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STUDENT NOTES

CORPORATIONS: CAN A DIRECTOR'S ATTORNEYS' FEES BE PAID BY CORPORATION FOR SUCCESSFUL DEFENSE OF SUIT AGAINST DIRECTOR BY STOCKHOLDER?

Can the directors of a corporation who have been sued individually for alleged dereliction of duty, resulting in a loss to the corporation, and who have successfully defended such suit, pay out of the corporation treasury the necessary cost of attorneys' fees in defending such suit?

The above question has arisen surprisingly few times. *Griesse v. Lange*,¹ the latest case deciding such issue, held in the negative. In that case certain stockholders brought an action in a common pleas court against the directors of a corporation, seeking to recover on behalf of the corporation losses claimed to have been caused by the directors' alleged malfeasance, nonfeasance, and misfeasance. The suit resulted in favor of the directors. The directors caused to be paid from the treasury of the corporation the sum of \$5,000 as attorney's fees. Judgment was given for the defendant and the stockholders sought a writ of error. The higher court, in reversing, said, "It is elementary that property or funds of a corporation can only be used or expended for the advantage of the corporation, or for the purpose stated in its charter unless assented to by all the stockholders".

Griesse v. Lange cited two Wisconsin cases, *Figge v. Bergenthal*² and *Jesse et al. v. Four Wheel Drive Auto Co. et al.*,³ apparently basing its decision on the latter. In *Figge v. Bergenthal* the plaintiff was a director of the corporation and the defendants were directors and also husband and wife. The defendants held the controlling amount of shares in the corporation. The plaintiff brought an action against the defendants for fraudulently controlling the affairs of the corporation to their individual interests. The defendants successfully defended the suit and paid their attorneys' fees out of the corporate treasury. The court assented to such payment stating, "Respecting the payment of attorneys' fees out of corporate funds in the defense of this action little need be said. Clearly, if no case is made against the defendants it is not improper or unjust that the corporation should pay for the defense of the action".

It can be seen that a majority of the stockholders assented to the use of the corporation funds for the payment of the attorneys' fees in *Figge v. Bergenthal* in that the defending directors were the majority

¹ *Griesse v. Lange*, 37 Ohio App. 553, 175 N. E. 222 (1931).

² *Figge v. Bergenthal*, 130 Wis. 594, 109 N. W. 581 (1906).

³ *Jesse et al. v. Four-wheel Drive Auto Co. et al.*, 177 Wis. 627, 189 N. W. 277 (1922).

stockholders. But the court made no mention of such an assent being necessary; it merely stated that such payment was just and proper.

In the later Wisconsin case, *Jesse v. Auto Co.*, upon which *Griesse v. Lange* relied for its authority, the World War caused a sudden expansion of the corporation's business which beforehand had been unprofitable. Former stockholders began a suit against the directors alleging that they, having knowledge of the prospective profits of the corporation, induced the stockholders to part with their stock; that this was accomplished by fraudulent concealment of the business and financial conditions of the corporation. At the annual meeting of the stockholders the directors were authorized to defend the suit out of corporate funds. There were nearly 3,000 shares not represented at the meeting. Minority stockholders sought to enjoin the use of the corporation's funds in defending the suit. The court granted the injunction saying,

"From no standpoint, legal, equitable, or moral, can less than all the shareholders authorize the use of the funds of the corporation for purposes not germane to the business of the corporation. Much less can it throw its powers and money behind a law-suit in which it has no interest. And if a corporation cannot do these things, it most certainly cannot spend the shareholders' interest in the corporation funds to fight those claiming an interest in such funds through an action to recover stock illegally secured from them".

It appears erroneous to say that *Jesse v. Auto Co.* overruled *Figge v. Bergenthal*. Their facts make them clearly distinguishable in that the appropriation of the funds in *Jesse v. Bergenthal* was prior to the action of the stockholders against the directors. It seems clear that it is against any sound policy to allow a director to use the corporation's funds to protect him from being exposed for his actions as a director. But *Figge v. Bergenthal* did not go so far. It allowed only the payment of the attorneys' fees after the director had received a judgment freeing him of the alleged misconduct. Therefore the Ohio court in *Griesse v. Lange* surely erred in citing *Jesse v. Auto Co.* as its authority in reaching its decision.

In *Halsbury's Laws of England*⁵ the author states, "Directors may not use the funds of the company in payment of their own costs of legal proceedings, although these would not have been incurred if they had not been directors, unless incurred on behalf of the company or for its benefit". But he cites no case where the director was or was not allowed the payment of attorneys' fees by the corporation when he was successful in defending a suit for misconduct in his official capacity.

The rule applied in *Griesse v. Lange*, that property or funds of a corporation can be used or expended only for the advantage of the corporation, or for the purposes stated in the charter unless assented to by all the stockholders, is a recognized principle of corporation law.⁶

⁵ *Halsbury's Laws of England* (2d ed.) 333.

⁶ *Joy v. Jackson and Michigan Plank Road Co.*, 11 Mich. 155 (1863).

Therefore the question arises, would the payment by the corporation of the attorneys' fees of a director who has successfully defended a suit by a stockholder for dereliction of duty to the corporation, be of a benefit to the corporation? It has been held that a corporation may pay extra wages to its workmen or other employees out of its undivided profits, for the purpose of advancing its interests.⁶ It has also been held that the payment of a bonus of one-third the net profits of a corporation to officers and employees was not a fraud upon dissenting stockholders because such bonus would result in a material benefit to the corporation.⁷ In *Corning Glass Works v. Lucas*⁸ a donation was made by the corporation to a hospital in a city two-thirds of the inhabitants of which were either employees of the corporation, or their dependents. It was held that the directors of a corporation may not give away corporate property, but may make donations to enterprises reasonably calculated to further the general business interest of the corporation. A director occupies a responsible position and it is essential that he be whole-heartedly interested in the welfare of the corporation. Such a relationship is ordinarily possible only if the director is satisfied that he is being fairly treated by the corporation. Therefore, it seems that the payment of the attorneys' fees by the corporation when a suit has been successfully defended by the director would materially benefit the corporation ultimately by the desire of the director to return the just treatment he has received in the form of extending himself to give the best of his abilities to directing the policies of the corporation. It would also be unduly harsh to require a director to pay out of his own pocket, the attorneys' fees incurred in successfully defending a suit, which would have cost him his position as a director had he not defended it. From another standpoint a director is under a fiduciary duty to the corporation and when he has protected his position by defending a suit for removal brought by a stockholder it would seem that he is merely fulfilling his duty to the corporation by maintaining the position which was entrusted to his care. Therefore, in performing such duty the corporation should assume the reasonable expenses incurred thereby.

In an almost analogous situation in the law applicable to executors, it has been held that if the attempt to remove the executor fails, it is proper to order payment of attorneys' fees out of the estate.⁹ *Ogden v. Shropshire and Adkins*¹⁰ held that the reason the attorneys' fees of an executor were paid when he successfully resisted removal was the

⁶ *Hampson v. Price's Patent Candle Co.*, 45 Law J. Ch. 437 (1867).

⁷ *Putnam v. Juvenile Shoe Corp.*, 307 Mo. 74, 269 S. W. 593 (1925).

⁸ *Corning Glass Works v. Robert H. Lucas*, Comm'r of Internal Revenue, 37 F. (2d) 798 (App. D. C. 1929).

⁹ *Smith v. Kennard*, 38 Ala. 695 (1863); *Tuckerman et al. v. Currier et al.*, 54 Colo. 25, 129 Pac. 210 (1912); *Armstrong v. Boyd*, et al., 140 Ga. 710, 79 S. E. 780 (1913); *Ogden v. Shropshire and Adams et al.*, 37 S. W. (2d) 249 (Tex. 1931).

¹⁰ 37 S. W. (2d) 249 (Tex. 1931).

benefit which accrued to the estate in removing the friction between the legatees and the executor as a result of the court action. In *Armstrong v. Boyd*¹¹ it was decided that when the suit against the executor was unjustifiable the attorneys' fees of the executor should be paid out of the estate. The test to determine whether or not the case is justifiable seems to be the result of the issue, that is, it is assumed that the suit against the executor was unjustifiable because the executor successfully defended the suit.

An executor and a director are both fiduciaries. The funds of a corporation and of an estate are to be expended only for their appropriate purposes. As shown above, it has been long held that it is just and proper to order payment of the costs of an unsuccessful suit against an executor out of the estate. In keeping with such a well settled principle as applied to one type of a fiduciary it seems only just that a director should be saved from paying the attorneys' fees when he successfully defends his position in the corporation.

Under the rule applied in *Griess v. Lange* it seems that the term benefit should justly include the circumstances resulting in favor of the corporation from the successful defense of a suit by the director. The different factions of the corporation in all probability tend to cooperate better as a result of the judicial settlement of the tensions.

Finally, as one of the reasons for protecting the director is that he has proven himself free from wrong in having successfully defended such an action, the rule here sought to be applied should only be applicable where the director has been absolved from guilt on the merits of the case, and should not be extended to protect him when his defense to such action rests on a bar of remedy only, such as the laches doctrine in equity. Similarly, it has been held that where an executor is at fault, although he successfully defeats an attempt to remove him, his attorneys' fees will not be allowed as costs of administration.¹²

Due to the question presented by this note being so unsettled, a director should, if possible, when suit is brought against him contract with his attorney against personal liability for the fee of counsel, and that the attorney should look to the corporation for his fee. This was done by a trustee in a New York case¹³ when certain beneficiaries of the trust were seeking his removal. The trust estate was held liable for the attorney's fees incurred in successfully defending the suit. Mr. Justice Cardozo reasoned that the defending of the trustee's removal was beneficial to the trust estate and that the trustee owed a duty to the estate to stand his ground against unjust attack and because of such benefit and duty the attorney's fees were payable out of the trust estate in that such services, if paid for by the trustee personally, would justify reimbursement to the trustee from the estate. Of course there is not

¹¹ 140 Ga. 710, 79 S. E. 780 (1931).

¹² *Smith v. Kennard*, 38 Ala. 695 (1863).

¹³ *Jessup v. Smith*, 223 N. Y. 203, 19 N. E. 403 (1918).

complete analogy between a director and a trustee in that a director can resign from his position while a trustee can only be relieved of his duties by the court's permission.

VINCENT KELLEY.

CONFLICT OF LAWS—BASIS FOR DIVORCE—JURISDICTIONAL FACT CONCEPT.

Prior to the decision in the *Haddock*¹ case, the traditional theory of divorce was that the action was in rem.² The marital status was treated as the res,³ thus making actual notice to non-residents unnecessary when one of the spouses was domiciled within the domiciliary forum,⁴ due process being satisfied by constructive service upon a non-resident when the nature of the action is in rem.⁵

*Atherton v. Atherton*⁶ is the well known example of this theory. In that case the spouses were domiciled in state X. The wife established a separate domicile in state Y. The spouse domiciled in X brought suit in X against the absent spouse, giving notice by constructive service, and the court granted a divorce to the domiciled spouse in X. Subsequently the spouse in Y brought action in Y for a divorce against the absent spouse. The absent spouse appeared and set up the decree he obtained in X, and the Supreme Court sustained the argument that state Y must give the state X decree full faith and credit in state Y.

This theory is easily applied in proceedings when a tangible asset is the res because the res remains within one jurisdiction, but when the res is changed to an intangible object such as the marriage status, then difficulties multiply rapidly. For example, the absent spouse who has part of the marital res with him may never hear of the proceedings against him, and yet if he were to appear in the suit he would easily disprove the allegations of the complaining spouse. The *Atherton* case presents many disadvantages in holding the divorce action to be in rem.⁷

The Supreme Court, in 1906, decided the *Haddock* case.⁸ There one spouse was domiciled in state X, the other in Y. The spouse domiciled in X, but not the last marital domicile, obtained a divorce from the

¹ *Haddock v. Haddock*, 201 U. S. 562 (1906).

² *Atherton v. Atherton*, 181 U. S. 155 (1901); See *Ballard v. Hunter*, 204 U. S. 241 (1907); *Hughes v. Hughes*, 211 Ky. 799, 275 S. W. 121 (1925); *Harding v. Allen*, 9 Greenl 140 (Me. 1832).

³ Story, *Conflict of Laws* (1924), Secs. 229-230; Beale, *Haddock Revisited* (1926) 39 Harv. L. Rev. 417 at 418.

⁴ *Haddock v. Haddock*, 201 U. S. 562 (1906).

⁵ *Tibbets v. Olson*, 91 Fla. 824, 108 So. 679 (1926); *Axtell v. Axtell*, 181 Ga. 24, 181 S. E. 295 (1935); *Hinners v. Banville*, 114 N. J. Eq. 348, 168 Atl. 618 (1933).

⁶ 181 U. S. 155 (1901).

⁷ *Maynard v. Hill*, 125 U. S. 100 (1887); *Kempson v. Kempson*, 63 N. J. Eq. 783, 52 Atl. 360 (1902).

⁸ 201 U. S. 562 (1906).