colleagues who must seek repayment.

Twenty-three states follow the Delaware approach on advances,[200] which requires no assessment, prior to granting the advance, of whether

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incorporation, the bylaws, an agreement, a resolution of shareholders or directors. N.Y. BUS. CORP. LAW § 721 (McKinney Supp. 1990); N.M. STAT. ANN. § 53-11-4.1(G) (Supp. 1989).

In addition, other states which have adopted other indemnification provisions of the RMBCA have rejected its "consistent with" language in favor of the "shall not be deemed exclusive" language of the Delaware statute. *See, e.g.*, IND. CODE ANN. § 23-1-37-15 (West 1989). *See also id.* (Official Comments); VA. CODE ANN. § 13.1-704 (1989).

199. Vermont's incorporation statute does not explicitly authorize corporations to pay defenses as incurred. VT. STAT. ANN. tit. 11, § 1852(15) (1984).

200. Alabama, Arizona, Arkansas, California, Florida, Hawaii, Idaho, Illinois, Kansas, Louisiana, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Dakota, Utah, and West Virginia all follow the Delaware approach. *See supra* note 11 for statutory citations.

As noted, *supra* note 30, (regarding exclusivity of statutes), some incorporation statutes apply different standards to different categories of corporate executives. Advancement-of-fees is one instance when this occurs. Delaware, Florida, Kansas, Oklahoma, and South Dakota, for example, all provide that advancement of fees *to a director or officer* is permissible upon an undertaking to repay if the director or officer is ultimately found

the executive appears able to ultimately meet the standard for permissive indemnification. Moreover, the Delaware approach provides little assurance of repayment since it allows a corporation to advance funds to an executive simply upon an "undertaking by or on behalf of [the executive] to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified."[201] Because there is no explicit requirement that this undertaking be secured, it may be meaningless; as one draftsman of the Delaware statute opined, this undertaking is simply an agreement to repay.[202] The RMBCA makes it even more clear that security is not part of this undertaking to repay: it specifies that the undertaking "need not be secured and may be accepted without reference to financial ability to make repayment."[203] The Official Comments to the RMBCA explain that this is so "wealthy directors [will] not be favored over directors whose financial resources are modest."[204]

Admittedly, the RMBCA imposes two requirements additional to the undertaking to repay which must be met by the executive or the corporation before the corporation may advance funds.[205] Both requirements make an effort to assess the executive's ultimate ability to meet the statutory standards for indemnification but they fail to effectively do so. The first requirement is that an executive seeking an advance of funds for expenses must furnish the corporation with a written affirmation of her good faith belief that she has met the standard for indemnification.[206] The problem is that one cannot expect an executive to admit

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ineligible for indemnification, but that advancement of fees *to other employees and agents* may be "so paid upon such terms and conditions, if any, as the board of directors deems appropriate." *See supra* note 11 for statutory citations.

201. The Delaware provision provides in full as follows:

> Expenses incurred by an officer or director in defending a civil or criminal action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it ultimately be determined that he is not entitled to be indemnified by the corporation as authorized in this Section. Such expenses incurred by other employees and agents may be so paid upon such terms and conditions, if any, as the board of directors deems appropriate.

DEL. CODE ANN. tit. 8, § 145(e) (1983 & Supp. 1988).

202. Professor Ernest L. Folk, *quoted in* Comment, *Law For Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 883 (1969).

203. RMBCA § 8.53(b) (1984).

204. RMBCA Official Comments § 8.53, 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 58.

205. RMBCA § 8.53(a) (1984).

206. The following states follow the RMBCA in imposing this requirement: Alaska, Colorado, Georgia, Indiana, Kentucky, Iowa, Maine, Maryland, Michigan, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, Rhode Island, South Carolina,

anything but good faith, certainly in the early stages of a criminal proceeding. As such, this requirement provides little assurance that an undeserving executive will fail to qualify for advances. The second requirement is that the advance of funds must be preceded by a determination "that the facts then known to those making the determination would not preclude indemnification."[207] This requirement has more potential to be a viable check on improper advances than does the affirmation of good faith requirement, but it is still inadequate. Its weakness lies in its reliance upon other provisions in the indemnification statutory scheme that also ineffectively control improper indemnification. For example, in determining whether facts "then known" preclude indemnification, the parties must apply the statutory standard for permissive indemnification. As noted, because these standards are too broad, they improperly allow indemnification to convicted executives.[208] Also, the individuals making this preliminary "determination" will be those officials eligible to make the final indemnification decision. As noted, because of the interests and loyalties of these officials, they may well be inappropriately biased toward the convicted executive.[209]

Another problem with this fact-finding obligation is the difficulty of fulfilling it. Conceivably, to fully inform oneself of the facts "then known" could take as long as the criminal investigation itself, thereby depriving the executive of any advance. To undertake no investigation and truly rely on facts "then known" is perilous when the fact-finder knows very little; shareholder derivative actions may later challenge whether the fact-finder's reliance on facts "then known" met the requisite duty of care. This predicament points to a deeper truth: The fact-finders

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Tennessee, Texas, Virginia, Washington, Wisconsin, and Wyoming. (Washington makes this requirement an alternative to a determination "that the facts then known to those making the determination would not preclude indemnification.") *See supra* note 11 for statutory citations.

207. The following states also impose this requirement: Alaska, Colorado, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, Mississippi, Montana, New Mexico, New York, North Dakota, Rhode Island, South Carolina, Tennessee, Virginia, Washington, and Wyoming. (Washington imposes this requirement as an alternative to the requirement of the executive's affirmation of good faith.) Interestingly, six states (Georgia, Iowa, Maryland, Oregon, Texas, and Wisconsin) that followed the RMBCA in imposing the requirement of an affirmation of good faith belief in qualification for indemnification, declined to also impose this requirement which is found in the RMBCA. The Comment accompanying the Georgia Code explained that it rejected this additional requirement "[b]ecause all of the board are frequently named defendants, [therefore] such a determination would involve a conflict of interests, and implementation of . . . costly procedures . . . ." Official Comment to GA. CODE ANN. § 14-2-853 (1989).

208. *See supra* notes 55-131 and accompanying text.

209. *See supra* notes 132-42 and accompanying text.

who have been given the responsibility of making a preliminary determination of eligibility for indemnification may have an impossible mission. In the early stages of a criminal investigation it is unusual for anyone to determine how wide or deep the illegal conduct goes.

In short, the authority given to corporations to advance expenses provides another opportunity for a convicted executive to receive corporate indemnification without meeting statutory standards. Although it is undoubtedly envisioned by the forty-nine incorporation statutes that explicitly allow these advances that an unworthy executive will not receive an advance, or will return the advance if unworthiness is determined after a verdict, these expectations are unrealistic. To be realistic, the statutory limitations on improper advances and the statutory duty to return advances must be meaningful; as currently drafted, they are not.

*e. The significance of convictions and pleas of nolo contendere*

Forty-nine state incorporation codes address the relevance of convictions and pleas of nolo contendere;[210] forty-eight of these statutes take a position quite favorable to the convicted executive, providing that termination of a proceeding by conviction or upon a plea of nolo contendere "shall not, of itself, create a presumption" that the executive does not meet the statutory standard for indemnification.[211] Maryland alone rejects this approach by adopting the inverse presumption, albeit a rebuttable one: "The termination of any proceeding by . . . conviction, or upon a plea of nolo contendere or its equivalent creates a rebuttable presumption that the [executive] did not meet the requisite standard of conduct . . . ."[212]

This statement by forty-eight states of the irrelevance of convictions in assessing eligibility for indemnification does two unfortunate things. By its disjunctive phrasing, this pronouncement lends credence to the view that a plea of nolo contendere is somehow different from a con-

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210. California's state incorporation code is the only one not specifically addressing the issue of the relevance of a conviction or plea of nolo contendere. CAL. CORP. CODE § 317 (West 1977 & Supp. 1990).

211. DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1988). There are some variations in the language used but all are to the same effect. For example, Minnesota and North Dakota used the language that termination of a proceeding by conviction, or upon plea of nolo contendere does not, of itself, "establish" that the executive does not meet the statutory standard for indemnification. MINN. STAT. ANN. § 302A.521 subd. 2(b) (West 1985 & Supp. 1990); N.D. CENT. CODE § 10-19.1-91.(3) (1985) (emphasis supplied). The RMBCA provides that termination of a proceeding by conviction or upon a plea of nolo contendere is not, of itself, "determinative" that the executive does not meet the standard for indemnification. RMBCA § 8.51(c) (1984).

212. MD. CORPS. & ASS'NS CODE ANN. § 2-418(b)(3) (1985 & Supp. 1989).

viction. For criminal justice purposes it is not; a plea of guilty, a verdict of guilty by a jury or a court after a trial, and a plea of nolo contendere all result in a conviction of guilt.[213] More ominously, however, this statement tells corporations and their executives that they may ignore the societal condemnation inherent in a criminal conviction.

*f. Power given to courts to indemnify*

As noted supra,[214] some of the incorporation statutes provide that the court where the proceeding is pending may determine whether an executive qualifies for indemnification. Twenty statutes also provide another role for courts, but not necessarily the court before which the proceeding is pending. These statutes allow a corporate executive to apply "to the court conducting the proceeding" or "to another court of competent jurisdiction" for indemnification and advances of expenses "notwithstanding the failure of a corporation to provide indemnification." If the court determines that the executive "is fairly and reasonably entitled to indemnification . . . in view of all relevant circumstances," the court may order indemnification "despite any contrary determination of the board or of the shareholders," and "regardless of whether or not such person met the standard of conduct set forth in the statute."[215]

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213. A plea of nolo contendere has the same effect as a plea of guilty except that it does not create estoppel. United States v. Norris, 281 U.S. 619, 622 60 S. Ct. 424, 425, 74 L. Ed. 1076, 1077 (1930); UNITED STATES ATTORNEY'S MANUAL §§ 9-16.000, -16.400 (Oct. 1, 1988); W. LAFAVE & J. ISRAEL, CRIMINAL PROCEDURE § 20.4(a), at 801 (1985); FED. R. EVID. 410; MCCORMICK ON EVIDENCE § 265, at 783 (1984).

214. *See supra* note 135 and accompanying text.

215. RMBCA § 8.54(2) (1984). The following states provide some variation of this role for courts: Colorado, Georgia, Iowa, Kentucky, Maryland, Michigan, Mississippi, Montana, New Jersey, New Mexico, New York, North Carolina, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Washington, Wisconsin, and Wyoming. There are numerous variations among the states authorizing this option. Some states are more direct than is the RMBCA in making clear that the court is not bound by an adverse decision on indemnification made by the corporation. For example, New Jersey's statute specifies that a court may award indemnification "notwithstanding a contrary determination" made by the corporation. N.J. STAT. ANN. § 14A:3-5(7)(a)(i) (West 1969 & Supp. 1990). New York's statute is also explicit: It provides that a court may order indemnification "notwithstanding the failure of a corporation to provide indemnification, and despite any contrary resolution of the board or of the shareholders." Notably, however, in New York the court must still use the permissive guidelines in the statute to determine if indemnification is appropriate. N.Y. BUS. CORP. LAW § 724 (McKinney 1986 & Supp. 1990). Although relevant to very few, if any, criminal proceedings, it should be noted that the RMBCA and most of the states following it in this respect, provide that the award by a court is limited to expenses if the executive is adjudged liable in connection with a proceeding by or in the right of the corporation, or in connection with any other proceeding where the executive is charged with receiving an improper benefit and adjudged liable on that basis.

Consider a dramatic example: A convicted executive denied indemnification by the directors, independent counsel, or shareholders of a corporation on the ground that she did not meet the statutory standards for indemnification, could go to any court "of competent jurisdiction" and seek indemnification. As long as this court found that the executive was "fairly and reasonably entitled to indemnification," it could order indemnification.

This provision may be appropriate in cases where a hostile take-over has occurred. In such an instance, new directors may refuse to authorize mandatory or permissive indemnification, however appropriate it may be according to statutory standards. In such circumstances, resort to an independent fact-finder is needed. There are, however, two areas of potential abuse presented by this authorization avenue when it is available beyond the hostile take-over situation. First, allowing an executive to go to a court other than the one before whom the proceeding at issue is pending encourages blatant forum shopping, a lack of awareness by the new tribunal of relevant facts, and disrespect of the original tribunal. At a minimum, allowing an executive to go to a tribunal that is not familiar with the prior proceeding unnecessarily absorbs scarce judicial resources by duplicating the work of the first tribunal. The second potential for abuse posed by this provision is that it allows a court to order indemnification by applying a standard more lenient than that already set forth in the statute. The vagueness of the "fairly and reasonably entitled" standard, coupled as it is with the declared expectation that the executive will not have met the other standards of conduct set forth in the statute, leaves too great of a possibility that a convicted executive will be indemnified by a court indifferent to, or unaware of, the executive's malfeasance.

This provision is a prime example of a protection needed for one particular situation but inappropriately expanded to other situations. Allowing this avenue to be used in the criminal arena where it is subject to abuse only serves to further threaten the unique policy concerns presented by the criminal justice system.

*g. Mandated disclosure to shareholders*

One suspects that requirements for shareholder notification of the indemnification paid to corporate executives detrimentally influences a convicted executive's chance for indemnification. It is unlikely that observant shareholders will favor an expenditure of corporate funds to pay attorney fees, fines, or penalties for an executive who has committed crimes in the exercise of his corporate duties. The risk of inquiries, publicity, and even shareholder derivative suits for breach of duty in granting overly generous indemnification undoubtedly serves as a chilling influence on those who are asked to authorize indemnification.

The opportunities and requirements for shareholder notification of indemnification payments are hidden in the patchwork of indemnification rights. Seven states require that shareholders be informed of indemnification made pursuant to the incorporation statute but such disclosure is required only when the indemnification is for claims arising in actions "by or in the right of the corporation."[216] There are only four statutes that require disclosure of indemnification to an executive who has been convicted of crimes.[217]

Interestingly, shareholders may have greater rights of notification if the indemnification is made outside of the incorporation statute, for example, if the indemnification is made pursuant to power granted by articles of incorporation or bylaws. Most incorporation statutes require shareholder approval to amend the articles of incorporation,[218] and provide that the shareholders share in the power to amend bylaws.[219] There are problems with this level of notice however: shareholders change, the articles or bylaws authorizing indemnification probably do not require notice of each instance of indemnification, and, the fact that the indemnification permitted in the articles or bylaws includes indemnification to executives convicted of crimes may be so hidden in legalese that shareholders do not realize that they have authorized indemnification for criminal liability.[220] Indemnification pursuant to contracts negotiated between a corporation and executives may offer the greatest degree of secrecy. Rarely will anyone but the parties signing the contract know of its terms.

In short, it will be unusual for shareholders to learn that corporate funds are being used to pay a convicted executive's attorney fees, fines,

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216. Iowa, Maryland, Minnesota, Montana, New Mexico, North Dakota, Rhode Island. *See supra* note 11 for statutory citations.

217. Florida, Illinois, Nebraska, New York. *See supra* note 11 for statutory citations.

There are variations among these provisions that limit this disclosure requirement. For example, Florida and New York require disclosure only when indemnification is authorized by the corporate directors or "independent legal counsel." FLA. STAT. ANN. § 607.014(13) (West 1986 & Supp. 1989); N.Y. BUS. CORP. LAW § 725(c) (McKinney 1986 & Supp. 1990).

218. Amendments to articles of incorporation are almost always initiated by the board of directors, but in almost four-fifths of the states, shareholder approval of amendments is necessary. 3 MODEL BUSINESS CORP. ACT ANN. § 10.03 Official Comment and Statutory Comparison (3d ed. Supp. 1990).

219. At common law shareholders retained the sole power to amend or repeal bylaws. Today this power is shared by the board of directors and shareholders. The major reason for this is convenience; it is usually cheaper and easier for a board of directors to meet to amend bylaws than it is to call a shareholders' meeting. 3 MODEL BUSINESS CORP. ACT ANN., *supra* note 218, § 10.20 (Official Comment, Historical Background, and Statutory Comparison).

220. For sample bylaws see BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at app. 7A; P. RICHTER, INDEMNIFICATION OF DIRECTORS AND OFFICERS, *supra* note 2.

or penalties. Only four states require such disclosure when the indemnification is made pursuant to an incorporation statute. The disclosure available when indemnification is made outside the indemnification statute, that is, pursuant to articles of incorporation or bylaws, is unlikely to be specific enough to be helpful. No disclosure is likely when indemnification is made pursuant to a contract negotiated between the corporation and the executive. This lack of notice to shareholders seems unjustifiable in any indemnification circumstance because of the shareholders' financial stake in such payments, but it seems especially egregious when the payments are to an executive convicted of crimes. In this situation shareholders should have the special opportunity, and responsibility, to determine whether the use of their equity is circumventing the criminal justice system.

*h. Miscellaneous restrictions*

Numerous statutory codes provide additional limitations on indemnification that may apply to criminal actions. For example, New York's indemnification statute provides that no indemnification, advancement or allowance shall be made when it would be inconsistent with the law of the incorporating jurisdiction of a foreign corporation, the certificate of incorporation, the bylaws, a corporate resolution, an agreement, or a court-approved settlement.[221] None of these restrictions will consistently limit indemnification of convicted executives. To the extent "the law of the jurisdiction of incorporation" refers to principles of public policy, this limitation is unreliable because, as noted,[222] courts erratically recognize and apply principles of public policy to limit indemnification. Reliance upon limitations in certificates of incorporation, bylaws, resolutions and agreements is illusory because there will rarely be limitations on indemnification in these sources; more often than not they generously grant indemnification. Lastly, it is unlikely that court-approved settlements will consistently limit indemnification. Courts may not be sufficiently aware of the indemnification issue to include it in a settlement, and the courts that do so may not resolve the indemnification issue uniformly, or even wisely.

Iowa contains the following limitation: "indemnification shall not be provided . . . for acts or omissions . . . which involve intentional misconduct or a knowing violation of the law. . . ."[223] To the extent a

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221. N.Y. Bus. Corp. Law § 725(b) (McKinney 1986 & Supp. 1990).

222. See *supra* text accompanying notes 159-98.

223. Iowa Code Ann. § 496A.4A(7) (West Supp. 1990). Several states have similar provisions. For example, Arizona prohibits indemnification if there has been a "final adjudication establish[ing] that acts of active and deliberate dishonesty committed by the

criminal conviction demonstrates "intentional misconduct" or a "knowing violation of the law," this limitation should prevent indemnification even if it was determined that the convicted executive met the standards for permissive indemnification. However, this limitation may be deemed inapplicable when the corporate executive has been convicted for reckless disregard of truth or falsity, or convicted upon a finding of ignorance — even deliberate ignorance.

Another limitation that may apply to criminal matters, depending upon the facts, is contained in several statutes. This limitation provides that a corporation may not indemnify "in respect of any proceeding charging improper personal benefit . . .in which [the executive] was adjudged to be liable on the basis that personal benefit was improperly received."[224] Most obviously, this prohibition applies to shareholder derivative suits charging self dealing. To the extent a conviction also rests upon findings of personal benefit, this prohibition may limit indemnification to the convicted executive. Sometimes, convictions in some criminal cases will imply that the defendant improperly received a personal benefit. For example, in 1989 Michael R. Milkin was indicted on charges that he "enriched [himself] through unlawful securities trading."[225] However, allegations or proof of such self dealing will not always be present. Major white collar crimes such as mail fraud,[226] securities fraud,[227] and RICO,[228] may all be charged and proven without any evidence of self dealing. Thus, this restriction will not consistently apply to indemnification sought by convicted executives.

Of all of the miscellaneous limitations in incorporation statutes, a provision in Pennsylvania's statute may have the greatest potential applicability to convicted executives. Pennsylvania's statute provides that "[i]ndemnification . . . shall not be made in any case where the act or failure to act giving rise to the claim for indemnification is determined by a court to have constituted willful misconduct or recklessness."[229] To the extent this provision applies to all actions, not simply shareholder derivative suits, and to the extent it extends to instances of recklessness,

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person with actual dishonest purpose and intent [which] were material to the cause of action adjudicated." ARIZ. REV. STAT. ANN. § 10-005(I) (1990). *See also* MO. ANN. STAT. § 351.355(7) (Vernon 1966 & Supp. 1990); VA. CODE ANN. § 13.1-704 (1989).

224. MD. CORPS. & ASS'NS CODE ANN. § 2-418(c) (1985 & Supp. 1989). *See, e.g.*, COLO. REV. STAT. § 7-3-101.5(2)(d)(II) (Supp. 1990); FLA. STAT. ANN. § 607.014(7) (West 1986 & Supp. 1989); MISS. CODE ANN. § 79-4-8.51(d)(2) (1972 & Supp. 1988).

225. United States v. Milkin, Cause Number S 89CR. 41(KBW), Indictment at 4 (S.D.N.Y. 1989).

226. 18 U.S.C. § 1341 (Supp. 1990).

227. 15 U.S.C. § 78j (1981).

228. 18 U.S.C. § 1961-1964 (Supp. 1990).

229. 15 PA. CONS. STAT. ANN. § 1746(b) (Purdon 1990).

this provision could provide a meaningful limitation on indemnification to convicted executives, even when the statutory standards for permissive indemnification are determined to have been met. The language, "is determined by the court," clouds the applicability of this standard somewhat, however. If an explicit finding by a court is essential before this prohibition applies, and an implicit finding contained in a jury's guilty verdict is insufficient, Pennsylvania's limitation may have an impact only when there is a bench trial, rather than a jury trial, and only when the court issues specific findings supporting its verdict of guilty.

Significantly, however, none of these limitations, including that of Pennsylvania's, may effectively limit indemnification to convicted executives when the statute is nonexclusive, since in nonexclusive jurisdictions corporations are allowed to disregard all statutory limitations in indemnifying executives.

### *C. SUMMARY OF INDEMNIFICATION BY CORPORATIONS*

A corporation is empowered to indemnify its executives through the incorporation statute of the state where it is incorporated. Although the statutes vary in their definitions of "success," all statutes require that corporations indemnify executives who have been successful in defending the charges against them. Depending upon the definition of "success," executives convicted in part may qualify for mandatory indemnification. Incorporation statutes also permit corporations to indemnify executives who have not successfully defended themselves on the criminal charges if the executives qualify for "permissive" indemnification. Convicted executives can easily qualify for permissive indemnification under most incorporation statutes despite their convictions because of trends in criminal law regarding proof of mens rea; the standards that must be met to qualify for permissive indemnification; the procedure for determining whether an executive has met these standards; the explicitly insignificant relevance attributed to a criminal conviction by most statutes; and, the secrecy in which indemnification may be granted.

Moreover, even if the convicted executive fails to qualify for permissive indemnification, she may still receive indemnification through a variety of statutory avenues that dispense with the need for compliance with the permissive standards. Twenty states allow a court to order indemnification even if the permissive standards have not been met.[230] Forty-eight states allow corporations to disregard the statutory standards for indemnification to some extent, if not altogether, and order indemnification pursuant to bylaws, resolutions or privately negotiated con-

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230. *See supra* note 215 and accompanying text.

tracts.[231] Lastly, forty-nine statutes explicitly allow advances of litigation costs. These advances may result in defacto indemnification to a convicted corporate executive who is ultimately found to be incapable of meeting statutory standards. There are no meaningful requirements for a preliminary assessment of eligibility for indemnification before the advance is made, and there is no meaningful mechanism to enforce repayment of advances if the executive is later found to be utterly incapable of meeting the permissive standards.[232]

The only limit on indemnification legitimately made through the above avenues is a review by the courts to determine if the indemnification frustrates public policy. However, because the courts review only a fraction of indemnification awards, and because they erratically interpret and apply principles of public policy, this is an unpredictable and ineffectual limit on improper indemnification.

Despite this seemingly good news for the convicted executive, she may still have cause for concern. A corporation's willingness to indemnify its executives depends upon the corporation's economic stability and leadership. The corporation with few or no assets cannot indemnify anyone. And, if the officials charged with authorizing indemnification are hostile to the executive seeking indemnification, or determine that the executive has failed to meet necessary standards, there is little chance indemnification, statutory or otherwise, will be paid by the corporation. For this reason many executives turn to D&O liability insurance for reimbursement. It is less likely, however, that the convicted executive will fare well with D&O insurers.

## II. D&O Insurance for Convicted Executives

### *A. OVERVIEW*

D&O insurance has expanded tremendously since the first two policies were sold in 1962.[233] Currently, every state incorporation code, except that of Vermont,[234] specifically authorizes corporations to purchase D&O insurance even allowing coverage of costs not indemnifiable by the corporation. The Delaware code, followed by forty-eight states,[235] pro-

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231. *See supra* notes 25, 27 and 28.

232. *See supra* notes 199-209 and accompanying text.

233. Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 Yale L.J. at 1078 n. 1.

234. Vt. Stat. Ann. tit. 11, § 1852(15) (1984).

235. All states except Vermont and New York follow the Delaware provision. Vermont's statute does not address the insurance issue, Vt. Stat. Ann. tit. 11, § 1852(15) (1984), and New York's provides limitations on a corporation's power to obtain insurance,

vides . . . that "[a] corporation shall have the power to purchase and maintain insurance on behalf of any [corporate executive] . . . whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section."[236]

D&O insurance provides coverage for losses arising from wrongful acts committed by directors and officers, and in some cases, by other employees.[237] A "wrongful act" includes "any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the [insureds] . . . claimed against them solely by reason of their being [executives] of the company."[238] Losses covered include "damages, judgments, settlement and costs, charges and expenses, incurred in the defense of actions, suits or proceedings and appeals".[239]

D&O policies insure only losses arising from liability on the part of corporate executives; this insurance is not available for losses arising from corporate liability.[240] D&O insurance provides two types of coverage: It reimburses a corporation for amounts it has indemnified its officers and directors, and it reimburses officers and directors personally if they have incurred liabilities not indemnified by the corporation.[241] Ninety-five percent of all claims filed on D&O policies are by corporations for indemnification they have paid to directors or officers.[242] Direct reimbursement to executives is needed only when the corporation cannot, or will not, indemnify its directors and officers. A corporation cannot indemnify its executives if the applicable corporate code, bylaws, re-

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N.Y. Bus. Corp. Law § 726(b) (McKinney 1986 & Supp. 1990). Many of the statutes otherwise modeled after Delaware's insurance provision provide additional specific authority to create alternative funding sources for D&O insurance. *See, e.g.*, Md. Corps. & Ass'ns Code Ann. § 2-418(l)(3) (1985 & Supp. 1989); Nev. Rev. Stat. § 78.752(2) (Michie 1987); Tex. Bus. Corp. Ann. § 2.02-1(R) (Vernon 1980 & Supp. 1990).

236. Del. Code Ann. § 145(g) (1983 & Supp. 1988).

237. Johnston, *Indemnification and Insurance*, *supra* note 8, 33 Bus. Law. at 2015-16.

238. J. Bishop, Indemnification and Insurance, *supra* note 1, app. 8A, at 52 (Stewart Smith Form) (1981 & Supp 1990).

239. *Id.*

240. *Id.* ¶ 8.07; Note, *Practical Aspects of D&O Insurance*, *supra* note 8, 32 UCLA L. Rev. at 692.

241. *See, e.g.*, Johnston, *Indemnification & Insurance*, *supra* note 8, 33 Bus. Law. at 2013; Note, *Protecting Corporate Directors and Officers: Insurance and Other Alternatives*, 40 Vand. L. Rev. 775, 783 (1987) [hereinafter *Insurance and Other Alternatives*].

242. The 1982 Wyatt Directors and Officers And Fiduciary Liability Survey: Comprehensive Report 61 (1982) [hereinafter The 1982 Wyatt Survey]. The Wyatt Company is an international pension, actuarial and risk management consulting organization. In its 1982 Survey of Directors and Officers Liability Insurance, 1,979 American corporations and 275 Canadian corporations participated. *Id.* at Introduction.

solutions or contracts forbid indemnification, or if the corporation is insolvent. A corporation may choose not to indemnify its executives if there has been a change in management or if management determines that the executive does not qualify for indemnification.

The claims filed with D&O insurers are large; in 1988 the total average claim was $1,848,000.[243] Of this total claim, a surprising percentage is attributable to attorney fees. The 1988 Wyatt Survey estimated that the average defense cost was $693,000, over one-third of the total average claim.[244] Moreover, attorneys fees have risen astronomically — in 1974 the average defense cost was $182,000.[245] The number of companies experiencing D&O claims is also increasing. In 1987, the Wyatt Survey estimated that 20% of the Fortune listed companies will experience a D&O claim each year.[246] This is double the frequency of claims in 1981.[247] Approximately 47% of the D&O claims arise from litigation brought by shareholders, 22% arise from litigation brought by employees or former employees, and 20% arise from litigation brought by customers.[248]

In the 1980s a "crisis" emerged in D&O coverage.[249] This crisis was fueled, in part, by a landmark case which made it easier for plaintiffs

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243. THE 1988 WYATT DIRECTORS AND OFFICERS LIABILITY SURVEY 12 (1988) [hereinafter THE 1988 WYATT SURVEY]. *See supra* note 242 regarding The Wyatt Company. The 1988 Survey is the eleventh survey the Wyatt Company has conducted regarding directors and officers liability insurance markets. In this survey, 1,708 American business corporations participated. *Id.* at 1.

244. *Id.* at 12. The Wyatt Survey noted that 421 of the 759 claims reported (55.4%) failed to disclose defense costs. The surveyors did not know if companies otherwise participating in the survey were reluctant or unable to disclose such costs. *Id.* at 14. The average defense expenses associated with claims filed but dropped were $146,150; the average defense expenses for settled claims were $396,881; and, the average defense expenses for claims closed through litigation were $330,906. *Id.* at 15.

245. *Id.* at 15.

246. THE 1987 WYATT DIRECTORS AND OFFICERS AND FIDUCIARY LIABILITY SURVEY 11 (1987) [hereinafter THE 1987 WYATT SURVEY]. *See supra* note 242 regarding the Wyatt Company. The 1987 survey is the tenth survey the Wyatt Company has conducted regarding directors and officers liability insurance markets. In this survey, 895 American and 152 Canadian companies participated. *Id.* at 1-3.

247. THE 1982 WYATT SURVEY, *supra* note 242, at 11.

248. THE 1988 WYATT SURVEY, *supra* note 243, at 116.

249. *See, e.g.*, Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 BUS. LAW at 1207; Hazen, *The Race to the Bottom*, *supra* note 20, 66 N.C.L. REV. at 171, 179; Veasey, Finkelstein & Bigler, *Responses to the D & O Insurance Crisis*, 19 REV. SEC. & COMMODITIES REG. 263 (1986) [hereinafter *Responses*]; Johnston, *Indemnification and Insurance*, *supra* note 8, 33 BUS. LAW at 1993; Heyler, *Indemnification of Corporate Agents*, *supra* note 20, 23 UCLA L. REV. at 1255; Purcell, *D & O Liability - New Protection*, BUSINESS 50-52 (Jul.-Sept. 1988); Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1078-79; Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1403.

to hold corporate executives liable. In *Smith v. Van Gorkom*,[250] a shareholders class action,[251] the Delaware Supreme Court held that the directors of Trans Union, a publicly traded, diversified holding company, failed to exercise adequate business judgment in approving a cash-out merger[252] and were personally liable for the fair value of the plaintiffs' shares of Trans Union. The Court reached this conclusion despite the facts that the $55 price per share negotiated was $27 higher than the current market price;[253] the merger proposed was approved by 69.9% of outstanding shares; the Board met three times over a four month period to discuss the merger; and, at the initial meeting an attorney hired to provide advice on this merger advised the Board members that they might be sued if they did not approve the merger.[254] The nine Trans Union directors were held personally liable for $23.5 million.[255]

There followed a "record number" of cases holding directors and officers liable for breaches of their duties of care and loyalty.[256] Several stunning judgments were rendered. In 1984, insurers paid $25 million to settle a shareholder derivative claim against a Los Angeles retailer.[257] In 1985, a Delaware court approved a $32.5 million settlement against Chase Manhattan Bank Corporation and its officers.[258]

In response to these developments, D&O insurers raised premiums and deductibles. Sixty-four percent of corporations renewing their D&O insurance in late 1985 and 1986 faced increases of 100% in premiums; 20% faced increases of 1000%.[259] Premiums are still on the rise.[260] Deductibles for personal coverage increased an average of 44% between 1984 and 1987, while deductibles for corporate coverage increased by 196%.[261] D&O insurers also increased the number and scope of exclu-

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250. 488 A.2d 858 (Del. 1985).

251. *Id.* at 863.

252. *Id.* at 863-64.

253. *Id.* at 875.

254. *Id.* 870, 868

255. Olson, *Why Directors Keep Getting Sued*, FORTUNE 14 (Mar. 13, 1989) (It should be noted that insurance covered less than half of this amount but the purchaser of Trans Union's stock volunteered to pick up most of the director's bill.).

256. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.01; Note: *Insurance and Other Alternatives*, *supra* note 241, 40 VAND. L. REV. at 780.

257. Hilder, *Liability Insurance is Difficult to Find Now for Directors and Officers*, Wall St. J., July 10, 1985, at 1, col. 6.

258. Fox v. Chase Manhatten Corp., No. 8192-85 (Del. Ch. Dec. 9, 1985) (LEXIS, Del. library, Cases file); Sloane, *Insurer-Management Liability Rift Seen Growing*, N.Y. TIMES, Dec. 19, 1985, at D8, col. 1.

259. THE 1987 WYATT SURVEY, *supra* note 246, at 89-95.

260. THE 1988 WYATT SURVEY, *supra* note 243, at 45.

261. *Id.* at 75.

sions.[262] These changes in exclusions had an effect: in 1988, over one-fourth of claims filed against D&O insurers were outside the policy, or coverage was unclear.[263]

The response to this "crisis" by the insurers has had an impact on companies holding D&O insurance. In 1984, 70% of small companies (assets under $10 million) held D&O insurance.[264] Three years later, in 1987, only 29% of small companies held such insurance.[265] The reasons given for not buying D&O insurance are telling. Between 1984 and 1987 the percentage of companies indicating that they thought D&O insurance was important increased, but the percentage of companies not buying insurance, either because it was too expensive or because the coverage provided was too limited, rose from 1.7% to 9.5%.[266] Interestingly, the large companies (assets of $2 billion or more) have consistently maintained D&O coverage, even throughout this "crisis" period. Approximately 95% of corporations with assets of $2 billion or more maintain D&O coverage.[267] In part, such coverage is still feasible for these larger companies because they are able to secure financing alternatives not available to smaller companies.[268]

The 1987 Wyatt Survey attempted to determine whether these changes in liability and insurance coverage have truly created a crisis, making it more difficult to hire capable directors and officers.[269] The Survey

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262. Note, *Insurance and Other Alternatives*, *supra* note 241, 40 VAND. L. REV. at 776-777.

263. THE 1988 WYATT SURVEY, *supra* note 243, at 17. This is a "relative increase" in claims falling outside policy provisions but not a dramatic increase. *Id.* at 18. THE 1982 WYATT SURVEY showed that in 1980, 31.6% of claims fell outside the policy or coverage was uncertain. *See supra* note 242, at 22.

264. THE 1984 WYATT DIRECTORS AND OFFICERS AND FIDUCIARY LIABILITY SURVEY 64 (1984) [hereinafter THE 1984 WYATT SURVEY]. *See supra* note 242 for a description of the Wyatt Company. In its 1984 Survey, 1,451 American and 201 Canadian companies participated. *Id.* at 5.

265. THE 1987 WYATT SURVEY, *supra* note 246, at 51. It is not possible to determine if 1988 showed a reversal of this trend, at least from the Wyatt Surveys, because the 1988 Wyatt Survey broadened its category for small companies. Beginning with the 1988 Survey, the Wyatt Company expanded its category for small companies to include companies with assets under $50 million, instead of limiting this category to companies with assets under $10 million.

266. *Id.* at 50, 55.

267. THE 1987 WYATT SURVEY indicated that 95.9% of companies with assets of $2 billion or more held D&O insurance. The 1984 Wyatt Survey found that 97.2% of such companies held D&O insurance. *Id.* at 51.

268. *See, e.g.*, BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.01; Carlton & Brooks, *Corporate Director and Officer Indemnification: Alternative Methods For Funding*, 24 WAKE FOREST L. REV. 53 (1989); Note, *Insurance and Other Alternatives*, *supra* note 241, 40 VAND. L. REV. at 793-803.

269. THE 1987 WYATT SURVEY, *supra* 246, at 161; *see also* Bishop, *Sitting Ducks*

found that 8.8% of the companies participating in its 1987 study had been unable to obtain adequate D&O coverage. A little over one-fourth of these companies stated that they lost some board members because of this failure.[270] Whether this crisis is fact or fiction, however, state legislatures[271] have acted to aid corporations and corporate executives.[272]

### *B. D&O COVERAGE FOR THE CONVICTED EXECUTIVE*

Compared to corporate indemnification, D&O insurance provides less of an opportunity for convicted executives to receive reimbursement for costs associated with criminal liability. Historically, insurance coverage has not been available for deliberate and willful acts.[273] The definition of "loss" in most D&O policies grows out of this history. These policies specifically provide that the "loss" covered by the policies "shall not include fines or penalties imposed by the law or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed."[274] This definition would seem to exclude insurance coverage for any costs incurred by a convicted executive.

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*and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1078. Bishop questions whether this "crisis" has been created by "aggressive and imaginative propaganda of underwriters." *Id.*

270. THE 1987 WYATT SURVEY, *supra* note 246, at 161.

271. As discussed in Part One, one response by legislatures has been to increase the power of corporations to indemnify executives. For other sources discussing this as a response to the perceived crisis see THE 1987 WYATT SURVEY, *supra* note 246 at 161; Hazen, *The Race To The Bottom*, *supra* note 20, 66 N.C.L. REV. at 177-79; *see generally* Carlton & Brooks, *Corporate Director and Officer Indemnification: Alternative Methods For Funding*, *supra* note 268, 24 WAKE FOREST L. REV. 53; Hanks, *Evaluating Recent Legislation*, *supra* note 6, 43 BUS. LAWYER at 1221-1227.

272. *See, e.g.*, Veasey, Finkelstein & Bigler, *Responses*, *supra* note 249, 19 REV. SEC. & COMMODITIES REG. 263; Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1079.

Another response has been authorization for corporations to amend their charter with provisions limiting or eliminating director liability for money damages. Delaware pioneered this approach when it passed DEL. CODE ANN tit. 8, § 102(b)(7) (1988):

> [T]he certificate of incorporation may also contain . . . [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law, (iii) under section 174 of this title, or (iv) for any transaction from which the director derived an improper personal benefit."

273. *See supra* note 159-168 and accompanying text.

274. *See, e.g.*, J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, app. 8A, at 33 (American Adaptation of Lloyd's two-part form), at 52-53 (Stewart-Smith form);

Some commentators, however, have suggested that this definition does not exclude coverage for criminal or other intentional acts.[275] They rely on the phrase, "matters which are uninsurable under the law pursuant to which this policy shall be construed." In some jurisdictions, the law pursuant to which an insurance policy is construed allows insurance coverage of intentional or even criminal misconduct.[276] In these jurisdictions the definition of loss, by explicitly incorporating this applicable law, may extend to intentional or criminal misconduct.

Upon full examination of what is excluded as a loss in a D&O policy, however, this suggested interpretation appears to be incorrect. The "fines or penalties" excluded from the policy definition of loss is not qualified by the reference to "matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed"; rather, the reference to uninsurable matters is an additional exclusion to "fines or penalties." As such, all fines and penalties are excluded, not just those deemed uninsurable by the law of a particular jurisdiction. Nevertheless, it is worth noting that if a court finds this definition to be ambiguous, costs incurred by a convicted executive may be covered since ambiguities in policies are resolved in the insured's favor.[277]

There is an additional argument that has been made as to why fines and penalties should be covered by D&O policies. Professor Bishop suggested that the D&O policy definition of "loss" should extend to costs incurred by a convicted executive when the corporation is empowered to indemnify these costs because "a corporation should be able to validly contract with an insurer for reimbursement of any payment that . . . applicable statutes . . . permit it to make by way of indemnification."[278] Admittedly, there is some merit to this argument for allowing corporations to obtain insurance coverage coextensive with its powers to indemnify. However, this Article suggests that a better policy argument can be made that such symmetry should be achieved by restricting the corporation's indemnification authority, not by expanding the coverage of the insurer.

The "dishonesty" exclusion contained in most D&O policies is also relevant in assessing the insurability of costs incurred by a convicted

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P. RICHTER, INDEMNIFICATION OF DIRECTORS AND OFFICERS, *supra* note 2, at app. 2-6 (Ipalco Enterprises, Inc. Form - corporate reimbursement policy) and at app. 2-18 (Ipalco Enterprises, Inc. Form - directors and officers reimbursement).

275. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.10; Note, *Insurance For Executives*, *supra* note 8, 80 HARV. L. REV. at 665-66.

276. *See supra* notes 187-197 and accompanying text.

277. COUCH, 2 CYCLOPEDIA OF INSURANCE LAW § 15:83 (2d ed. 1984); 7A APPLEMAN, INSURANCE LAW & PRACTICE § 4491.01 (Berdal ed. 1979); KEETON, INSURANCE LAW, BASIC TEXT § 5.5(a)(2) (1971).

278. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.10.

executive. The applicability of this exclusion to such costs depends upon its precise wording, which varies considerably from policy to policy.

The following dishonesty exclusion, which focuses upon "a judgement . . . [of] criminal acts," has been criticized for its ambiguity,[279] which would, of course, require that it be resolved in the insured's favor. Aside from this problem, however, this particular exclusion is not favorable to a convicted executive. It provides:

> The insurer shall not be liable to make any payment for loss in connection with any claim or claims made against the insureds . . . brought about or contributed to by the fraudulent, dishonest or criminal acts of the insureds, however the provisions of this exclusion shall not apply unless a judgment or other final adjudication thereof adverse to the insureds shall establish fraud, dishonesty or criminal acts. . . .[280]

Thus, this dishonesty exclusion makes a conviction conclusive on the insurability issue. If the executive is acquitted or secures dismissal of charges, there is no "judgment or other final adjudication" of "fraud, dishonesty or criminal acts" and the executive's costs would be insurable under this provision. On the other hand, if the executive is convicted, there has been a "judgment" and "final adjudication" of "criminal acts" and the executive's costs would be excluded from coverage. One advantage of this particular dishonesty exclusion is that it is simple and easy to administer. Such a claim cannot be made for some of the other dishonesty exclusions.

The Stewart Smith D&O Insurance form, upon which many American policies are based,[281] includes the following dishonesty exclusion:

> Except insofar as the company may be required or permitted by law to pay as indemnity to the directors and officers, the underwriters shall not be liable to make any payment for loss in connection with any claim made against directors or officers . . . brought about or contributed to by the dishonesty of the directors and officers; however, notwithstanding the foregoing, the directors shall be protected under the terms of this policy as to any claims upon which suit may be brought against them by reason of any alleged dishonesty on the part of the directors

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279. *See* Johnston, *Indemnification and Insurance*, *supra* note 8, 33 BUS. LAW., at 2019-2020; Bishop, *Sitting Ducks and Decoy Ducks*, *supra* note 8, 77 YALE L.J. at 1088-89; Note, *Practical Aspects of D&O Insurance*, *supra* note 8, 32 UCLA L. REV. at 701.

280. This exclusion is contained in the American adaptation of Lloyd's two-part form. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, app. 8A, at 43. This form, and the Stewart Smith form, are the models for many of the D&O policies in current use. *Id.* at ¶ 8.04.

281. J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.04.

> or officers, unless a judgment or other final adjudication thereof adverse to the directors or officers shall establish that acts of active and deliberate dishonesty committed by the directors or officers with actual dishonest purpose and intent were material to the cause of action so adjudicated.[282]

This prolix provision contains two features that make it quite possible to find that costs incurred by a convicted executive are insurable. First, the exclusion specifically states that it does not apply if the company is "permitted by law to pay . . . indemnity to the directors and officers." As we have seen, virtually all incorporation statutes easily permit corporations to indemnify convicted executives. Thus, this dishonesty exclusion simply will not apply to most instances when an executive has been convicted.

Second, even if this exclusion does apply, it may be difficult to find "dishonesty" under it, primarily because of the law on mens rea in white collar criminal cases. Unlike the prior dishonesty exclusion which excludes coverage whenever there is a conviction, this dishonesty exclusion applies only when there is a "judgment or other final adjudication" establishing that the executive committed "acts of active and deliberate dishonesty . . . with actual dishonest purpose and intent."[283] A simple verdict of guilty will not provide sufficient detail to determine if "active and deliberate dishonesty" is present. Moreover, when one digs through the evidence and applicable law, it is more likely that one will find "gray areas" of criminality, or recklessness, or deliberate disregard of facts, rather than "active and deliberate dishonesty" or "actual dishonest purpose." As always, of course, to the extent the above dishonesty exclusion is unclear, it helps convicted executives since an ambiguous insurance policy is to be construed in the insured's favor.[284]

A D&O insurer's obligation to advance attorneys fees before judgment has been rendered varies from jurisdiction to jurisdiction depending upon how the courts interpret provisions in the policies.[285] D&O policies are viewed as "indemnity," not "liability" policies. Under an "indemnity" policy, an insurer is not obligated to pay until after the insured has been held liable and paid, out of his own pocket, an actual monetary amount. The insurer then indemnifies the insured directly.[286] In contrast, under a liability policy, the insurer becomes obligated to pay before the

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282. *Id.*, app. 8A, at 54.

283. *Id.*

284. *See supra* note 277.

285. *See generally* Note, *Practical Aspects of D&O Insurance*, 32 UCLA L. Rev. at 691.

286. Couch, 11 Couch on Insurance § 44.4 (2d. 1982).

insured suffers any out-of-pocket loss.[287] Attorneys fees complicate this distinction because criminal defendants, or potential criminal defendants, are obligated to pay attorneys fees as the fees are incurred, which is usually long before any judgment of liability is rendered.

Court opinions addressing the D&O insurers' obligation to advance attorneys fees are split. The opinions focus on the language in insurance policies but often reach different conclusions about similar language. In *Okada v. MGIC Indemnity Corporation*,[288] the United States Court of Appeals for the Ninth Circuit held that an insurer had a duty to reimburse attorneys fees as they are incurred. Finding ambiguity in the contractual language, the court construed the ambiguity in the insured's favor, holding that the insurer had an obligation to pay the legal expenses of the corporate executive as the expenses came due, rather than when the case was completed.[289] Other courts that have reached the same conclusion as the Ninth Circuit have found similar terms to be ambiguous.[290] As noted,[291] the United States Court of Appeals for the Third Circuit added another reason for construing the D&O insurance policy to cover attorneys fees as incurred. It found that because the legal fees could be "staggering," any contractual provision allowing the insurer "absolute discretion over the timing of reimbursement of defense costs" would be "unconscionable."[292]

*Zaborac v. American Casualty Co.*[293] represents the opposite view. In this case, a federal district court held that unless it is specifically spelled out as a contractual duty, insurers are not obliged to advance

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287. 6B APPLEMAN, INSURANCE LAW & PRACTICE § 4261 (Buckley ed. 1979); *cf.* COUCH, 11 COUCH ON INSURANCE § 44.4 (2d 1982).

288. 823 F.2d 276 (9th Cir. 1986) (amending and correcting 795 F.2d 1450 (9th Cir. 1986)).

289. *Id.* at 281-282.

290. Gon v. First State Ins. Co., 871 F.2d 863 (9th Cir. 1989); American Cas. Co. v. Bank of Montana System, 675 F. Supp. 538 (D. Minn. 1987); Little v. MGIC Indem. Corp., 649 F. Supp. 1460 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987); Pepsico v. Continental Casualty Co., 640 F. Supp. 656 (S.D.N.Y. 1986).

The policy language in *Gon* and *Little* was identical to that in *Okada*. The policy language in *Pepsico*, unlike the policies in *Okada*, *Little* and *Gon*, did not have language that expressly allowed the insurer to advance defense costs at its option. *Pepsico*, 640 F. Supp. at 660. Instead, the court found that the insurer had agreed to reimburse Pepsico for defense costs "whenever Pepsico 'may be required or permitted by law' to reimburse its directors and officers." *Id.* The court then found that Pepsico, through a by-law, "broadened its ability to indemnify its directors and officers" so that the advanced attorneys fees were covered. *Id.* at 661.

291. *See supra* note 186 and accompanying text.

292. *Little*, 649 F. Supp. at 1468.

293. 663 F. Supp. 330 (C.D. Ill. 1987). *See also* American Cas. Co. of Reading Pa. v. FDIC, 677 F. Supp. 600 (N.D. Iowa 1987) and cases cited therein.

legal fees as these fees are incurred.[294] Addressing the same contractual terms as the *Okada* court, the court in *Zaborac* found the terms clear and held that the insurer was not obligated to pay any covered "loss" until the case was concluded and the court had made certain findings relevant to coverage[295] (i.e. regarding fraud, dishonesty, etc.). *Zaborac* never addressed the unconscionability argument raised by the "staggering" size of attorneys fees.

Currently, therefore, the law is unclear as to whether D&O insurers are obligated to reimburse attorneys fees as those fees are incurred. Because of this uncertainty corporations, corporate executives, and insurers are on notice to negotiate and draft D&O policies so as to explicitly spell out their intention as to whether coverage includes payment of attorneys fees prior to final judgment.[296]

## III. Summary, Assessment and Proposal

### *A. SUMMARY*

Assume a corporate executive becomes the target of grand jury investigation or is indicted. During the investigation, pretrial negotiations, and trial if one occurs, the executive incurs hundreds of thousands of dollars in attorneys fees. Although there may not yet be a judgment that would indicate whether or not the executive qualifies for indemnification from the relevant corporation or reimbursement from the applicable D&O insurer, it is likely that the executive will seek an advance to cover these attorneys fees. If the executive seeks the advance from the corporation and meets statutory criteria (virtually pro forma)[297] he will receive the advance without posting security or proving an ability to repay if he is ultimately found ineligible for indemnification. If the executive seeks an advance from the D&O insurer, or if the corporation seeks coverage for amounts it advanced to the executive, the law is unclear and the policy language and the jurisdiction will determine whether coverage is available.[298]

If the grand jury does not return charges against the executive or if the executive is acquitted on all charges, he will be entitled to mandatory indemnification from the corporation for all attorneys fees and other

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294. *Zaborac*, 663 F. Supp. at 333-34.

295. *Id.* at 332.

296. *Cf.* Note, *Practical Aspects of D&O Insurance*, *supra* note 8, 32 UCLA L.Rev. at 712-715 and 717-718 (suggesting that D&O policies be clarified and also that they should include a duty to defend on the part of the D&O insurer).

297. *See supra* notes 55-131 and accompanying text.

298. *See supra* notes 285-96 and accompanying text.

costs. The corporation should then be able to collect the amount it indemnified its executive from its D&O insurer.[299] If the executive's corporate employer is unable or unwilling to indemnify, the executive should be able to recover directly from the D&O insurer for the attorneys fees and other costs he paid.[300] If the executive secures a pretrial dismissal on procedural grounds of some of the charges, and seeks indemnification from the corporation, he is entitled to mandatory pro-rata indemnification for the dismissed charges only if the applicable indemnification statute requires reimbursement when one is "successful on the merits or otherwise."

If the executive negotiates a plea agreement and secures a dismissal of some of the charges in return for a plea of guilty to other charges, he is not entitled to mandatory reimbursement if the applicable statute requires that one be "wholly successful." He is entitled to any mandatory pro-rata reimbursement for the dismissed charges if the applicable law requires only that one be "successful."

If the executive has been partially successful on the criminal charges, (i.e. through pretrial motions to dismiss charges or a plea agreement dismissing some of the charges), but this measure of success is insufficient to qualify for mandatory indemnification, the executive may still receive indemnification by qualifying under statutory standards for permissive indemnification. Similarly, the executive who has been convicted on all criminal charges may receive indemnification by qualifying under these permissive standards.[301] Through the interplay of applicable principles of corporate, criminal and insurance law, a convicted executive may well qualify under these permissive standards.[302] However, even if the executive cannot qualify under the permissive standards, he may still receive indemnification under the incorporation statutes of the twenty states that allow a court to order indemnification even if the permissive standards are not met.[303] Also, an executive who is ultimately unable to meet the permissive standards may receive defacto indemnification in forty-nine states by receiving an advance of attorneys fees with no repayment required or, in some cases, even requested.[304] In the forty-eight states

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299. This collection would, of course, be subject to applicable limits and deductibles. For a discussion of limits and deductibles see J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, at ¶ 8.03 (1981 Supp. 1990); THE 1987 WYATT SURVEY, *supra* note 246, at 57, 75.

300. *See* sources cited *supra* note 299.

301. Such a result assumes that no other limitations apply. *See supra* notes 221-29 and accompanying text.

302. *See supra* notes 55-131 and accompanying text.

303. *See supra* notes 214-15 and accompanying text.

304. *See supra* notes 199-209 and accompanying text.

governed by a nonexclusive or quasi-nonexclusive incorporation statute, the executive may obtain indemnification from the corporation even if he fails to meet the statutory standards as long as corporate bylaws, resolutions, or a negotiated contract allow indemnification.[305] The only hurdle the convicted corporate executive must overcome in receiving indemnification through any of these routes is principles of public policy enforced by the courts. However, because of the small likelihood that an indemnification award will be reviewed by a court, and because courts erratically apply these principles of public policy, this is an unlikely impediment.[306]

If the convicted executive attempts to collect from the insurer for his fines, penalties and defense costs, or if the corporation attempts to collect from the insurer for amounts it indemnified the convicted executive, coverage is uncertain. D&O policies purport to exclude coverage of claims arising from criminal liability. However, because of ambiguity in the policy definitions and exclusions,[307] and because some policies grant coverage equal to a corporation's power to indemnify,[308] such claims may be covered.

### *B. ASSESSMENT AND PROPOSAL*

Having surveyed this land of riches for convicted executives, the merits of such reimbursement must be evaluated. There are legitimate business reasons why corporations and insurers should be allowed to reimburse executives for costs these executives incur due to liability arising from their corporate duties. It is probably true, and it is certainly the perception, that corporate executives may be exposed to greater risks of liability than are most of us. With increasingly creative plaintiffs,[309]

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305. *See supra* notes 143-45 and accompanying text.

306. *See supra* notes 159-98 and accompanying text.

307. *See supra* notes 275-84 and accompanying text.

308. *See, e.g.*, Stewart Smith Form, in J. BISHOP, INDEMNIFICATION AND INSURANCE, *supra* note 1, app. 8A, at 51 (1981 & Supp. 1990).

309. Lynch, *RICO: The Crime of Being A Criminal, Parts I & II*, 87 COLUM. L. REV. 661 (1987) (and cases cited at 661 n.3); Note, *The Civil Rico Pattern Requirement: Continuity and Relationship, A Fatal Attraction?*, 56 FORDHAM L. REV. 955, 960 n.37 (1988) (private plaintiffs are finding more creative uses for the RICO statute). *See, e.g.*, Fleet Management Systems, Inc. v. Archer-Daniels-Midland Co., 627 F. Supp. 550 (C.D. Ill. 1986) (licensor of computer software program filed action against licensee alleging violation of RICO Act when licensee participated in a scheme to fraudulently misappropriate and market the licensed software); Grogan v. Platt, 835 F.2d 844 (11th Cir. 1988), *cert. denied*, ____U.S. ____, 109 S. Ct. 531, 102 L. Ed. 2d 562 (1988) (federal agents and estates of two other agents involved in a shootout with criminal suspects filed a complaint against the estates of the suspects seeking damages under civil provisions of the RICO Act).

a financial market riddled with scandals,[310] and courts rendering unpredictable verdicts,[311] these risks may even be rising. In today's business environment, some degree of indemnification is undoubtedly necessary to attract and retain talented and capable executives. Moreover, executives cannot be burdened with layers of bureaucracy installed solely to protect them against frivolous lawsuits. The fear of litigation cannot be allowed to cripple our innovative executives who can, and should, be able to act quickly and intuitively before promising business opportunities vanish.[312] To the extent indemnification and D&O insurance provide this freedom, they should be encouraged. However, reimbursement to convicted executives is a different matter. It should not be allowed to continue unchecked because we fail to acknowledge its true girth or because we fail to comprehend the unique policy interests it tramples.

An analogy may help demonstrate why indemnification to convicted executives should not be allowed. We would not be concerned if the family of a convicted bank robber paid the expenses of his defense and the fine imposed upon him. Indeed, most of us would probably approve of such familial support at a time of stress and need. The difference between our bank robber and the corporate executive, however, is in who is paying and the threat such payment poses to our legal system. If the bank robber's "family" was a gang that recruited individuals to be bank robbers and to share their ill-gotten gains with the organization, reimbursement of fines, penalties and expenses by the gang after a gang-member's conviction would strengthen this organization's influence on its remaining members. It is not difficult to see that if an organization is able, by money, to partially neutralize the sanctions of society, the organization's values have a better chance of superseding those of society. When the members of the organization see payments to their fallen comrade, they cannot help but believe that wealth and status within the organization are worth the risks (now neutralized, at least somewhat, by money) of robbing banks.

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310. Labaton, *'Junk Bond' Leader is Indicted by U.S. in Criminal Action*, N.Y. Times, Mar. 30, 1989, §I, at 1, col 6 (Michael Milken faces 98 counts and forfeitures of $1.8 billion for cheating clients and stockholders, manipulating the marketplace, and deceiving a corporation about to be taken over); Nash, *S.E.C. is Under Fire in Letting Boesky Sell Off Holdings*, N.Y. Times, Nov. 21, 1986, §I, at 1, col. 1, ("[T]he first class action suit was filed against Mr. Boesky, seeking damages for his insider trading . . . Lawyers expect to see an avalanche of claims against Mr. Boesky and companies and individuals involved with him."); Wayne, *Wall St. Saw a Tough 'ARB,'* N.Y. Times, Nov. 22, 1986, §I, at 41, col. 3 (Ivan F. Boesky pays a record $100 million fine for illegal insider trading).

311. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

312. Stone, *Enterprise Liability, supra* note 8, 90 YALE L.J. at 47; Note, *Evaluating the New Director Exculpation Statutes*, 73 CORNELL L. REV. 786, 806 (1988).

The analogy of a gang of bank robbers to a corporation is faulty in two respects, both of which provide further insight as to why we should not indemnify convicted executives. First, robbing banks is clearly a crime and it would take alot of indoctrination to overcome society's stigma of it as criminal. Often, however, corporate crime is not clearly criminal; it is "puffing" a little too much about the value of assets, or speculating too optimistically about profits, or compromising on technical regulations to meet a deadline. Corporate crime is also "hidden within an organization"[313] and, because it may take the independent acts of many people to actually complete the criminal conduct, its criminal character is often subtle. Since corporate crime is not as obvious of a crime as is bank robbery and does not fit our traditional notion of a crime, it is also not as hard to convince otherwise respectable people to engage in it. In short, a corporate organization has a better chance of instilling its values in its members than does a bank-robbing gang.

The second flaw in our analogy to bank robbers is the respective impact on society of bank robbers and corporate criminals. Bank robbers are not good for any of us, but their immediate damage is confined to a particular bank and its employees or customers. Their long term harm to the security of our savings system is dwarfed, however, by the harm caused by white collar crime.[314] Whether we are talking about our savings system, political infrastructure, environment, health care system, defense industry, or pension system, the damage caused by white collar crime debilitates the foundation of our society.[315] Because of this impact, there

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313. *White Collar Crime Hearing*, *supra* note 62, at 103 (1986) (testimony of Professor Stanton Wheeler, Yale Law School); *cf.* D. TIMMER & D. EITZEN, CRIME IN THE STREETS AND CRIME IN THE SUITES 248-255 (1989); K. MANN, DEFENDING WHITE COLLAR Crime 8-13 (1985); J. COLEMAN, THE CRIMINAL ELITE 212-217 (1985); F. LEE BAILEY & H. ROTHBLATT, DEFENDING BUSINESS AND WHITE COLLAR CRIMES 2-3 (1984); M. CLINARD & P. YEAGER, CORPORATE CRIME 6-7 (1980).

314. In 1982, the estimated loss due to bank robberies, burglaries and larcenies was $45 million. Daniels, *Crimes Against Financial Institutions Decline During Second Half of 1982*, 16 FED. HOME LOAN BANK BD. J. 20, 22 (1983). By comparison, estimates of the loss due to fraud and embezzlement in the banking industry was $401.5 million for the same time period. *Id.* Current estimates of the amount that will be lost because of fraud and mismanagement in the Savings and Loan industry is $200 billion. Rosenbaum, *S&L's: Big Money, Little Outcry*, N.Y. Times, Mar. 18, 1990, § 4, at 1, col. 1.

315. *See, e.g.*, J. COLEMAN, THE CRIMINAL ELITE 1-3 (1985) ("[Street crime's] image has become so bloated in the mirror of public opinion that it blocks our view of the white collar crimes which are both more costly and more dangerous to society."); E. SUTHERLAND, WHITE COLLAR CRIME: THE UNCUT VERSION 8-9 (1983) ("The financial cost of white collar crime is probably several times as great as the financial cost of all the crimes which are customarily regarded as the 'crime problem.'"); M. CLINARD & P. YEAGER, CORPORATE CRIME 8-9 (1980) ("[Corporate crimes] involve not only large financial losses but also injuries, deaths, and health hazards. They also involve the incredible costs

is a greater societal need to control our many corporations than our few bank-robbing gangs.

There can be no question that because of the increasingly significant role corporations assume in modern society, it is essential that they encourage lawful, rather than unlawful, behavior. They have the power to do either. To examine this, all one has to do is turn to the wealth of business literature on corporate culture which examines how a particular corporate environment can encourage, or discourage, behavior.[316] For criminal justice purposes, some of the most interesting work on corporate culture has been conducted by sociologists who have examined the commission of corporate crime to determine the characteristics of lawful and unlawful organizations. These scholars suggest that certain social structures and processes internal to an organization encourage unlawful behavior.[317]

For example, in a study of sixty-four retired, middle management employees of Fortune 500 corporations,[318] Marshall Clinard found that these executives consistently identified corporate internal structure (versus outside market forces) as primarily determinative of whether a corporation was lawful or unlawful.[319] One such internal factor was top management's attitude toward applicable laws and regulations.[320] Top management who encouraged law abiding behavior were described as respectful of appli-

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of the damage done to the physical environment and the great social costs of the erosion of the moral base of society. Such crimes destroy public confidence in business and in the capitalist system as a whole, and they seriously hurt the public image of the corporations themselves and their competitors."); A. Bequai, White Collar Crime: A 20th Century Crisis 2-4 (1978) ("Victims [of white collar crime] range from the average, unsuspecting consumer to the sophisticated banker; both young and old are open to attack. No individual or institution is immune to white collar criminals."); J. Conklin, Illegal But Not Criminal 4-5 (1977) ("Violations of the law by businessmen not only cost money; they may also lead to physical harm or even death.").

316. *See, e.g.*, D. Graves, Corporate Culture-Diagnosis and Change (1986); T.E. Deal & A.A. Kennedy, Corporate Cultures (1982); T.J. Peters & R.H. Waterman, In Search of Excellence: Lessons From America's Best Run Company (1982); A. Sampson, The Seven Sisters (1975).

317. M. B. Clinard, Corporate Ethics and Crime 122 (1983); Fisse, *Reconstructing Corporate Criminal Law: Delerance, Retribution, Fault & Sanctions*, 56 S. Cal. L. Rev. 1141, 1163 n.96 (1983); Vaughan, *Toward Understanding Unlawful Organizational Behavior*, 80 Mich. L. Rev. 1377, 1378 (1982).

318. M. B. Clinard, Corporate Ethics and Crime, *supra* note 317, at 24-25.

319. *Id.* at 132. It should be noted that Clinard focused this study on unethical as well as unlawful behavior. *Id.* at 35. When studying illegal behavior, such co-mingling may be problematic but it seems appropriate given the lack of legal training of the managers in Clinard's sample. As one executive stated: "[l]aw violations are about the same as ethics except in the former you go to jail." *Id.* at 132.

320. *Id.* at 132

cable government regulations, encouraging of their enforcement, and effective in monitoring their compliance by employees.[321] Another significant internal factor was the pressure placed on middle management to show a profit. Companies that encouraged unlawful behavior communicated to their employees that compromises in following the law were permitted if necessary to meet the profit goal.[322] Indemnification of executives convicted of violating the law cannot help but communicate this.

Diane Vaughan's study of Revco Inc. is especially interesting as a case study of organizational crime.[323] In 1977, Revco Inc., a pharmaceutical retailer, pled guilty to submitting over $500,000 in false medicaid claims.[324] Drawing upon this case study Vaughan focuses, in part, on the relationship between corporate structural factors and unlawful behavior.[325] She concludes that the "organizational processes . . . create an internal moral and intellectual world" in which "individuals within the organization are encouraged to engage in unlawful behavior."[326] These organizational processes include reward mechanisms, internal education and training, and informational processing and recording methods.[327]

In short, there is no question that the formal and informal structure of a corporation can encourage or discourage violations of the law. Indemnification by a corporation or reimbursement by an D&O insurer to an executive who has been convicted of crimes is part of this structure. By paying a convicted corporate executive for fines, penalties and costs incurred in his criminal case, and often by doing so after explicitly finding that this executive acted in good faith and had no reason to believe his conduct was unlawful, corporations and insurers are sending a message to corporate executives. They are telling these employees that pursuit of corporate goals justifies breaking the law and that they will reward those who do so. Moreover, this indemnification separates corporate executives from other criminal defendants. With someone else paying their litigation expenses and fines or penalties, corporate executives do not feel the pain or stigma of a criminal verdict and sentence as do other criminal defendants. Thus, indemnification and insurance not only contribute to a corporate culture that encourages corporate crime but also perpetuate two levels of justice.

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321. *Id.* at 74, 132.
322. *Id.* at 91, 140-44.
323. D. VAUGHAN, CONTROLLING UNLAWFUL ORGANIZATIONAL BEHAVIOR (1983).
324. *Id.* at 17.
325. *Id.* at 68.
326. *Id.* at 70.
327. *Id.* at 68-77.

When one examines the historical evolution of indemnification and D&O insurance, one can see how their potential for encouraging corporate crime was overlooked. These methods of reimbursement developed in the context of civil law,[328] the traditional objective of which is reimbursement to a victim by the party causing the injury.[329] Indemnification and insurance further this goal because they assist the party found liable in paying the judgment to the victim. Notably, even when indemnification does not further this goal, as when the civil defendant has sufficient assets to pay the judgment, indemnification still does not detract from it.

By comparison, the major objective of criminal liability is deterrence.[330] Our criminal justice system is based upon the belief that by public condemnation, sufficiently harsh penalties and loss of privileges, a defendant and all others who observe his conviction and sentence will be discouraged from engaging in the proscribed behavior. Indemnification and D&O insurance never serve this goal of deterrence; rather, they allow a private party (either a corporation or an insurer) to neutralize, if not defeat it.[331]

While this proffered explanation may help explain our current practice of indemnifying convicted executives, it cannot justify it. We cannot continue to ignore the very different impact indemnification and D&O insurance have in the civil and criminal arenas. Reimbursement through indemnification and D&O insurance to convicted executives should not

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328. *See supra* notes 3-5.

329. HART, THE CONCEPT OF LAWS 157 (1961) (Hart refers to the civil law as "conceived as offering redress for harm" whereas the criminal law is "conceived not only as restricting liberty but as providing protection from various sorts of harm."). *See, e.g.*, J. HALL, GENERAL PRINCIPLES OF COMMON LAW 188-214 (1947); Mueller, *Mens Rea and the Corporation*, 19 U. PITT. L. REV. 21, 37, 38 (1957). For a fascinating discussion of how punitive damages interface civil tort law and criminal law, see *Symposium: Punitive Damages*, 40 ALA. L. REV. 687 (1989).

330. This is the utilitarian theory of punishment. A discussion of it may be found in J. BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION, ch. 16, in BOWRING, THE WORKS OF JEREMY BENTHAM (1962); *see also* AMERICAN LAW INSTITUTE, COMMENTS ON MODEL PENAL CODE § 2.07, at 148 (Tent. Draft No. 4) (1956) ("It would seem that the ultimate justification of corporate criminal responsibility must rest in large measure on an evaluation of the deterrent effects of corporate fines on the conduct of corporate agents."). Some would disagree that this should be the reason for criminal punishment arguing that criminal punishment should not be imposed because of the consequences it will have on future behavior but because an individual acted immorally. Kant sets forth the classic argument for this position. I. KANT, THE METAPHYSICAL ELEMENTS OF JUSTICE 99-107 (Bobbs-Merrill ed. 1965).

The positions are not incompatible. Some commentators suggest that both goals should be served by criminal punishment. *See, e.g.*, Hart, *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 422-425 (1958).

331. Stone, *Enterprise Liability*, *supra* note 8, 90 YALE L.J. at 48, 55.

be allowed.[332] Indemnification statutes should be amended so that they directly and plainly exclude indemnification to any convicted executive. The nonexclusivity provision in these statutes should also be amended so that corporations cannot circumvent such a prohibition by indemnifying convicted executives through bylaws, resolutions, or contracts. To the extent that the definition of "loss" or the dishonesty exclusion in D&O policies obligates insurers to reimburse convicted executives or corporations that have indemnified convicted executives, these polices should be redrafted to clearly exclude such coverage.

Advances of fees to executives who are targets of a criminal investigation or who have been charged but not yet acquitted or convicted, presents a more complex question than does that posed by reimbursement to convicted executives for fines and penalties. Currently every state incorporation code, except that of Vermont, gives corporations the power to advance attorneys fees before there has been a judgment.[333] Four reasons can be offered in favor of allowing these advances.

The first reason is based upon fundamental fairness and the need to attract qualified executives. Every person is presumed innocent until found guilty. By refusing to advance funds, corporations and insurers are presuming guilt or at the least, questioning innocence. Because of the increased, and perhaps increasing, risks to which corporate executives are exposed, the fair assurance that advances of fees will be provided if the need arises may be necessary to attract capable and talented executives.

The second reason in favor of advancing fees is the one propounded by most commentators,[334] and in a related situation, by the Supreme Court.[335] It is that because attorneys fees are so large, an advance is necessary for the executive to wage a vigorous defense. The importance of this interest is viewed by these scholars to outweigh the "minimal"

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332. Some statutes and agencies already attempt to prohibit such reimbursement. *See, e.g.*, Investment Companies and Advisers, 15 U.S.C. § 80a-17(h) (Supp. 1990) (prohibits "any provision which protects . . . any director or officers of [a registered investment company] against . . . willful misfeasance, bad faith, gross negligence or reckless disregard of . . . duties"); Foreign Corrupt Practices Act, 15 U.S.C. § 78ff(c)(3) (Supp. 1990) (prohibits indemnification of criminal fines owed for violations of the FCPA); 17 C.F.R. § 230.461(c) (1990) (the SEC requires corporate executives to waive their right to indemnification for personal liability for the corporation to qualify for acceleration of the effective date of a registration statement). *Cf.* Stone, *Enterprise Liability*, *supra* note 8, 90 YALE L.J. at 55-56.

333. *See supra* note 199.

334. *See, e.g.*, Note, *Insurance For Executives*, *supra* note 8, 80 HARV. L. REV. at 660; Note, *Indemnification of Directors*, *supra* note 4, 76 HARV. L. REV. at 1411.

335. Comm'r v. Tellier, 383 U.S. 687, 694-95, 86 S. Ct. 1118, 1122-23, 16 L. Ed. 2d 185, 190-191 (1966).

deterrence achieved of not advancing funds.[336] There can be no doubt that the attorneys fees incurred by corporate executives in defense of criminal charges may be large: as noted, the 1988 Wyatt Survey found the average attorneys fees in cases involving corporate executives to be $693,000.[337] There are two flaws, however, in using this argument to justify advances; both stem from a failure to look at who will be receiving the advance. Most corporate executives are relatively wealthy.[338] Of all people defending themselves against criminal charges, corporate executives probably need financial assistance the least. Also, it seems fair to suggest, most corporate executives are articulate, intelligent, and assertive people who are concerned about their reputations. These are the type of people who will wage a vigorous defense without having to be encouraged to do so. Thus, while superficially appealing, advancing fees so as to encourage a vigorous defense is of minimal relevance when we recognize that the people receiving the advances are unusually wealthy and determined defendants.

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336. Note, *Insurance for Executives*, *supra* note 8, 80 HARV. L. REV. at 661; *see also* Note, *Indemnification for Directors*, *supra* note 4, 76 HARV. L. REV. at 1411-12.

The deterrence argument is that an executive who knows she must pay her own attorneys fees will be deterred from committing criminal acts *and* that this deterrence is additional to any deterrence achieved by the executive's knowledge that she will suffer other penalties imposed because of a criminal conviction (fines, loss of job and damage to reputation). This deterrence argument has merit if the defense attorneys fees habitually dwarf the fine imposed (i.e., $495,000 in attorneys fees and a $1000 fine). One must concede, however, that this balance would be unusual and unpredictable. Although the "package" of tangibles (indemnification for all costs, fines, penalties, and retention of corporate rank, privileges, salary & benefits) and intangibles (emotional support from colleagues) offered to a convicted colleague by a corporation or insurer may effectively dilute the deterrence effect of the criminal law, an advance of fees is such an unusual portion of this package, it is of little consequence.

337. THE 1988 WYATT SURVEY, *supra* note 246, at 15.

338. The estimated median annual salary of top executives was around $34,000 in 1986 and many earned well over $52,000. *Bureau of Labor Statistics, U.S. Dept. of Labor, Bulletin 2300 Occupational Outlook Handbook* (1988-89). Most salaried executives in the private sector receive additional compensation in the form of bonuses, stock awards, and cash equivalent fringe benefits. *Id.* In addition to salary, the average director makes $50,000 a year for each outside board on which he serves and roughly $35,000 of this amount is cash. Krusekopf, *Pushing Corporate Boards to be Better*, FORTUNE, July 18, 1988, at 58. Most companies also offer a few hidden benefits, the most valuable of which is retirement pay. *Id.* This often amounts to $25,000 a year for life. *Id.* The number of directorships held by an individual serves to multiply these benefits. The mean number of directorships held by individuals in 1988 was 3.1. HEIDRICK AND STRUGGLES, THE CHANGING BOARD 13 (1988). The percentage of directors holding four or more directorships in 1988 was 31.7. *Id.*

To the extent a corporate executive should be indigent, or become indigent during the legal proceedings, appointment of counsel would be required by the sixth amendment to the United States Constitution. *See generally* Bucy, *Corporate Ethos: Reformulating Corporate Criminal Liability*, 75 MINN. L. REV. ____(1991).

The third reason for allowing advances for attorneys fees, at least from the perspective of the corporate employers and D&O insurers, is that the result in the criminal case may adversely affect civil lawsuits against the corporation or the insurer.[339] For example, if the executive refuses to enter into a plea agreement and pursues an aggressive defense which entails a lengthy and notorious trial, potential civil plaintiffs may gather information from the criminal trial which they can use in obtaining judgments in related civil cases against other corporate executives or the corporation, and for which the D&O insurer may be liable.[340] By advancing attorneys fees, however, the corporation or the D&O insurer may be able to influence the course of the criminal case in a way that best serves their interests, as for example, by encouraging a guilty plea instead of a protracted and public defense. Although many corporate executives may eagerly, or unknowingly, enter into this Faustian bargain to obtain advanced payment for attorneys fees, it has a corrupting influence on our system of justice. Not only is a convicted defendant avoiding, at least in part, the burden of a criminal conviction when someone else pays her fees, but she may also deprive the crime's victims of a collateral estoppel effect otherwise available as well as jeopardize her rights to a fair trial. We would be naive to ignore the fact that this potential collateral estoppel effect on related civil cases may be the major reason corporations and D&O insurers advance monies for fees.

The fourth argument proffered in favor of allowing corporations to advance attorneys fees is that mechanisms exist to protect the public,

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339. The doctrine of "collateral estoppel," a concept developed by the courts, becomes relevant here. It provides that an issue of ultimate fact that has been actually litigated in one judicial proceeding cannot be relitigated in another judicial proceeding. Ashe v. Swenson, 397 U.S. 436, 90 S. Ct. 1189, 25 L. Ed. 2d 469 (1970). Originally, courts required "mutuality of parties" before collateral estoppel could apply; that is, the parties in the first, and collateral, lawsuits had to be the same. When mutuality of parties is required, a conviction for fraud in a criminal case will be of limited applicability in a subsequent civil law suit alleging the same fraud. Although the defendant in each action will be the same, only when the government is bringing both the civil and criminal cases will the plaintiff be the same in both actions. When the plaintiffs in the collateral civil lawsuit are private citizens the mutuality of the parties requirement would prevent these citizens from using collateral estoppel in their civil lawsuit. In recent years the federal courts and many state courts have dispensed with the mutuality of parties requirement. Coffee, *No Soul to Damn*, *supra* note 8, 79 MICH. L. REV. at 442-44.

When collateral estoppel is applicable, a shareholder suing the corporate directors may be able to prevail on a motion for summary judgment in his civil lawsuit by reference to the conviction handed down in the criminal lawsuit. The D&O insurer may then become liable on these related civil judgments.

340. J. COLEMAN, THE CRIMINAL ELITE 166-169 (1985) ("The nolo plea deprives the victims of white collar criminals of the benefit of using the government's investigatory efforts, in civil cases.").

and shareholders, against improper and imprudent advances. Arguably, there are three such mechanisms. First, there is the requirement, in at least some states, that the executive seeking an advance furnish a written statement of his good faith belief that he meets the standard for permissive indemnification.[341] Second, there is a requirement, again in some states, that before an advance can be paid a determination must be made that "the facts then known" would not preclude indemnification under the incorporation statute.[342] Third, every state requires that the executive provide an "undertaking to repay" before receiving the advance.[343] The problem is that these protections are inadequate to ensure that improper advances will not be made. As noted, the good faith affirmation is pro forma only; virtually no one will admit anything but good faith early in a criminal case.[344] The requirement of a "determination" is not much better; the "determination" of facts is made by friendly parties using overly broad standards, and upon inadequate information.[345]

Ostensibly, the undertaking to repay provides more viable protection. Yet, it too is inadequate. The following scenario may help demonstrate why. We will assume that an advance is granted to an indicted executive. As her trial progresses, it becomes clear that this executive committed egregious acts of thievery and deceit upon the shareholders and public. She is convicted. Under no reasonable interpretation of any incorporation statute, bylaw, resolution, or contract can one say that this executive exhibited sufficient good faith to qualify for indemnification. Yet, our executive does not repay the advance; in this way she has received defacto indemnification, at least thus far.

There are two things that must occur before our executive's advance is recovered and she is prevented from obtaining defacto indemnification for her attorneys fees. The first is that the corporation, or insurer, must initiate the recovery of the advance. The second is that the corporation, or insurer, must be able to recover the advance.

One may safely assume that the insurer would fulfill both conditions in most situations. Unlike the corporation, which may have emotional or other loyalties to its executive, the insurer would have no incentive not to seek recovery. Also, unlike the corporation, which paid the advance directly to the executive and must now seek recovery of it from the recently convicted executive herself, most of the time[346] the insurer reimbursed the corporation which had already indemnified the executive.

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341. *See supra* statutes at notes 206 and 11.
342. *See supra* statutes at notes 207 and 11.
343. *See supra* statutes at notes 199 and 11.
344. *See supra* text at notes 207-09.
345. *See supra* text at notes 207-10.
346. THE 1982 WYATT SURVEY, *supra* note 242, at 61.

Thus the D&O insurer must simply collect the funds which were paid to the corporation. Assuming the corporation is solvent, generally it will be easier for an insurer to recover monies from a corporation than it is for a corporation to recover monies from a convicted executive.[347]

Whether a corporation will initiate or be able to recover an advance of funds paid to its executive, is a different matter. A corporation may not seek recovery of advances despite the egregiousness of the executive's actions because the remaining corporate executives are loyal to their convicted colleague or her family. More cynically, these executives may fear that their colleague will start pointing fingers at them unless she feels beholden to them, which she may if the corporation allows her to keep the funds advanced. For whatever reason, if the corporation is unwilling to seek recovery, there is a smorgasbord of loopholes by which the corporate executives may legally justify not doing so.

Even if the corporation decides to seek recovery of the funds advanced, however, it may be unable to find assets available. Perhaps anticipating a guilty verdict, wealthy executives may secret their assets or legally transfer title in them. Or, it is possible that during the years it may have taken the criminal case to run its course, the executive's wealth has been dissipated through over-leveraging or other financial misfortunes. This brings us back to the ineffectual nature of the "undertaking to repay" requirement. Without security, this undertaking to repay is worthless and confers defacto indemnification to executives who may have egregiously and blatantly committed crimes.

Sorting out the merits of allowing advances of attorneys fees is now easier. It is not only fair and equitable, but probably necessary to attract quality individuals, that these advances be available to corporate executives. This consideration is more powerful than the one typically suggested, that advances are necessary to encourage and facilitate a vigorous defense. Granted, a few executives may be able to wage a more vigorous defense if an advance is available but given the assets, personality, and reputation at stake of most executives, this rationale is relatively insignificant. On the other hand, the opportunity to influence an indicted or targeted executive's decisions in the criminal case is probably the main reason insurers and corporations prefer to make advances. Given

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347. The circumstances in which a D&O insurer would have difficulty recovering an advance include occasions when the insurer made the advance directly to the executive and executive has no locatable assets; when the insurer has reimbursed the corporation for an advance it made to its executive, and the corporation refuses to repay the advance. A corporation may refuse to repay an advance to its D&O insurer if it has no assets itself, or if it asserts that the executive is entitled to the advance under applicable state law. The latter position, of course, could not occur if indemnification to convicted executives is categorically disallowed.

the hazards this influence poses to potential civil plaintiffs, and perhaps even to the executive herself, however, this reason militates against advances, at least from a public policy point of view. Lastly, the protections against imprudent advances already in the incorporation statutes cannot serve as an argument in favor of allowing advances because these protections are inadequate.

The previous proposal, that incorporation statutes be amended to categorically disallow indemnification to a convicted executive, should encourage a corporation to seek recovery of funds it advanced to an executive who now stands convicted of crimes. If this change is made, there would be no loopholes through which a corporation could dodge its obligation to seek recovery of advances. The ability to actually recover the monies advanced presents a separate problem, however. Before they are given an advance, which is in effect an interest-free loan, executives should be required to commit to a meaningful undertaking to repay; in other words, they should have to post security.[348] There should also be mechanisms for exempting those executives who truly are unable to post security, but need advances. Qualifying for this exemption could be handled in several possible ways, such as a blanket exemption for all outside directors representing charitable or consumer groups, or an exemption granted by a court after an ex parte review of the executive's financial statement.

Requiring security in all but appropriate exceptions recognizes the importance of providing corporate executives with advances to pay attorneys fees without doing so at the expense of the public interest. With the requirement of security the corporate executive is assured of sufficient money to hire able counsel, while shareholders are assured that they will not be left with the bill for the attorneys fees if the executive is ultimately convicted. More importantly, the public is assured that the goals and integrity of the criminal justice system cannot be flouted by private parties.

The last proposal for change pertains to the standards for mandatory indemnification in state incorporation statutes. Unlike the other avenues for reimbursement to convicted executives discussed herein, the statutory standards for mandatory indemnification are too restrictive. By failing to account for the practicalities of the criminal justice system, these standards can lead to bizarre and unfair results. Use of the "wholly successful" and "successful on the merits or otherwise" standards, while perhaps well-intentioned, delegate decisions with tremendous personal

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348. At least one court has apparently required such security before allowing an advance. Professional Ins. Co. of New York v. Barry, 60 Misc. 2d 424, 303 N.Y.S.2d 556, 561 (N.Y. Sup. 1969).

and policy ramifications to the unbridled discretion of one prosecutor. Because of the "wholly successful" language, executives who have been vindicated on serious and substantial charges but convicted on minor charges are not entitled to mandatory indemnification pro-rated to cover the charges on which they were successful. Because of the "successful on the merits or otherwise" language, executives who have secured a dismissal of criminal charges on procedural grounds but reek of bad faith and illegal intentions are entitled to full indemnification. A better approach to mandatory indemnification would be to require that the court before whom the criminal proceeding is pending determine whether the interests of justice are served by allowing indemnification to the executive who has been successful, in whole or part, on the criminal charges. Because the condition precedent to the court's exercise of such power is some form of success by the executive on at least some of the criminal charges, the court's discretion is considerably limited. Because the only court eligible to make this determination is the court before whom the criminal matter is pending, there is little danger of the manipulation and duplication posed by the provision in some statutes that allows courts other than the one familiar with proceedings to authorize indemnification.

Appendix A contains a proposed indemnification statute that incorporates all of the legislative reforms suggested herein.

## IV. Conclusion

Because of the interplay of incorporation statutes, criminal law, and insurance law, corporations have broad discretion to indemnify their corporate executives who have been convicted of crimes. Because of ambiguity in D&O insurance policies and the courts' erratic application of principles of public policy, it is possible that insurers will be held liable for costs incurred by a convicted executive. One cannot assume that corporations or insurers will protest strongly about this. Corporate executives often want to indemnify their convicted colleagues. Moreover, due to the potential collateral estoppel effect of an executive's conviction on the future civil liability of the corporation, on other corporate executives and on the D&O insurer, these sources may be quite willing to indemnify the convicted corporate executive. Lost in the shuffle is the public's interest in fairness and the deterrence of corporate crime.

The compensatory goal of civil liability is well served by indemnification. This is the context in which corporate indemnification and D&O insurance developed and most commonly exists. With little analysis of public policy concerns, however, these sources of reimbursement have been extended to the criminal arena whose goal of deterrence is undercut by reimbursement to a convicted executive. Modifications in incorporation

statutes and D&O insurance policies such as those suggested herein are needed to insure that indemnification continues to serve the appropriate needs for which it was designed, yet not frustrate the goals and integrity of our criminal justice system.

# APPENDIX A:

## *PROPOSED INDEMNIFICATION STATUTE**

I. *DEFINITIONS*: In this Subchapter:
   (A) "Corporation" includes any domestic or foreign predecessor entity of a corporation in a merger or other transaction in which the predecessor's existence ceased upon consummation of the transaction.
   (B) "Person" means any individual who is or was a director, officer, employee or agent of the corporation or who is or was serving at the request of the corporation as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, employee benefit plan or other enterprise.
   (C) "Expenses" include counsel fees.
   (D) "Liability" means the obligation to pay a judgment, settlement, penalty, fine (including an excise tax assessed with respect to a proceeding).
   (E) "Party" includes an individual who was, is, or is threatened to be made a named defendant or respondent in a proceeding.
   (F) "Proceeding" means any threatened, pending, or completed action, suit, or proceeding, whether civil, administrative, criminal or investigative and whether formal or informal.

II. *AUTHORITY TO INDEMNIFY*
   (A) Except as provided in subsection (D), a corporation may indemnify any person who was or is a party to any threatened, pending, or completed action, suit, or proceeding or investigation, whether civil or administrative against liability incurred in the proceeding if:
      (1) the person acted in good faith; and
      (2) the person reasonably believed:
         (i) in the case of conduct in his official capacity with the corporation, that his conduct was in the corporation's best interests; and
         (ii) in all other cases, that his conduct was at least not opposed to the best interest of the corporation.
   (B) A person's conduct with respect to an employee benefit plan for a purpose he reasonably believed to be in the interests

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* Developed from the Revised Model Business Corporation Act, §§ 7.50-8.58 (1984) and The Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 145 (1983 & Supp. 1988).

of the participants in and beneficiaries of the plan is conduct that satisfies the requirement of subsection (A)(2)(ii).

(C) The termination of a proceeding by judgment, order, settlement, or its equivalent is not, of itself, determinative that the person did not meet the standard of conduct described in this section.

(D) A corporation may not indemnify a person under this section:

(1) in connection with a proceeding by or in the right of the corporation in which the person was adjudged liable to the corporation;

(2) in connection with any other proceeding charging improper personal benefit to the person, whether or not involving action in an official capacity, in which the person was adjudged liable on the basis that he improperly received a personal benefit; or

(3) in connection with a criminal proceeding as to all changes on which the person was convicted.

(E) Indemnification permitted under this section in connection with a proceeding by or in the right of the corporation is limited to reasonable expenses incurred in connection with the proceeding.

III. *MANDATORY INDEMNIFICATION*

(A) Subject to subsection (B), a corporation shall indemnify a person who was successful, on the merits or otherwise, in the defense of any proceeding including civil, administrative, or criminal, against reasonable expenses incurred by the person in connection with the proceeding.

(B) The court before whom the proceeding was pending must certify that the interests of justice are served by indemnification, in whole or part, to the person who has been successful, on the merits or otherwise, in the defense of the proceeding.

IV. *ADVANCE FOR EXPENSES*

(A) A corporation may pay for or reimburse the reasonable expenses incurred by a person who is a party to a proceeding in advance of final disposition of the proceeding if:

(1) the person furnishes the corporation with a written affirmation of his good faith belief that he has met the standard of conduct described in section II;

(2) the person furnishes the corporation a written undertaking, executed personally or on his behalf, to repay the advance if it is ultimately determined that he did not meet the standard of conduct; and

(3) a determination is made that the facts then known to those making the determination would not preclude indemnification under this subchapter.

(B) The undertaking required by subsection (A)(2) must be secured unless the court before whom the proceeding is pending determines that:

(1) the person is serving solely as the representative of a charitable or educational, not-for-profit, organization; or,

(2) after an ex-parte, incamera review of the person's financial status, the ends of justice are not served by the requirement of security.

(C) Determinations and authorizations of payments under this section shall be made in the manner specified in section VI.

V. *COURT-ORDERED INDEMNIFICATION*

A person who is a party to a proceeding may apply for indemnification to the court conducting the proceeding. On receipt of an application, the court after giving any notice the court considers necessary, may order indemnification if it determines:

(1) the person is entitled to mandatory indemnification under section III, in which case the court shall also order the corporation to pay the person's reasonable expenses incurred to obtain court-ordered indemnification; or

(2) the person is entitled to permissive indemnification under section II.

VI. *DETERMINATION AND AUTHORIZATION OF INDEMNIFICATION*

(A) A corporation may not indemnify a person under this subchapter unless authorized in the specific case after a determination has been made that indemnification of the person is permissible in the circumstances because he has met the standard of conduct set forth in sections II or III.

(B) The determination shall be made:

(1) by the board of directors by majority vote of a quorum consisting of directors not at the time parties to the proceeding;

(2) if a quorum cannot be obtained under subsection (1), by majority vote of a committee duly designated by the board of directors (in which designation directors who are parties may not participate), consisting solely of two or more directors not at the time parties to the proceeding;

(3) if a quorum cannot be obtained under subsection (1) or a committee cannot be obtained under subsection (2), by special legal counsel:
  (i) selected by the board of directors or its committee in the manner prescribed in subsection (B)(1); or
  (ii) if a quorum of the board of directors cannot be obtained under subsection (B)(1), selected by the court before whom the proceeding is pending.

(4) by the shareholders, but shares owned by or voted under the control of directors who are at the time parties to the proceeding may not be voted on the determination.

(C) Authorization of indemnification and evaluation as to reasonableness of expenses shall be made in the same manner as the determination that indemnification is permissible or mandatory, except that if the determination is made by special legal counsel, authorization of indemnification and evaluation as to reasonableness of expenses shall be made by those entitled under subsection (B)(3) to select counsel.

VII. *INSURANCE*

(A) *Insurance for Civil Liability*

A corporation may purchase and maintain insurance on behalf of a person against civil or administrative liability asserted against or incurred by said person arising from his status as a director, officer, employee, or agent, whether or not the corporation would have power to indemnify him against the same liability under section II or III.

(B) *Insurance for Criminal Liability*

A corporation may purchase and maintain insurance on behalf of a person against criminal liability asserted against him arising from his status as a director, officer, employee, or agent; however, no corporation may maintain said insurance that would have the effect of reimbursing criminal fines or penalties.

VIII. *APPLICATION OF SUBCHAPTER*

(A) A corporation shall have the power to make any other or further indemnification of any of its directors, officers, employees, or agents under any bylaw, agreement, vote of shareholders or disinterested directors, or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office except no corporation may indemnify an executive against liability incurred because of gross negligence, willful misconduct or criminal conduct.

(B) This subchapter does not limit a corporation's power to pay or reimburse expenses incurred by any person in connection with his appearance as a witness in a proceeding at a time when he has not been named as a defendant or respondent in a civil proceeding, or as a defendant or grand jury target or grand jury subject in a criminal proceeding or investigation.