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INDEMNIFICATION OF FIDUCIARY AND EMPLOYEE LITIGATION COSTS UNDER ERISA†

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The Employee Retirement Income Security Act of 1974 ("ERISA"),¹ imposes strict standards of fiduciary responsibility and accountability on persons involved with the management and disposition of employee benefit funds. The fiduciary responsibility provisions of ERISA, in essence, codify many principles of traditional trust law and make them applicable to ERISA fiduciaries.² Although the origin of these fiduciary responsibility provisions is clear,³ many aspects of a fiduciary's rights and duties under ERISA remain unsettled. For example, the exact limits of an ERISA fiduciary's entitlement to indemnification for legal fees in his capacity as a fiduciary is not at all clear. The legislative history of ERISA is simply devoid of any explanation or discussion of such indemnification rights. Thus, the intended scope of ERISA with respect to such fiduciary indemnification is subject to varied interpretation. Also absent from the statutory language and legislative history of ERISA is any discussion of whether fiduciaries may authorize indemnification payments by an employee benefit plan to employees who perform services for the plan. The absence of any clear congressional guidance in these areas has created significant practical difficulties for fiduciaries, because if a fiduciary authorizes an indemnification payment which is not permitted by ERISA, the fiduciary will be in breach of his statutory duties.

The purpose of this article is to establish workable guidelines for determining when indemnifying ERISA fiduciaries and employees for their legal costs is proper under the statute. Section I will discuss the provisions of ERISA relevant to the indemnification of these two groups. Indemnification principles in the law of trusts, private foundations, corporations and unions will also be examined to provide guidance in interpreting these ERISA provisions. Section II will examine employee indemnification principles in the law of agency. Finally, based upon an analysis of the indemnification principles analyzed in

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¹ Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified at 29 U.S.C. §§ 1001-1461 (1976)). ERISA applies to both employee welfare benefit plans and employee pension benefit plans.

² H.R. REP. NO. 93-533, 93d Cong., 2d Sess. 323, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4639, 4649.

³ See *supra* note 1.

Sections I and II, specific fiduciary and employee indemnification guidelines will be proposed in Section III for adoption by ERISA benefit plans. The purpose of these guidelines is to provide a consistent analytical framework from which to evaluate the propriety of fund indemnification payments to ERISA fiduciaries and trustees in place of the ad hoc decision system which currently is used in tackling indemnification problems. With a consistent analytic framework, ERISA fiduciaries will be more adequately equipped to determine the propriety of any given indemnification request. Consequently, their exposure to liability for improper authorization of indemnification payments will dramatically decrease.

1. FIDUCIARY INDEMNIFICATION PRINCIPLES

A. *The Provisions of ERISA Relevant to Fiduciary Indemnification*

The basic fiduciary principles of ERISA are set out in section 404(a)⁴ which establishes "*uniform federal requirements to be interpreted both in light of the common law of trusts, as well with a view toward the special nature, purpose, and importance of modern employee benefit plans.*"⁵

The general fiduciary obligations imposed by section 404 are supplemented by the specific "prohibited transaction" provisions of section 406 of ERISA.⁶ For example,

⁴ Section 404(a) provides, in pertinent part:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents are consistent with the provisions of this title or Title IV.

29 U.S.C. § 1104(a)(1) (1976).

⁵ *Marshall v. Glass/Metal Ass'n.*, 507 F. Supp. 378, 383 (D. Hawaii 1980) (emphasis added). *Accord* *N.L.R.B. v. Amax Coal Co.*, 453 U.S. 322, 330 (1981) ("[w]e must infer that Congress intended to impose on [ERISA fiduciaries] traditional fiduciary [trust] duties unless Congress has unequivocally expressed an intent to the contrary."). *See also*, H.R. REP. NO. 93-533, 93d Cong., 2d Sess. 323, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4651 ("The principles of fiduciary conduct are adopted from existing trust law, but with modifications appropriate for employee benefit plans.").

⁶ Section 406 states in relevant part:

(a) Except as provided in section 408 [of this title]:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect —

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

section 406 was enacted by Congress to prevent categories of transactions which offer a high potential for insider abuse of plans or for loss of plan assets.⁷ Section 406(a) prohibits a fiduciary from causing a plan to enter into transactions with parties whom he knows or should know are "parties in interest" with respect to the plan.⁸ Such transactions are prohibited regardless of how incidental the benefit to the party in interest is, and notwithstanding how beneficial the transaction may be to the plan and its participants.⁹ Section 406(b) also contains broad prohibitions against fiduciary self-dealing and other forms of misconduct.

Literally interpreted, the provisions of section 406 prohibit an ERISA fiduciary from obtaining reimbursement or indemnification for expenses reasonably incurred in the administration of the fund. Section 408 of ERISA, however, provides certain statutory exemptions from section 406's broad definition of prohibited transactions. In particular, section 408(c)(2) authorizes the reimbursement of expenses properly incurred by a fiduciary.¹⁰ A clear example of a "properly incurred" expense is the cost of legal services incurred to assist in the regular administration of the fund.¹¹ The reimbursement authorization granted by section 408(c)(2) for proper expenses actually incurred in the performance of plan duties, however, does not apply if the expenses are the result of a

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a).

(b) A fiduciary with respect to a plan shall not —

(1) deal with the assets of the plan in his own interest or for his own account, . . .

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan. . . .

29 U.S.C. § 1106(a), (b) (1976).

⁷ ERISA "prescribes new and stringent rules of conduct required for trustees and fiduciaries administering employee benefit funds, and prohibits conflicts of interest and various specific practices to prevent actual or potential misuse of such funds." S. REP. NO. 93-127, 93d Cong. 2d Sess., reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4838, 4839. See also, *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 636-37 (W.D. Wis. 1979).

⁸ A "party in interest" includes any fiduciary, employee of the plan, or person providing services to the plan, an employer, any of whose employees are covered by the plan, any union, any of whose members are covered by the plan, any employee, officer, director or ten percent or more shareholder of an employer or a union, and certain relatives and related entities to certain categories of parties in interest. See 29 U.S.C. § 1002(14) (1976).

⁹ See 29 U.S.C. § 1104(a)(1)(A) (1976).

¹⁰ 29 U.S.C. § 1108(c)(2) (1976).

Section 4975 of the Internal Revenue Code of 1954 imposes an initial 5% excise tax upon any disqualified person (essentially a party in interest) who engages in a "prohibited transaction" with a qualified pension plan. I.R.C. § 4975 (1954). Although Section 4975 is not generally discussed herein, Section 4975(d)(10) uses language similar to that found in ERISA Section 408 to exempt from its definition of "prohibited transactions" any payment for the "reimbursement of expenses properly and actually incurred." *Id.*

¹¹ In pertinent part, Section 408(c) states that nothing in Section 406 shall be construed to prohibit any fiduciary from:

(2) receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan; except that no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan, or from an employee organization whose members are participants in such plan shall receive compensation from such plan, except for reimbursement of expenses properly and actually incurred. . . . (emphasis added)

29 U.S.C. § 1108(c)(2) (1976).

breach of a fiduciary's duty under the plan.¹² Specifically, section 409 of ERISA renders a fiduciary personally liable for any losses to an ERISA plan which result from a breach of any of his obligations, responsibilities or duties under ERISA.¹³

A corollary to section 409's imposition of personal liability in the event of a fiduciary breach is section 410's prohibition of indemnification for liabilities incurred as a result of such a breach.¹⁴ Section 410 expressly provides, however, that insurance may be purchased for the fiduciary either by the plan, if such insurance permits recourse against the fiduciary in the event of a fiduciary breach, or by the fiduciary himself.¹⁵ Given these insurance provisions, the Department of Labor has interpreted section 410 to permit further any type of indemnification which leaves the fiduciary fully responsible for his breach, but permits another party to satisfy any liability incurred by the fiduciary in the same manner as insurance may be purchased under section 410.¹⁶ Agreements which provide for indemnification of the fiduciary by the plan itself, however, are void.¹⁷ Such an arrangement would have the same effect as an exculpatory clause in that it would relieve the fiduciary of responsibility and liability by abrogating the plan's right to recover from the fiduciary for breaches of fiduciary obligations.¹⁸

In certain circumstances, the express language of ERISA specifically establishes whether an ERISA fiduciary is allowed indemnification for legal expenses incurred by the fiduciary in his administration of an ERISA plan. For example, section 408 allows an ERISA fiduciary to receive indemnification for reasonable expenses incurred in employing legal services to assist him in the regular administration of the fund.¹⁹ In all other

¹² 29 U.S.C. § 1109(a) (1976).

¹³ Section 409 provides in relevant part:

(a) Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary

29 U.S.C. § 1109(a) (1976).

¹⁴ Section 410 provides:

(a) . . . any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy.

(b) Nothing in this subpart shall preclude —

(1) a plan from purchasing insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary;

(2) a fiduciary from purchasing insurance to cover liability under this part from and for his own account; or

(3) an employer or an employee organization from purchasing insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan.

29 U.S.C. § 1110 (1976).

¹⁵ As a practical matter, this provision for insurance coverage is of little help to the fiduciary as the cost of obtaining such insurance is prohibitive. For example, in 1983 the premium for \$2,000,000 coverage was approximately \$1,200,000. Accordingly, the availability of such insurance has very little practical effect on our indemnification discussion.

¹⁶ See 29 C.F.R. § 2509.75-4 (1983).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ See *supra* note 11 and accompanying text. The term "regular administration of the fund" refers to those duties which are predictable or necessary to accomplish the fund's purposes.

circumstances, however, an ERISA fiduciary's right to indemnification depends upon whether the expenses incurred are deemed "proper" under section 408.²⁰ Unfortunately, the legislative history of ERISA is of little help in fixing the scope or the meaning of the word "proper" except insofar as it refers to the law of trusts as the basis for many of the fiduciary responsibility provisions.²¹

This absence of a clear standard for identifying "proper" plan expenses makes it very difficult for fiduciaries to determine under what circumstances they may authorize or receive indemnification for legal costs consistent with ERISA. For example, although fiduciaries are clearly not entitled to indemnification if it is established that they are in breach of their duties under the plan, it is not at all clear whether it is ever proper under ERISA for a fiduciary to receive indemnification for expenses incurred in successfully defending breach of trust charges. Similarly, it is uncertain whether indemnification is proper in a situation where a claim against the fiduciary is settled or where the fiduciary is found only partially guilty of breach of trust charges. Finally, the provisions of ERISA offer no assistance in determining whether an ERISA fiduciary may ever properly receive payments of legal expenses incurred in breach of trust litigation prior to a final determination of the merits of the litigation.

In an effort to provide a general background for understanding ERISA fiduciary indemnification principles and to formulate appropriate guidelines for answering questions which are currently unresolved, indemnification principles in the law of trusts, private foundations, corporations and unions will be examined.

B. Trustee Indemnification Under the Law of Trusts

As a general rule, a trustee is authorized to incur all expenses necessary and proper to the administration of a private trust.²² Whether an expense is "necessary" and "proper" depends to a great extent upon the powers granted to the trustee in the trust instrument and the context in which the expense is incurred.²³ Technically, the trustee is personally liable for all expenses properly incurred, but is entitled to indemnity from the trust estate.²⁴ This right to indemnification for expenses properly incurred includes not only the right of reimbursement after the trustee makes payments out of his individual funds, but also a right of exoneration,²⁵ which allows him to use trust property in the first instance to satisfy an obligation he has incurred as a trustee.²⁶

²⁰ See *supra* note 11 and accompanying text.

²¹ See *supra* note 2 and accompanying text where it is noted that the legislative history of ERISA refers to trust law principles as the basis for the fiduciary responsibility provisions.

²² See generally A. SCOTT, *THE LAW OF TRUSTS* §§ 188, 244 (3d ed. 1967) (hereinafter cited as SCOTT); *RESTATEMENT (SECOND) OF TRUSTS* § 188 (1959) (hereinafter cited as *RESTATEMENT*).

²³ See SCOTT, *supra* note 22, at § 188; *RESTATEMENT*, *supra* note 22, at § 188.

²⁴ *Greenough v. Tax Assessors*, 331 U.S. 486, 494-95 (1947); *Templeton v. Continental Illinois Nat'l Bank & Trust Co.*, 429 F. Supp. 1294, 1304 (N.D. Ill. 1977); *In re Estate of Fisher*, 461 Pa. 696, 700, 337 A.2d 834, 836 (1975). See also SCOTT, *supra* note 22, at § 244.

²⁵ The term "exoneration" is a term of art in trust law. As Professor Scott points out, if a trustee properly incurs an expense in the administration of the trust, he has a right of reimbursement where he has made payment out of his personal funds, or he may exonerate his liability for the expense by applying the trust property to the discharge of the liability in the first instance. If the trustee exercised his right of exoneration to satisfy an expense which was later deemed "improperly incurred," the trustee would in most instances be surcharged for the amount taken. See SCOTT, *supra* note 22, at § 244.

²⁶ SCOTT, *supra* note 22, at § 244; G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 718 (rev. 2d ed. 1982) (hereinafter cited as BOGERT).

Attorneys' fees are one type of expense often incurred in the administration, preservation or execution of the trust estate. The fact that such expenses are typically incurred, however, does not mean that they are always necessary and proper. It is within the court's discretion whether these fees will be charged to the trust estate or borne by the trustee personally.²⁷ In exercising such discretion, the courts generally focus on two issues: first, whether the litigation benefits the interests of the trust estate;²⁸ and second, if the interests are not benefited, whether the outcome of the litigation is favorable to the trustee.²⁹

1. Benefits of Litigation

Courts allow expenses for attorneys' fees and other related costs to be paid from the trust estate if the litigation is brought for the benefit of the trust as a whole.³⁰ Conversely, costs and fees will not be allowed out of the trust estate under this principle if the suit is brought for the benefit of the complaining beneficiary or if the defense is interposed for the benefit of the defendant trustee.³¹

The Supreme Court of Kansas decision in *Jennings v. Murdock*³² is illustrative. In *Jennings*, the beneficiaries of a spendthrift trust sought to compel the trustee to vote stock held in trust as they directed.³³ Additionally, plaintiffs requested that their attorneys' fees be paid from the trust estate.³⁴ The court rejected plaintiffs' first claim holding that the trust instrument vested voting discretion entirely with the trustee.³⁵ Considering the plaintiffs' second request, the court determined that since plaintiffs' action conferred a benefit on the trust estate by helping to establish the respective roles of the trustees and beneficiaries, plaintiffs' attorneys' fees and costs should be paid by the estate.³⁶ According

In *Cann v. Barry*, 298 Mass. 186, 189, 10 N.E.2d 88, 89-90 (1937), the court refused to advance the trustee security from the trust for expenditures he might have to make. In *McClure v. Middletown Trust Co.*, 95 Conn. 148, 160, 110 A. 838, 842 (1920), the trustee was not required to advance his own funds to meet obligations of the estate where the estate had no assets. These cases taken together suggest that while the trustee need not incur liability on behalf of the estate when there are no assets to reimburse him, the right to reimbursement or exoneration does not arise until the expense is certain and definite, as opposed to hypothetical or conjectural.

²⁷ See *In re Storm's Estate*, 40 Misc. 2d 390, 391-92; 243 N.Y.S.2d 53, 55 (1963); *Murphy v. Dalton*, 314 S.W.2d 726, 733 (Mo. 1958); *West Coast Hosp. Ass'n v. Florida Nat'l Bank*, 100 So. 2d 807, 812 (Fla. 1958). See also BOGERT, *supra* note 26, at § 871.

²⁸ See *infra* notes 30-37 and accompanying text.

²⁹ See *infra* notes 38-45 and accompanying text.

³⁰ *Weidlich v. Comley*, 267 F.2d 133, 134-35 (2d Cir. 1959) (trustee's defense of suit held beneficial to estate); *In re Estate of Campbell*, 46 Hawaii 475, 522, 382 P.2d 920, 953 (1963) (groundless suit attacking validity of trustee appointment held not beneficial to estate); *In re Freeman*, 247 Minn. 50, 56, 75 N.W.2d 906, 910 (1956) (unsuccessful suit charging trustee with improper trust management held beneficial to the estate); *Linn v. Linn*, 146 Neb. 666, 669, 21 N.W.2d 283, 284 (1946) (suit to enforce trust and compel an accounting held beneficial to the estate). See also 76 AM. JUR. 2d *Trusts* § 657 (1975); RESTATEMENT, *supra* note 22, at § 245.

³¹ RESTATEMENT, *supra* note 22, at § 245.

³² 220 Kan. 182, 553 P.2d 846 (1976).

³³ *Id.* at 184-85, 553 P.2d at 851.

³⁴ *Id.* at 185, 553 P.2d at 851.

³⁵ *Id.* at 211, 553 P.2d at 869.

³⁶ *Id.* at 215, 553 P.2d at 872. See also *Zimmerman v. First Nat'l Bank*, 348 So. 2d 1359, 1367 (Ala. 1977) (under statute award of parties' attorneys' fees not proper when litigation not beneficial to estate); *Palmer v. Hartford Nat'l Bank & Trust Co.*, 160 Conn. 415, 420, 279 A.2d 726, 733-34 (1971) (beneficiary who with his own funds has benefited estate has right to recover expenses from trust estate). See generally BOGERT, *supra* note 26, at § 871.

to the *Jennings* court, the fact that plaintiffs sought to reap personal benefit from their suit did not preclude a benefit from being conferred on the estate.³⁷ *Jennings* is significant, in that it not only recognizes the validity of the estate benefit theory, but also recognizes that estate benefit is not limited to financial or monetary gain.

2. Outcome of the Litigation

In an action charging the trustee with breach of trust, litigation costs may be imposed on the trust estate even though the litigation does not benefit the trust if the trustee successfully defends the charges.³⁸ Attorneys' fees are also recoverable when there is no decision on the merits, as is the case when the suit is dismissed by the plaintiff.³⁹ On the other hand, if the trustee is found to have breached his duties, he must personally bear his litigation expenses.⁴⁰

The Supreme Court of Pennsylvania illustrated these principles in *In Re Coulter*⁴¹ where the beneficiaries of an express trust brought an action against the trustee, charging him with negligent administration and self-dealing.⁴² The beneficiaries requested that the trustee be surcharged for all losses proximately caused by his conduct.⁴³ The court denied the beneficiaries' claim, finding no evidence of negligence or self-dealing by the trustee.⁴⁴ In addition, the court held that the trustee's attorneys' fees were chargeable to the trust estate. The court stated, "[i]t is well established that whenever there is an unsuccessful attempt by a beneficiary to surcharge a fiduciary the latter is entitled to an allowance out of the estate to pay for counsel fees and necessary expenditures in defending himself against the attack."⁴⁵

3. Effect of Trustee's Good or Bad Faith on Indemnification Right

Under certain circumstances, the trustee is entitled to indemnification for expenses incurred, even if the expenses were not proper, and regardless of the outcome of litigation instituted against him. For example, if the trustee takes action in good faith

³⁷ 220 Kan. at 215, 553 P.2d at 872.

Significantly, in *Ball v. Mills*, 376 So. 2d 1174, 1179 (Fla. 1979), *cert. denied sub nom.*, *Mills v. Ball*, 388 So. 2d 1116 (Fla. 1980), the court noted that a trustee might be granted an interim award of attorneys' fees, prior to a merits determination of the litigation, if the trustee could demonstrate that such fees were beneficial and necessary to the trust estate. The court observed that it was necessary to determine that the services were both beneficial to the trust and reasonable and necessary, prior to an interim award of funds paying for such services.

³⁸ See *In re Smathers*, 212 N.Y.S.2d 152, 155 (1961); *Coates v. Coates*, 316 S.W.2d 875, 878 (Mo. App. 1958); *In re Coulter*, 379 Pa. 209, 108 A.2d 681, 686 (1954).

³⁹ *Saulsbury v. Denton Nat'l Bank*, 25 Md. App. 669, 677, 335 A.2d 199, 203 (1975).

⁴⁰ *Harvey v. Leonard*, 268 N.W.2d 504, 517 (Iowa 1978); *Behrman v. Egan*, 31 N.J. Super. 95, 100, 106 A.2d 36, 39 (1953). See generally *BOGERT*, *supra* note 26, at § 871.

⁴¹ 379 Pa. 209, 108 A.2d 681 (1954).

⁴² *Id.* at 214, 108 A.2d at 683-84.

⁴³ *Id.* at 217, 108 A.2d at 685.

⁴⁴ *Id.* at 220, 108 A.2d at 686.

⁴⁵ *Id.* at 220, 108 A.2d at 686 (quoting *In re Wormley*, 359 Pa. 295, 300, 59 A.2d 98, 100 (1948)). See also *Leibrandt v. Adler*, 30 Ill. App. 2d 257, 262, 174 N.E.2d 228, 230 (1961) (unsuccessful trustees in will construction case not entitled to attorneys' fees if suit brought for personal benefit); *Hatfield v. First Nat'l Bank*, 317 Ill. App. 169, 182, 46 N.E.2d 94, 100 (1943) (trustee not being liable for surcharge entitled to recover solicitor's fees). See generally *Annot.*, 9 A.L.R.2d 1132 (1950) (allowance of attorneys' fee in, or other cost of, litigation by beneficiary respecting trust).

which results in a benefit to the estate indemnification is proper.⁴⁶ A trustee is not entitled to indemnification for expenses not properly incurred, however, if he takes action in bad faith, even though it benefits the estate.⁴⁷ This principle is demonstrated in *Craven v. Craven*⁴⁸ where the defendant trustee held certain properties in trust for the benefit of plaintiff.⁴⁹ The terms of the trust authorized defendant to make expenditures which were "reasonably necessary" to maintain the trust properties.⁵⁰ The defendant authorized a substantial number of expenditures for capital improvements, maintenance and repairs.⁵¹ The plaintiff charged that these expenditures were excessive and thereby constituted a breach of trust.⁵² Plaintiff prayed for an accounting and the defendant counterclaimed seeking indemnity for all expenses incurred.⁵³

The Supreme Court of Illinois agreed with plaintiff and held that defendant's expenditures for capital improvements constituted a breach of trust because the terms of the trust did not contemplate outlays for such excessive capital improvements.⁵⁴ The court noted, however, that its holding did not automatically require denial of defendant's request for indemnity.⁵⁵ The court observed that "[w]here a trustee or agent makes unauthorized improvements he may or may not be reimbursed to the extent the property is benefited, depending upon whether he acted in good faith or in bad faith."⁵⁶ Considering the expenses for which the trustee sought indemnity, the court found that a substantial portion of defendant's reimbursement claim consisted of charges for defendant's own labor.⁵⁷ Such charges constituted self-dealing by defendant because he was performing unauthorized services with his own labor and, as such, this indicated bad faith.⁵⁸ Consequently, the court denied defendant's claim for indemnity.⁵⁹

⁴⁶ *In re Rainone*, 33 A.D.2d 1048, 1048, 309 N.Y.S.2d 529, 530 (1970) (former trustee indemnified for improperly incurred expenses which benefit estate); *In re Griffith*, 33 Del. Ch. 387, 394, 93 A.2d 920, 924 (1953) (trustee indemnified for unauthorized expenditures which benefit the estate). See also RESTATEMENT, *supra* note 22, at § 245. See *supra* note 30 and accompanying text for a discussion of other cases upholding right to indemnification for expenses which benefit the estate.

While no cases have been found which deal specifically with indemnification for attorneys' fees improperly incurred, but which benefit the estate, the principles discussed herein appear nonetheless applicable to such a situation. See SCOTT, *supra* note 22, at § 246.

⁴⁷ *Craven v. Craven*, 407 Ill. 252, 262, 95 N.E.2d 489, 495 (1950); *Trimble v. Boles*, 169 Okla. 228, 230, 36 P.2d 861, 864 (1934) (trustee who denied existence of resulting trust and claimed trust property as his own in bad faith, not entitled to expenses). See also RESTATEMENT, *supra* note 22, at § 245 comment g; SCOTT, *supra* note 22, at § 245.1.

⁴⁸ 407 Ill. 252, 95 N.E.2d 489 (1950).

⁴⁹ *Id.* at 253, 95 N.E.2d at 491.

⁵⁰ *Id.* at 262, 95 N.E.2d at 495.

⁵¹ *Id.* at 257, 95 N.E.2d at 493. The capital improvements consisted of the following: new chimney, new back porches, new fence and gates, new doors on garage, new storerooms and coal bins in basement, insulation of roof, new sinks in two apartments, remodeling of front entrance and first floor apartment, rewiring of the entire building, new light fixtures in all apartments, front hall and basement, new locks on all doors front and rear, including the basement and garage, and new screens for the entire building. *Id.*

⁵² *Id.* at 262, 95 N.E.2d at 495.

⁵³ *Id.* at 253, 95 N.E.2d at 491.

⁵⁴ *Id.* at 262-63, 95 N.E.2d at 495-96.

⁵⁵ *Id.* at 262, 95 N.E.2d at 495.

⁵⁶ *Id.*

⁵⁷ *Id.* at 263, 95 N.E.2d at 496.

⁵⁸ *Id.*

⁵⁹ *Id.*

The principles of trust law indemnification discussed in Section 1,B apply to both contractual

4. Effect of Exculpatory Provisions on Indemnification Right

If specifically authorized by an exculpatory clause in the trust instrument, a trustee may bind the estate and avoid personal liability for most liabilities incurred irrespective of any right to indemnification.⁶⁰ For example, in *Gwin v. Fountain*⁶¹ the trustee was given absolute discretion in the management of the trust estate. According to the trust, he was to be relieved from all personal liability for expenses incurred in the administration of the estate, except those costs incurred on account of bad faith.⁶² In the course of administering the trust, the trustee hired an attorney to assist him with trust affairs.⁶³ After the trustee died, the attorney instituted a claim against the trust estate for services rendered.⁶⁴ The beneficiaries objected to the suit on the ground that the attorneys' fees were a personal liability of the trustee and could not be properly construed as a direct charge against the estate.⁶⁵ The Supreme Court of Mississippi, however, rejected the beneficiaries' claim and held that a trust instrument could, by its express terms, insulate a trustee from liability for expenses otherwise borne by the trustee, provided the intent of the settlor was clear.⁶⁶

A trust instrument expressly providing that the trustee shall not be liable "except for willful default or gross negligence" is an example of an exculpatory provision designed to relieve the trustee of tortious or contractual liabilities incurred in the administration of the trust estate for which he might otherwise be liable.⁶⁷ Such provisions are strictly construed by the courts, however, and are often struck down on public policy grounds.⁶⁸

and tortious liability incurred by the trustee in the administration of the trust. See SCOTT, *supra* note 22, at §§ 246-247. Therefore, while a trustee is personally liable upon a contract made in the administration of the trust, he is entitled to indemnification for any claims arising under such contract if such contractual liability is properly incurred. *Hamlen v. Welch*, 116 F.2d 413, 418 (1st Cir. 1940); *Peyser v. American Sec. & Trust Co.*, 107 F.2d 625, 626 (D.C. Cir. 1939); *Pan American Petroleum Corp. v. Gibbons*, 168 F. Supp. 867, 876-77 (D. Utah 1958), *aff'd*, 262 F.2d 852, 855-56 (10th Cir. 1958); *Lazenby v. Codman*, 28 F. Supp. 949, 950-51 (S.D.N.Y. 1939). If the trustee improperly incurs contractual liability, he is nonetheless entitled to indemnification if he acts in good faith and the trust estate is benefited. SCOTT, *supra* note 22, at § 246.

Similarly, a trustee who incurs tortious liability in the proper administration of the trust is entitled to indemnification provided he is not personally at fault. See generally *Sherr v. Winkler*, 552 F.2d 1367, 1377 (10th Cir. 1977) (non-negligent trustee not personally liable to beneficiaries for losses to estate); *Cook v. Holland*, 575 S.W.2d 468, 476 (Ky. 1978) (non-negligent trustee indemnified for injury caused by trustee's agent); *Smith v. Rizzuto*, 133 Neb. 655, 660, 276 N.W. 406, 409 (1937) (trustee personally liable for damages if personally responsible for dangerous condition of property).

⁶⁰ See SCOTT, *supra* note 22, at §§ 270-71; 76 AM. JUR. 2d *Trusts* § 353 (1975); RESTATEMENT, *supra* note 22, at § 270.

⁶¹ 159 Miss. 619, 126 So. 18 (1930), *modified*, 159 Miss. 653, 132 So. 559 (1931).

⁶² *Id.* at 643, 126 So. at 21.

⁶³ *Id.* at 637, 126 So. at 19.

⁶⁴ *Id.*

⁶⁵ *Id.* at 639, 126 So. at 20.

⁶⁶ *Id.* at 644, 126 So. at 22.

⁶⁷ *First Nat'l Bank v. Edgeworth*, 94 Ill. App. 3d 873, 882, 419 N.E.2d 372, 379 (1981); *Sullivan v. Mosner*, 266 Md. 479, 495-96, 295 A.2d 482, 491-96 (1972); *Jarvis v. Boatmen's Nat. Bank*, 478 S.W.2d 266, 274 (Mo. 1972). See also SCOTT, *supra* note 22, at § 222; RESTATEMENT *supra* note 22, at § 222.

⁶⁸ See *Rippey v. Denver United States Nat'l Bank*, 273 F. Supp. 718, 736-37 (D. Colo. 1967); *Hoppe v. Hoppe*, 370 So. 2d 374, 375 (Fla. 1978), *cert. denied*, 379 So. 2d 206 (Fla. 1979); *Langford v. Shamburger*, 417 S.W.2d 438, 444 (Tex. Civ. App. 1967). See also SCOTT, *supra* note 22, at §§ 222.2, 222.3; BOGERT, *supra* note 26, at § 542.

An example of this public policy doctrine is found in *Vredenburg v. Jones*,⁶⁹ where the trustee was given "complete and unquestioned" discretion with regard to the management of certain mining properties.⁷⁰ The trust instrument exculpated the trustee from liability and provided for indemnification of all his expenses.⁷¹ In the course of administering the trust, the trustee breached his fiduciary duties by self-dealing with the trust properties.⁷² The beneficiaries sued to recover the assets which the trustee had sold to himself.⁷³ The Chancery Court of Delaware confronted the question of whether the trustee was entitled to indemnity pursuant to the terms of the trust instrument for all liabilities assessed against him.⁷⁴ Despite the broad exculpatory language of the trust instrument, the court held the trust's indemnity provisions inapplicable, and rendered the trustee personally liable for all losses to the trust resulting from his self-dealing.⁷⁵ Although it did not expressly articulate its reasoning, the court felt that it would be contrary to public policy to relieve the trustee of the liabilities normally attendant upon acts of self-dealing.

5. Summary of Private Trust Law Indemnification Principles

In summary, there are essentially four rules of indemnification relating to legal expenses incurred in the administration of a private trust. First, indemnification of legal expenses is proper where the litigation maintained by the applicant benefits the trust estate.⁷⁶ Second, in a breach of trust action, indemnification of a trustee's legal expenses is proper where the trustee is successful in his defense.⁷⁷ Third, in an unsuccessful breach of trust action, indemnification is generally not proper unless the trustee acted in good faith and the trust estate was benefited. Even if these conditions are met, indemnification is proper only to the extent that the estate benefits.⁷⁸ Fourth, exculpatory provisions may broaden the scope of indemnification unless such provisions are deemed void on public policy grounds.⁷⁹

C. Indemnification of the Foundation Manager Under the Law of Private Foundations

Fiduciary indemnification principles are also found in the tax area. The Internal Revenue Code ("Code") provides minimum standards of conduct for the trustees and managers of private foundations. The Code also provides guidelines governing indemnification payments to a manager of a private foundation for expenses incurred in the administration of the foundation.

⁶⁹ 349 A.2d 22 (Del. Ch. 1975).

⁷⁰ *Id.* at 27.

⁷¹ *Id.* at 28.

⁷² *Id.* at 30-32.

⁷³ *Id.* at 32.

⁷⁴ *Id.* at 37.

⁷⁵ *Id.* at 37-38.

⁷⁶ See *supra* note 30 and accompanying text.

⁷⁷ See *supra* note 38 and accompanying text.

⁷⁸ See *supra* note 46 and accompanying text.

⁷⁹ See *supra* note 60 and accompanying text.

The rights, powers, duties and liabilities of a trustee of a charitable trust are similar to those of a private trustee. Accordingly, the indemnification and exculpation provisions applicable to a private trustee are in most instances equally applicable to a charitable trustee except to the extent such rules may be modified by the doctrine of charitable tort immunity.

Every charitable organization exempt from income tax under section 501(c)(3) of the Code is presumed to be a private foundation, subject to certain exceptions such as publicly supported charities.⁸⁰ The Code prohibits certain types of self-dealing transactions between private charitable foundations and their managers.⁸¹ The Code defines "self-dealing" transactions as "any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation."⁸² Significantly, a foundation manager is included in the definition of a "disqualified person."⁸³ If a self-dealing transaction occurs, an excise tax is imposed upon the foundation manager and the self dealer participating in the transaction.⁸⁴

While this prohibition against manager self-dealing would appear to preclude indemnification or reimbursement of the fund manager for expenses incurred in the administration of the foundation, section 4941 of the Code specifically permits payment of reasonable compensation and reimbursement of expenses to such persons.⁸⁵ In fact, the Treasury Regulations under this section expressly provide that a foundation manager may receive indemnification for expenses reasonably incurred in the administration of the foundation.⁸⁶ The law of private foundations also permits the fund manager to receive advance payments of foundation funds to meet anticipated expenses.⁸⁷

A number of Revenue Rulings interpreting section 4941(d)(1)(D) of the Code and the regulations promulgated thereunder allow a foundation manager to be indemnified

⁸⁰ I.R.C. § 501(c)(3) (1954), *as amended*. The term "private foundation" is defined in I.R.C. § 509(a) (1954).

⁸¹ I.R.C. § 4941. Specific acts prohibited include: (1) the sale, exchange or leasing of property; (2) lending of money or other extension of credit; (3) furnishing of goods, services or facilities; (4) payment of compensation or expenses to a "disqualified person" which includes the fund manager; and (5) transfer to, or use by or for the benefit of, a disqualified person of the foundation's income or assets. *Id.*

⁸² *Id.* at § 4941(d)(1)(E).

⁸³ *Id.* at § 4946(a)(1)(B).

⁸⁴ *Id.* at § 4941.

⁸⁵ *Id.* at § 4941(d)(2)(E) provides in part:

[T]he payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive

Id.

⁸⁶ Treas. Reg. § 53.4941(d)-3(c) (1973) specifically provides that:

the payment of compensation (and the payment or reimbursement of expenses, including reasonable advances for expenses anticipated in the immediate future) by a private foundation to [the foundation manager] for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation shall not be an act of self-dealing if such compensation (or payment as reimbursement) is not excessive. . . . Further, the making of a cash advance to a foundation manager or employee for expenses on behalf of the foundation is not an act of self-dealing so long as the amount of the advance is reasonable in relation to the duties and expense requirements of the foundation manager. Similar provision is found in the law of trusts.

Id. See *supra* note 22 and accompanying text.

⁸⁷ Section 4941, however, does not explicitly create a substantive right to receive advances beyond that granted by traditional trust law principles. As previously noted, the law of trusts requires the expense to be reasonably definite and certain before receipt of trust funds is proper. See *supra* note 26.

for expenses incurred in the administration of the foundation which confer a benefit on the foundation. For example, in Revenue Ruling 73-613⁸⁸ the Internal Revenue Service ("IRS") held that a private foundation's payment of its manager's legal fees did not constitute self-dealing and was therefore allowable.⁸⁹ The manager had filed suit against the other directors to require them to carry out the foundation's charitable purpose.⁹⁰ According to the IRS, the litigation helped accomplish the foundation's charitable purposes and, thus, was beneficial to the foundation.⁹¹ Given this beneficial effect, the manager's litigation expenses were permitted to be paid from the foundation's assets.⁹²

A similar result was reached in Revenue Ruling 74-405,⁹³ where the IRS held that payments by a foundation to indemnify a "disqualified person" against liability for claims in connection with his assistance in the preparation of a stock registration statement did not constitute self-dealing.⁹⁴ The disqualified person agreed to assist in the preparation of a registration statement which was to be filed with the Securities and Exchange Commission only if the foundation indemnified him against all liability for claims arising from the registration process.⁹⁵ The stock sold pursuant to this registration process enabled the foundation to sell a substantial block of stock that would otherwise have given rise to liability for taxes on excessive business holdings.⁹⁶ The IRS noted that because the services of the disqualified person were necessary to preserve the tax exempt status of the foundation, the indemnification payments were allowable as an appropriate expense which benefited the charitable estate.⁹⁷

These rulings demonstrate the IRS's willingness to follow indemnification principles from the private law of trusts in exempting from tax self-dealing payments made by a private foundation which operate as a benefit to the foundation estate. The IRS also follows the law of trusts in that it exempts otherwise self-dealing payments made to a foundation manager who successfully defends breach of trust litigation.

While the Code clearly provides that the payment by a private foundation of any excise tax imposed upon a foundation manager under Code sections 4941-4945 constitutes self-dealing,⁹⁸ the IRS has adopted the position that where a foundation manager successfully defends against the imposition of an excise tax, or where the proceedings are settled, and the manager has not acted willfully or without reasonable cause, the foundation may pay his reasonable attorney's fees.⁹⁹

⁸⁸ 1973-2 C.B. 385, 385.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ 1974-2 C.B. 384.

⁹⁴ *Id.* at 384-85.

⁹⁵ *Id.* at 384.

⁹⁶ *Id.*

⁹⁷ *Id.* at 384-85. See also Rev. Rul. 495, 1975-2 C.B. 449 involving Section 4942 computations, where a beneficiary's legal fees, incurred in a suit to construe the terms of the foundation instrument, were held to be reasonably necessary to the administration of the foundation and, therefore, properly payable by the foundation, and deductible for purposes of computing any Section 4942 tax.

⁹⁸ See §§ 4941(a)(1) and (2), 4941(d)(1)(E). See also H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 279 (1969).

⁹⁹ Treas. Reg. § 53.4941(d)-2(f)(3) (1973). The indemnification policy espoused by these regulations and the relevant private and charitable trust law is to be contrasted with the more liberal state corporation laws which allow indemnification of reasonable legal expenses in a third party suit regardless of whether the defense of the litigation is successful. See *infra* note 148 and accompanying text.

This principle has been applied by the IRS in a number of revenue rulings. In Revenue Ruling 82-223,¹⁰⁰ the IRS held that indemnification payments made by a private foundation to its manager for legal fees and costs incurred in settling a suit brought by state officials for alleged mismanagement did not constitute self-dealing.¹⁰¹ Because the manager's acts satisfied the nonwillful and reasonable cause tests, the IRS found that such payments were proper "expenses" within the meaning of Treas. Reg. § 53.4941(d)-2(f)(3).¹⁰² The IRS noted, however, that any settlement amount paid by the foundation on behalf of the manager would be taxable to the manager as an act of self-dealing.¹⁰³ The Service characterized the settlement amount as a personal liability of the foundation manager, rather than as a properly payable expense of the foundation.¹⁰⁴ The logic of this rule stems, of course, from the fact that any indemnification by the foundation of a settlement amount paid to the foundation would merely result in the funds first being paid by the manager to the foundation, and then being paid back to the manager.

Significantly, the IRS also held that a foundation could properly pay premiums for an insurance policy protecting the manager against all liabilities, *including settlement amounts*, provided, however, that such premiums were treated as compensation paid to the manager, and that his total compensation was not excessive within the meaning of section 4941(d)(2)(E) of the Code. Such an expense, the Service reasoned, was necessary and appropriate in order for the foundation to "attract and retain qualified management personnel."¹⁰⁵ In effect, this holding permits private foundations to insure their managers against liabilities incurred in the administration of the fund regardless of whether the foundation has the power to indemnify the manager in the first instance, so long as the cost of this insurance and other compensation to the managers meets a reasonable compensation test.¹⁰⁶

To summarize, there are three rules of indemnification applicable to legal expenses incurred in the administration of a private foundation. First, indemnification of legal expenses is proper where the litigation benefits the private foundation.¹⁰⁷ Second, indemnification of legal fees and costs incurred in settling a suit brought against a foundation manager on behalf of the foundation is proper *provided* the alleged wrongful acts of the manager are reasonable and non-willful.¹⁰⁸ Third, indemnification or reimbursement to pay premiums for an insurance policy which protects the manager against

¹⁰⁰ 1982-2 C.B. 301.

¹⁰¹ *Id.* at 303.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 302.

¹⁰⁵ *Id.*

¹⁰⁶ Corporate law statutes also permit the corporation to purchase insurance on behalf of a director, officer, agent or employee against liabilities incurred in their respective capacities regardless of whether the corporation would have the power to indemnify them in the first instance. See *infra* text accompanying note 156.

Left unanswered by Revenue Ruling 82-223, which involves an action brought by state officials, and Treas. Reg. § 53.4941(d)-2(f)(3) which refers to "a judicial or administrative proceeding involving . . . state laws relating to mismanagement of funds of charitable organizations . . .," is the extent to which indemnification is proper when private suits charging mismanagement are brought. This question is not of great significance, however, because virtually all actions involving private foundations will involve state officials because state laws give the officials supervisory responsibilities over charitable trusts.

¹⁰⁷ See *supra* notes 88-97 and accompanying text.

¹⁰⁸ See *supra* note 99 and accompanying text.

all liabilities, including settlement amounts, is proper *provided* such premium payments are treated as compensation to the manager and the total compensation package is reasonable.¹⁰⁹

D. Director Indemnification Under Corporate Law

1. The Common Law Right of Corporate Indemnification

Under the common law corporate directors did not have a clear right to indemnification for legal expenses incurred in defending charges of wrongdoing. In most instances, courts routinely denied indemnification to a director found guilty of wrongdoing because it was believed that a corporation could not justifiably pay the expenses of a director found derelict in his duties.¹¹⁰ There are some cases, however, which suggest that a director's good faith might entitle him to indemnification regardless of the outcome of litigation against him.¹¹¹

One of the first cases to deal with the issue of director indemnification was *Figge v. Bergenthal*.¹¹² In that case, the director defendants successfully defended charges of fraud and paid their legal expenses with corporate funds.¹¹³ The Supreme Court of Wisconsin rejected the plaintiff shareholders' objection that any director indemnification would be improper, stating without further discussion or citation of authority, that "[c]learly, if no case is made against defendants it is not improper or unjust that the corporation should pay for the defense of the action."¹¹⁴ While the *Figge* court recognized that a corporation had the power to indemnify a successful director, the case did not establish a common law right to indemnification for successful corporate directors.

Not all cases subsequent to *Figge* agreed with its holding that corporations had the power to authorize indemnification of the legal expenses of a successful director. For example, in *Griesse v. Lang*,¹¹⁵ the directors successfully defended charges of wrongdoing, and subsequently paid their litigation expenses with corporate funds.¹¹⁶ The Ohio Court of Appeals upheld an action to compel the defendants to return the money, holding that the corporation did not have the power to award the payment.¹¹⁷ The *Griesse* court

¹⁰⁹ See *supra* note 106 and accompanying text.

¹¹⁰ See, e.g., *Kansas Operating Corp. v. Durwood*, 278 F.2d 354, 358 (8th Cir. 1960); *McCourt v. Singers-Bigger*, 145 F. 103, 114 (8th Cir. 1906); *Chabot & Richard Co. v. Chabot*, 109 Me. 403, 405-07, 84 A. 892, 893-94 (1912); *General Mortgage & Loan Corp. v. Guarantee Mortgage & Sec. Corp.*, 264 Mass. 253, 260-61, 162 N.E. 319, 322 (1928); *McConnell v. Combination Mining & Milling Co.*, 31 Mont. 563, 566, 79 P. 248, 249 (1905).

¹¹¹ See, e.g., *Blish v. Thompson Automatic Arms Corp.*, 30 Del. Ch. 538, 590, 64 A.2d 581, 607-08 (1948) (corporation has interest in clearing directors of insider stock manipulation charge because of potential adverse effect of unfavorable finding on defense-contract negotiations); *Simon v. Socony-Vacuum Oil Co.*, 179 Misc. 202, 205, 38 N.Y.S.2d 270, 274 (Sup. Ct. 1942), *aff'd without opinion*, 267 A.D. 890, 47 N.Y.S.2d 589 (1944) (corporation and directors are joined as defendants in an antitrust suit, the corporation has an interest in also defending its directors); *Albrecht, Maguire & Co. v. General Plastics, Inc.*, 256 A.D. 134, 139, 9 N.Y.S.2d 415, 420, *aff'd*, 280 N.Y. 840, 21 N.E.2d 887 (1939) (director sued by shareholder in derivative action to require declaration that amendment to charter is void, corporation has interest in defending director who acted in good faith).

¹¹² 130 Wis. 594, 109 N.W. 581 (1907).

¹¹³ *Id.* at 612, 109 N.W. at 587.

¹¹⁴ *Id.* at 625, 109 N.W. at 592.

¹¹⁵ 37 Ohio App. 553, 175 N.E. 222 (1931).

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 558-59, 175 N.E. at 223-24.

observed that, absent shareholder approval, funds of a corporation could be expended only for the benefit of the corporation.¹¹⁸ The court found that because the shareholders did not approve the payment, and the litigation did not benefit the corporation, the payment of the directors' expenses could not be sustained.¹¹⁹ The court's reliance on the benefit theory in disallowing the indemnification payment was not supported by cited authority or logic. Perhaps the absence of such authority explains why many subsequent cases have not required a meaningful showing of corporate benefit in permitting indemnification of successful directors.¹²⁰

The common law confusion concerning a successful corporate director's right to indemnification of legal expenses culminated in the landmark case of *New York Dock Co. v. McCollum*.¹²¹ In *McCollum*, the Supreme Court of Onondaga County refused to permit indemnification of directors who had successfully defended charges of wrongdoing.¹²² As in *Griesse*, the court noted that the litigation conferred no benefit on the corporation¹²³ and held that the corporation did not have the power to indemnify the expenses of such litigation.¹²⁴ The *McCollum* court based its holding upon its determination that a director should not be given the indemnification traditionally given to an agent¹²⁵ who would typically be indemnified under such circumstances — because the position of corporate director was created by statute.¹²⁶

The common law's uncertain treatment of a corporate director's right to indemnification in shareholder derivative suits is also present in cases involving indemnification rights of directors in third party, nonshareholder suits. In third party suits, the corporation-director relationship has been analogized to the principal-agent relationship, and regular agency indemnification principles have been theoretically applied.¹²⁷ Despite this comparison, however, in practice, courts nonetheless often denied indemnification. For example, in *DuPuy v. Crucible Steel Co.*,¹²⁸ a director acquitted of fraud charges in filing the corporation's tax return was held not entitled to indemnification of his legal fees because

¹¹⁸ *Id.* at 557, 175 N.E. at 223.

¹¹⁹ *Id.* at 553-56, 175 N.E. at 223-24. *Accord*, *Bailey v. Bush Terminal Co.*, 46 N.Y.S.2d 877, 880 (Sup. Ct. 1943), *aff'd*, 267 A.D. 899, 48 N.Y.S.2d 324, *aff'd mem.*, 293 N.Y. 735, 56 N.E.2d 739, 52 N.Y.S.2d 734 (1944).

¹²⁰ *In re E.C. Warner Co.*, 232 Minn. 207, 215, 45 N.W.2d 388, 393 (1950); *Solimine v. Hollander*, 129 N.J. Eq. 264, 273, 19 A.2d 344, 348 (Ch. 1941). Significantly, in both these cases the courts held that corporations could not pay litigation expenses of directors accused of fiduciary breaches until a favorable termination of the suit.

¹²¹ 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

¹²² *Id.* at 111-12, 16 N.Y.S.2d at 849-50.

¹²³ *Id.* at 111, 16 N.Y.S.2d at 849.

¹²⁴ *Id.*

¹²⁵ *Id.* at 109, 16 N.Y.S.2d at 847.

¹²⁶ *Id.* at 109-10, 16 N.Y.S.2d at 847-48.

Common law cases like *Griesse* and *McCollum*, which require the litigation to benefit the corporation before indemnification is proper, have been severely criticized. Most authors agree that corporate funds are to be expended only for the benefit of the corporation. They argue, however, that to look for the "benefit" in the litigation itself is improper because rarely, if ever, is a successful director defense of direct benefit to the corporation. Rather, the commentators contend that the "benefit" results from the act of indemnification itself insofar as indemnification enables the corporation to attract and retain qualified personnel. *See generally* J. BISHOP JR., *THE LAW OF CORPORATE OFFICERS AND DIRECTORS* § 5.03 (1981); Bishop, *Current Status of Corporate Directors' Right to Indemnification*, 69 HARV. L. REV. 1057 (1956).

¹²⁷ *See, e.g.*, *Du Puy v. Crucible Steel Co.*, 288 F. 583, 585 (W.D. Pa. 1923).

¹²⁸ *Id.*

it was not within the scope of his agency to act in such a way that he might subject himself to criminal liability. Similar reasoning was expressed in *Hoch v. Duluth Brewing & Malting Co.*,¹²⁹ wherein a director who had held title to a piece of land for the benefit of the corporation was sued by a subsequent purchaser for a defect in the title.¹³⁰ Even though successful in defending the charges against him, the director was denied indemnity because, according to the court, a director is not entitled to indemnification for liabilities which arise from his own misconduct, are not a result of the execution of the agency, or are caused by the independent and unexpected wrongful acts of others.¹³¹

Not all courts considering an innocent director's right to indemnification in a third party suit, however, have followed the holdings in *DuPuy* and *Hoch*. Other third party cases have reached a completely opposite result, and allowed indemnification of a guilty director who acted in good faith where the corporation was benefited by the defense of the suit.¹³² For example, in *Albrecht, Maguire & Co. v. General Plastics*,¹³³ the Supreme Court of New York held in a stockholder's action against a corporation and the officers thereof for a declaration that an amendment of the certificate of incorporation was void, that the individual defendants who acted in good faith were entitled to indemnification for their litigation costs even though plaintiff successfully prosecuted its suit.¹³⁴ The court noted that the individual defendants, by acting in good faith, were in essence carrying out the mandate of the stockholders and, therefore, ought not be required to bear the burden of litigation costs arising from their official duties.¹³⁵

As the above discussion indicates, the third-party cases are as inconsistent as the shareholder derivative cases. The uncertainty and unrest in the business community caused by these inconsistent and often unfavorable opinions provided the impetus for a great flood of legislation designed to unify and detail the scope of corporate indemnification principles.¹³⁶

2. The Statutory Right of Corporate Indemnification

Modern statutes moved towards liberalizing director indemnification rights and shielding directors from personal liability. The indemnification provisions of the Delaware statute,¹³⁷ which are substantially identical to those adopted in the Model Business Corporation Act,¹³⁸ serve as the model for the large majority of other states.¹³⁹ The New York statute is typical of the slightly stricter view found in a very small number of

¹²⁹ 173 Minn. 374, 217 N.W. 503 (1928).

¹³⁰ *Id.* at 375, 217 N.W. at 503.

¹³¹ *Id.* at 376-77, 217 N.W. at 504.

¹³² See *supra* note 111 and accompanying text.

¹³³ 256 A.D. 134, 9 N.Y.S.2d 415, *aff'd*, 280 N.Y. 840, 21 N.E.2d 887 (1939).

¹³⁴ *Id.* at 139, 9 N.Y.S.2d at 420.

¹³⁵ *Id.*

¹³⁶ See, e.g., ARIZ. REV. STAT. ANN. §§ 10-001 to 10-149 (1977 & Supp. 1983-1984); CAL. CORP. CODE §§ 100 to 2319 (West 1977 & Supp. 1984); COLO. REV. STAT. §§ 7-1-101 to 7-10-113 (1973 & Supp. 1983); FLA. STAT. ANN. §§ 607.001 to 607.414 (West 1977 & Supp. 1983); IND. CODE ANN. §§ 23-1-1-1 to 23-1-12-4 (Burns 1984).

¹³⁷ DEL. CODE ANN. tit. 8, § 145 (1975).

¹³⁸ MODEL BUSINESS CORP. ACT § 5 (1971).

¹³⁹ Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1996 (1978) (hereinafter cited as *Johnston*).

states.¹⁴⁰ Consequently, the Delaware statute will be discussed as representative of the "general" corporate law of the United States. Distinctions in the New York statute will be highlighted where relevant.

The indemnification provisions of Delaware law are contained in section 145 of the Delaware Code.¹⁴¹ Section 145 distinguishes between third party actions and shareholder derivative suits, granting a broader right to indemnification in the case of third party actions.¹⁴² Although the specific rationale for this distinction is not expressly articulated, it is presumably based on the concept that in a third party suit the director is like an agent acting in good faith to accomplish corporate goals, so that traditional agency indemnification principles should apply. In a shareholder derivative suit, however, the director is presumably viewed as having worked against corporate interests. Indemnification under such circumstances would defeat the purpose of the shareholder suit, which is to recover from the director the value of that which he has taken from the corporation.¹⁴³

In a shareholder derivative action, Delaware law permits a director to be indemnified for expenses, including attorneys' fees, if he acted in good faith and in a manner reasonably believed to be "in or not opposed to" the best interests of the corporation.¹⁴⁴ An exception to this rule exists where he is adjudged guilty of misconduct or negligence.¹⁴⁵ Because this right applies only to "expenses," it does not permit indemnification of the amount paid in settlement of a claim, but the costs incurred in reaching the settlement are indemnifiable.¹⁴⁶ In a third-party action, a director may be indemnified not only for his litigation expenses but also for judgments, fines and amounts paid in settlement.¹⁴⁷ Furthermore, the third party provisions do not require the director to be successful on the merits.¹⁴⁸ Rather, the director is only required to have acted in good

¹⁴⁰ N.Y. BUS. CORP. LAW §§ 721-727 (McKinney 1980). For a general discussion of the many variations among the state statutes see MODEL BUSINESS CORPORATION ACT ANNOTATED § 5 (1977 Supplement).

¹⁴¹ DEL. CODE ANN. tit. 8, § 145 (1983).

The Delaware statute does not exclude any other rights which a director might be entitled to "under any bylaws, agreement, vote of stockholders or disinterested directors or otherwise . . ." DEL. CODE ANN. tit. 8, § 145(f). A director, therefore, might be given broader indemnification protection than that afforded by the Delaware statute, although it is likely that public policy places some limitations on the extent to which a director can be indemnified. A number of courts have indicated that indemnification of conduct which violates traditional notions of fiduciary responsibility and good faith will not be permitted despite statutes or bylaws authorizing such indemnification. *See Teren v. Howard*, 322 F.2d 949, 955-56 (9th Cir. 1963); *People v. Uran Mining Corp.*, 13 A.D.2d 419, 424, 216 N.Y.S.2d 985, 990 (1961); *Diamond v. Diamond*, 307 N.Y. 263, 120 N.E.2d 819, 820 (1954).

Additionally, the "business judgment rule" would operate as a limit on the extent to which disinterested directors would authorize indemnification of a recalcitrant director. Too broad an indemnification principle is probably not prudent, and might subject the directors voting for such a bylaw to personal liability.

¹⁴² DEL. CODE ANN. tit. 8, § 145 (1983).

¹⁴³ *Johnston*, *supra* note 139, at 1997.

¹⁴⁴ DEL. CODE ANN. tit. 8, § 145 (1983).

¹⁴⁵ DEL. CODE ANN. tit. 8, § 145(b) (1983).

Delaware allows the court finding misconduct to award indemnification for expenses notwithstanding an adjudication of liability, but research to date has not discovered any instance in which a court has done this.

¹⁴⁶ *Id.*

¹⁴⁷ DEL. CODE ANN. tit. 8, § 145(a) (1983).

¹⁴⁸ DEL. CODE ANN. tit. 8, § 145 (1983).

faith and in a manner he reasonably believed to be "in or not opposed to" the best interests of the corporation.¹⁴⁹ With respect to criminal actions, the director must not have had reasonable cause to believe his conduct was unlawful.¹⁵⁰

Before indemnification is granted in either a derivative or third party action it must first be determined that the director has met the applicable statutory standard of conduct. This determination may be made by the majority vote of a quorum of disinterested directors, by independent legal counsel, or by the stockholders.¹⁵¹

While sections 145(a) and (b) specify circumstances in which a corporation *may* indemnify a director, section 145(c) provides that a defendant director *must* be indemnified "to the extent that" he has been successful on the merits.¹⁵² In addition, the statute permits a corporation to pay expenses incurred by the director in defending a civil or criminal action in advance of the final disposition of the action.¹⁵³ The advancement must be authorized by the board of directors, and the director receiving the advance must undertake to repay the advance unless it is ultimately determined that he is entitled to indemnification.¹⁵⁴ The statute does not require the undertaking to be secured, and the common practice of corporations is to accept an unsecured promise to repay.¹⁵⁵

The Delaware statute provides additional protection to directors by allowing corporations to purchase insurance on their behalf "whether or not the corporation would have the power to indemnify [the directors] against such liability. . . ."¹⁵⁶ Literally read, this section authorizes insurance against every type of fiduciary misconduct, no matter how grievous. As a practical matter, however, insurance policies generally contain exclusions for acts of self dealing or dishonesty, thereby bringing them within any limitations imposed by public policy.

In summary, there are essentially four rules of indemnification applicable to legal expenses incurred by a director in the performance of his duties under Delaware corporation law. First, in a shareholder derivative action, a director *may be* indemnified for expenses, including attorney's fees, provided the director acted in good faith and in a manner reasonably believed to be "in or not opposed to" the best interests of the corporation, except where the director is adjudged guilty of misconduct or negligence.¹⁵⁷

¹⁴⁹ *Id.* The New York statute is stricter in that it omits the words "or not opposed to" in the provision dealing with third party claims, thereby granting indemnification only if the director was acting in the interests of the corporation. NEW YORK BUS. CORP. LAW §§ 722-723 (McKinney 1977).

¹⁵⁰ DEL. CODE ANN. tit. 8, § 145 (1983).

¹⁵¹ DEL. CODE ANN. tit. 8, § 145(d) (1983). As noted by one commentator, since most actions against directors involve a majority of the directors it is often difficult to obtain a quorum of disinterested directors. Further, when dealing with a public corporation it is very difficult, as a practical matter, to hold a meeting to obtain shareholder approval every time indemnification is sought. See *Johnston, supra* note 139, at 1998. Therefore, the best alternative is often to seek the advice of "independent legal counsel." The Delaware statute, however, does not offer a definition of that term. See generally OHIO REV. CODE ANN. tit. XVII, § 1701.13(E)(4) (Page 1976) (counsel not "independent" if he or his firm has been retained or performed services for the corporation or person to be indemnified within the past five years).

¹⁵² DEL. CODE ANN. tit. 8, § 145(c) (1983). The section authorizes, therefore, partial indemnification of a director who is partially successful in a lawsuit. The relevant New York statute requires the director to be "wholly successful" before he is entitled to indemnification. See NEW YORK BUS. CORP. LAW § 724(g) (McKinney 1963).

¹⁵³ DEL. CODE ANN. tit. 8, § 145(e) (1983).

¹⁵⁴ *Id.*

¹⁵⁵ See *Johnston, supra* note 139, at 1999.

¹⁵⁶ DEL. CODE ANN. tit. 8, § 145(g) (1983).

¹⁵⁷ See *supra* notes 144-46 and accompanying text.

Because this right applies only to "expenses" it does not permit indemnification of an amount paid in judgment or an amount paid in settlement. Second, in a third-party action, a director *may* be indemnified not only for litigation expenses but also for judgments, fines and amounts paid in settlement.¹⁵⁸ The director need not be successful on the merits, but only need to have acted in good faith and not opposed to the best interests of the corporation. Third, a director *must be* indemnified in any suit or proceeding to the extent he has been successful on the merits.¹⁵⁹ Fourth, a director may be granted broader indemnification rights by the bylaws, stockholders or other disinterested directors, to the extent permitted by public policy.¹⁶⁰

E. Indemnification of Union Officers Under the Labor-Management Reporting and Disclosure Act of 1959

The Labor-Management Reporting and Disclosure Act of 1959 ("LMRDA")¹⁶¹ represents a significant attempt by Congress to regulate the administration and operation of labor organizations. The LMRDA provides a statutory framework designed to ensure financial responsibility of the unions.¹⁶² Section 501 of the LMRDA subjects union directors, officers and agents to broad federal fiduciary standards.¹⁶³

This provision is similar in a number of respects to the fiduciary responsibility provisions of ERISA.¹⁶⁴ Both the LMRDA and ERISA establish a federal standard of fiduciary responsibility.¹⁶⁵ Both implement certain principles governing common law fiduciaries, in light of the special problems and functions of unions and employee benefit

¹⁵⁸ See *supra* notes 147-48 and accompanying text.

¹⁵⁹ See *supra* note 152 and accompanying text.

¹⁶⁰ See *supra* note 156 and accompanying text.

¹⁶¹ 29 U.S.C. §§ 401-531 (1976).

¹⁶² The impetus for the enactment of the LMRDA came from the investigations, reports and recommendations of the Senate Select Committee on Improper Activities in the Labor Management Field, popularly known as the McClellan Committee, which exposed a significant number of union-management abuses. See SENATE SELECT COMM. ON IMPROPER ACTIVITIES IN LABOR OR MANAGEMENT FIELD, INTERIM REPORT, S. REP. NO. 1417, 85th Cong., 2d Sess. 3-6 (1958) (hereinafter cited as *Committee Report*).

¹⁶³ 29 U.S.C. § 501 (1976). Section 501 provides:

The officers, agents, shop stewards, and other representatives of a labor organization occupy positions of trust in relation to such organization and its members as a group. It is, therefore, the duty of each such person, taking into account the special problems and functions of a labor organization, to hold its money and property solely for the benefit of the organization and its members and to manage, invest, and expend the same in accordance with its constitution and bylaws and any resolutions of the governing bodies adopted thereunder, to refrain from dealing with such organization as an adverse party or in behalf of an adverse party in any matter connected with his duties and from holding or acquiring any pecuniary or personal interest which conflicts with the interests of such organization, and to account to the organization for any profit received by him in whatever capacity in connection with transactions conducted by him or under his direction on behalf of the organization. A general exculpatory provision in the constitution and bylaws of such a labor organization or a general exculpatory resolution of a governing body purporting to relieve any such person of liability for breach of duties declared by this section shall be void as against public policy.

29 U.S.C. § 501(a) (1976).

¹⁶⁴ See *supra* notes 4-7 and accompanying text.

¹⁶⁵ See *supra* note 5 and accompanying text.

plans, to develop these federal fiduciary standards.¹⁶⁶ Finally, both require fiduciaries to act "solely for the benefit" of their organizations,¹⁶⁷ and render void, as against public policy, any exculpatory agreements which relieve fiduciaries of the liabilities imposed upon them by the respective statutory frameworks.¹⁶⁸ Because of these similarities, an analysis of the cases decided under section 501 of the LMRDA concerning indemnification rights of union fiduciaries is particularly relevant to any discussion of ERISA fiduciary indemnification principles.

The indemnification issue can arise under LMRDA section 501 in a variety of contexts. For instance a union may expend funds to pay for the legal representation of its officers, either by an advancement of current litigation costs, reimbursement of expenses already paid, or the use of union counsel to defend union officials.¹⁶⁹ In assessing the validity of any advancement or reimbursement expenditure, courts traditionally consider a number of factors such as the policies underlying the LMRDA,¹⁷⁰ the express or implied authorization of relevant internal union law,¹⁷¹ general public policy relating to indemnification of fiduciaries,¹⁷² the nature of the underlying action,¹⁷³ the reasonableness of the expenditure,¹⁷⁴ and the stage of the proceedings at which the funds are expended.¹⁷⁵ The advancement and reimbursement issues will be discussed separately in analyzing how these various factors come into play.

I. Advancement of Legal Expenses

The right of union officials to advance union funds to pay litigation costs incurred by the officials in state civil and criminal suits was addressed by the United States District

¹⁶⁶ Compare H.R. REP. NO. 93-533, 93d Cong., 2d Sess. 323, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4649 with 29 U.S.C. § 501(a) (1976).

¹⁶⁷ Compare 29 U.S.C. § 1104(a) (1976) with 29 U.S.C. § 501(a) (1976).

¹⁶⁸ Compare 29 U.S.C. § 1110(a) (1976) with 29 U.S.C. § 501(a) (1976).

¹⁶⁹ Section 501(b) of the LMRDA empowers union members to bring suit to enjoin the use or expenditure of union counsel or union funds to defend union officials or to recover funds already spent. 29 U.S.C. § 501(b) (1976).

¹⁷⁰ See Bartosic & Mindla, *Union Fiduciaries, Attorneys, and Conflicts of Interest*, 15 U.C.D. L. REV. 227, 242 (1981) (hereinafter cited as *Union Fiduciaries*); Comment, *Counsel Fees for Union Officers Under the Fiduciary Provision of Landrum-Griffin*, 73 YALE L.J. 443, 449 (1964) (hereinafter cited as *Counsel Fees*). See also Int'l Bhd. of Elec. Workers v. Foust, 442 U.S. 42, 50-51 (1979) (public policy favoring financial stability of unions sufficient basis for denying punitive damage award).

¹⁷¹ See, e.g., Kerr v. Shanks, 466 F.2d 1271, 1277-78 (9th Cir. 1972), cert. denied sub nom. Screen Extras Guild v. Kerr, 412 U.S. 918 (1973); Local 92, Int'l Ass'n of Bridge, Structural & Ornamental Iron Workers v. Norris, 383 F.2d 735, 739 (5th Cir. 1967). See also, *Union Fiduciaries*, supra note 170, at 244.

¹⁷² *Morrissey v. Curran*, 482 F. Supp. 31, 52 (S.D.N.Y. 1979), aff'd in part, rev'd in part, vacated in part, 650 F.2d 1267 (2d Cir. 1981); *Highway Truck Drivers & Helpers Local 107 v. Cohen*, 215 F. Supp. 938, 940-41 (E.D. Pa. 1963), aff'd, 334 F.2d 378 (3d Cir.), cert. denied, 379 U.S. 921 (1964) (hereinafter cited as *Cohen II*); *Highway Truck Drivers and Helpers Local 107 v. Cohen*, 182 F. Supp. 608, 617 (E.D. Pa.), aff'd per curiam, 284 F.2d 162 (3d Cir. 1960), cert. denied, 365 U.S. 833 (1961) (hereinafter cited as *Cohen I*).

¹⁷³ See *Union Fiduciaries*, supra note 170, at 283-93 (compares and contrasts the policies favoring and opposing union payment of counsel fees in shareholder derivative actions, third party suits and vendetta or strike suits); *Counsel Fees*, supra note 170, at 462-68.

¹⁷⁴ See *Morrissey v. Curran*, 650 F.2d 1267, 1273-74 (2d Cir. 1981) (where union officer benefits from expenditure of union funds the court may determine whether the expenditure, notwithstanding its authorization, is so manifestly unreasonable as to evidence a breach of the fiduciary obligation imposed by Section 501(a)). See also *Union Fiduciaries*, supra note 170, at 293.

¹⁷⁵ See *Union Fiduciaries*, supra note 170, at 299-307; *Counsel Fees*, supra note 170, at 462-68.

Court for the Eastern District of Pennsylvania in *Highway Truck Drivers and Helpers Local 107 v. Cohen* ("Cohen I").¹⁷⁶ The issue presented in *Cohen I* was whether such an advancement constituted a violation of section 501, notwithstanding a resolution by union membership authorizing the expenditures.¹⁷⁷ The court held that because the authorizing resolution exceeded the powers of the union membership as set forth in the union's constitution, the payments were impermissible under section 501.¹⁷⁸ Further, the court held that the payments contravened the policies underlying LMRDA,¹⁷⁹ noting that "[t]o allow a union officer to use the power and wealth of the very union which he is accused of pilfering, to defend himself against such charges, is totally inconsistent with Congress' effort to eliminate the undesirable element which has been uncovered in the labor-management field."¹⁸⁰

After the union amended its constitution to authorize the payment of union officials' legal expenses, the issue of the right of unions to advance litigation expenses was again before the court.¹⁸¹ Recognizing that the *ultra vires* rationale expressed in *Cohen I* no longer applied, the court in *Cohen II* relied exclusively on the second basis of its earlier decision to invalidate the advancement. The court, quoting the language of *Cohen I*, emphasized that such an advancement by the union would clearly be in contravention of section 501.¹⁸²

LMRDA cases following the *Cohen I* and *Cohen II* courts have generally rejected the validity of advancing union funds to pay the legal expenses of union officials. For example, in *Milone v. English*,¹⁸³ union members brought an action to compel officials to restore to the union all counsel fees advanced to such officials during prior litigation.¹⁸⁴ The United States Court of Appeals for the District of Columbia stated that the funds of the union were not available to defend officers who were charged with wrongdoing.¹⁸⁵ The court stated in a footnote, however, that "[w]here there is no substance to a charge of wrongdoing it may be that the union is not barred from standing the cost of the defense. . . ."¹⁸⁶ While the general rule rejects the concept of union funds being used to pay litigation expenses, the *Milone* court recognized that an advancement of legal expenses in a LMRDA suit may be justified if the suit is first determined to be without merit.

2. Reimbursement of Legal Expenses

Although advancement may violate section 501, the reimbursement of legal expenses is not similarly prohibited. LMRDA cases follow other areas of the law which allow

¹⁷⁶ *Cohen I*, *supra* note 172, 182 F. Supp. at 608.

¹⁷⁷ *Id.* at 616.

¹⁷⁸ *Id.* at 620.

¹⁷⁹ *Id.* at 620-21.

¹⁸⁰ *Id.* See also *Morrissey v. Curran*, 482 F. Supp. 31, 38-39 (S.D.N.Y. 1979).

The common law origin of this general prohibition upon advances stemmed, in part, from the courts' desire to prevent the financial power of an institution from overwhelming the plaintiff. See generally *Union Fiduciaries*, *supra* note 170, at 272-73; *Counsel Fees*, *supra* note 170, at 458-459. Given the number of lawsuits a union or ERISA fiduciary may be subject to, it is arguable that advancements are necessary to prevent the financial power of the multitude of plaintiffs from overwhelming the defendant fiduciary.

¹⁸¹ *Cohen II*, *supra* note 172, 215 F. Supp. at 939.

¹⁸² *Id.* at 941.

¹⁸³ 306 F.2d 814 (D.C. Cir. 1962).

¹⁸⁴ *Id.* at 816.

¹⁸⁵ *Id.* at 817. *Accord*, *Belcher v. Birmingham Trust Nat'l Bank*, 348 F. Supp. 61, 154 (N.D. Ala. 1968).

¹⁸⁶ 306 F.2d at 817 n.2.

reimbursement when the fiduciary successfully defends charges against him and, correspondingly, deny reimbursement when the fiduciary is unsuccessful.¹⁸⁷ An example of the LMRDA's approach to this issue is *Morrissey v. Segal*.¹⁸⁸ *Segal* arose after union members had instituted a successful suit against union officials for paying out union funds in violation of the union's constitution.¹⁸⁹ *Segal* posed the question whether a negligent union trustee, who had not acted willfully or in bad faith, could properly be reimbursed with union funds for legal expenses which were incurred in his unsuccessful defense.¹⁹⁰ The Second Circuit held that the payment of attorney fees under such circumstances violated section 501,¹⁹¹ noting that although prior LMRDA case law indicated that the trustees could seek reimbursement if they were exonerated, there was no precedential support for extending indemnification if the trustees were found to have breached their duties to the union.¹⁹²

A similar result was reached in *Holdeman v. Sheldon*.¹⁹³ *Holdeman* involved an action brought by union members against union officers who allegedly expended union funds without proper authority.¹⁹⁴ The union sought to intervene on behalf of the defendant officers.¹⁹⁵ The United States District Court for the Southern District of New York began by noting that the rule in *Cohen I*, which prohibited the union from paying the legal fees of a union defendant prior to a merits determination in the action, also prevented the union from intervening and representing the union defendant.¹⁹⁶ According to the court, if intervention were allowed the rule prohibiting the advancement of legal fees could always be avoided by simply allowing the union to represent the defendants, as an alternative to the payment of counsel fees.¹⁹⁷ The court suggested, however, that if a preliminary inquiry of the merits by the court revealed plaintiff did not have a good claim and the interests of the union and defendants did not conflict, intervention might be proper.¹⁹⁸

¹⁸⁷ See *supra* notes 38-40, 98-99 and 152.

¹⁸⁸ 526 F.2d 121 (2d Cir. 1975).

¹⁸⁹ *Id.* at 124-26. See also *Morrissey v. Curran*, 351 F. Supp. 775, 784-85 (S.D.N.Y. 1972). *Id.* at 784. One defendant was found to have acted "recklessly" and two were found negligent.

¹⁹⁰ 526 F.2d at 126.

¹⁹¹ The court stated that none of the trustees could be reimbursed, deeming the distinction between "negligent" and "reckless" behavior to be irrelevant to the question of attorneys' fees. *Morrissey v. Segal*, 526 F.2d at 126.

¹⁹² 526 F.2d at 127.

¹⁹³ 204 F. Supp. 890 (S.D.N.Y.), *aff'd*, 311 F.2d 2 (2d Cir. 1962).

¹⁹⁴ 204 F. Supp. at 891-92.

¹⁹⁵ *Id.* at 892.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at 892-893. The court suggested in cases involving intervention that a procedure be adopted whereby the court determines preliminarily whether the plaintiff has made a showing that he has a claim and is likely to succeed. *Id.* Additionally, there should be an inquiry whether the interests of the union conflict with those of the individual defendants. *Id.* The court noted that the degree of preliminary inquiry should be similar to that performed by a court on any notice for injunctive relief. *Id.* Arguably, if a court makes a preliminary determination that plaintiff's claim is meritless and, therefore, has very little chance of success, and further determines that there is no potential conflict between the union and the individual defendants, then *Holdeman* is authority not only for allowing the union to intervene, but also authority for allowing the union to advance union funds to the individual defendants for the payment of defense costs.

A case where intervention or advancement would be proper could arise where a union member

After reviewing the claim in the matter before it, the *Holdeman* court concluded that the plaintiff had set forth a good cause of action, and that the interests of the defendants and the union conflicted. The court observed, however, that "[i]n the event that defendants are successful in proving the contentions which they have urged herein, there is no reason why the union may not reimburse them for legal expenses incurred in the defense of this suit."¹⁹⁹

While union law is relatively clear as to when reimbursement is proper in a trial on the merits, it is relatively unclear regarding whether a union can properly reimburse a union defendant for legal services incurred, or amounts paid, in the settlement of an action against the defendants. In *Morrissey v. Curran*,²⁰⁰ the United States District Court for the Southern District of New York, although it did not squarely address the issue, suggested that a union's payment of legal services incurred in settlement of an action against a union official would violate section 501.²⁰¹ Although commentators are divided on this issue,²⁰² the better view favors such payment, provided there is an opinion by independent legal counsel that the defendant had a meritorious defense with a high probability of success. In the absence of a policy allowing the union to pay settlement costs of frivolous litigation, union officials would have an incentive to pursue meritless litigation to a successful termination on the merits in order to entitle themselves to reimbursement. As a practical matter, this type of incentive would cause the union to incur the often higher costs of litigation rather than settlement costs.

In summary, there are three rules of indemnification applicable to legal expenses incurred by a union officer in the performance of his duties. First, a union may generally not advance funds to pay the legal expenses of union officials incurred in suits charging them with a violation of their duties unless such charges are determined to be wholly without merit.²⁰³ Second, a union may reimburse a union official for legal expenses incurred in successfully defending against charges of wrongdoing, but it may not reimburse him if he is unsuccessful in his defense.²⁰⁴ Third, the law is not settled as to whether the union may pay for legal services incurred by a union official in settling an action

brings an action to construe the terms of internal union law. In such an instance, there is no charge of wrongdoing on the part of the union officials, and there is no conflict of interests between the union and the officials. Intervention or advancement would clearly be proper since the action is in reality an action against the union.

¹⁹⁹ *Id.* at 895.

²⁰⁰ 482 F. Supp. 31 (S.D.N.Y. 1979), *rev'd*, 650 F.2d 1267 (2d Cir. 1981).

²⁰¹ *Id.* at 52. The district court held that the use of union funds for the payment of legal services rendered to union officials in a settlement action would violate section 501. *Id.* The court intimated, however, that its holding was predicated to some extent upon the officials' probable culpability. *Id.* On appeal, the Second Circuit reversed on the grounds that there was not sufficient evidence that the suit had in fact been settled as opposed to being involuntarily dismissed for failure to prosecute. *Morrissey v. Curran*, 650 F.2d 1267, 1280-81 (2d Cir. 1981). The court held, therefore, as far as the officials were concerned that the suit was successfully defended and a payment of legal fees was proper. *Id.* It is not clear from these cases whether a payment of legal fees incurred in settlement of an action where the defendant had a high probability of success would be violative of Section 501.

²⁰² Compare *Union Fiduciaries*, *supra* note 170, at 315 (unions should have discretion to reimburse officers for the legal expenses of settlement) with *Counsel Fees*, *supra* note 170, at 467 (union should not have discretion to indemnify officer for settlement costs); cf. Rev. Rul. 82-223, 1982-2 C.B. 301 (indemnification payments by private foundation for legal fees and costs incurred in settling suit against manager are permitted).

²⁰³ See *supra* notes 183-86 and accompanying text.

²⁰⁴ See *supra* note 187 and accompanying text.

against him, but the better view would permit such payment where the defense has a high probability of success.²⁰⁵

*F. Trust Law Principles as a Basis for Guidelines Governing the
Indemnification of ERISA Fiduciaries*

As demonstrated by the foregoing discussion, indemnification principles in the law of trusts, private foundations, corporations and unions are in many instances similar. These different areas of the law, however, are not in agreement with respect to the more difficult indemnification issues such as settlements and advances of litigation costs. Consequently, it is necessary to determine which area of law provides the best guidance for developing ERISA indemnification principles.²⁰⁶

The application of corporate indemnification standards to ERISA fiduciaries is appealing for a number of reasons. Both the ease of having a ready-made standard complete with interpretational case law and the self-evident shared rationale of encouraging the best qualified persons to fill the positions support the adoption of the statutory corporate indemnification rules. A closer examination of the analogy to corporate directors, however, suggests that corporate indemnification standards are not appropriate guidelines for ERISA fiduciaries.²⁰⁷

The roles of a corporate director and an ERISA fiduciary are distinguishable in a number of respects. A director's main objective is to invest the shareholder's money in the hope of a profit; an ERISA fiduciary's main goal is to ensure the safety of the fund's assets in order to secure the financial well-being of the fund's participants. Arguably, more liberal indemnity policies are appropriate for corporate directors to the extent they encourage directors to engage in sometimes risky, but potentially lucrative, conduct by minimizing personal liability in the event of failure. ERISA, however, encourages prudence and the maintenance of assets, and stricter indemnity standards are therefore

²⁰⁵ See *supra* notes 201-02 and accompanying text.

²⁰⁶ Given that most indemnification principles in the law of private trusts, charitable trusts, private foundations and unions are essentially identical, these areas of law will not be separately discussed, but will be collectively referred to as "the law of trusts" or "trust law" unless indicated otherwise. It should be recognized, however, that the areas are distinct in many other respects and should be treated accordingly.

²⁰⁷ One should note, when discussing whether corporate law indemnification standards are appropriate for ERISA fiduciaries, that both Delaware, DEL. CODE ANN. tit. 8, § 145(i) (Supp. 1982), and New York, N.Y. BUS. CORP. LAW § 723(c) (McKinney Supp. 1982), provide that a corporation may indemnify an officer serving, at its request, as fiduciary of an employee benefit plan to the same extent that it may otherwise indemnify an officer who acts in good faith and in a manner reasonably believed to be in the interest of the participants and beneficiaries of the plan. See also ILL. ANN. STAT. ch. 32, § 157.42-12 (Smith-Hurd Supp. 1982) (serving "another corporation, partnership, joint venture, trust or other enterprise"). Similarly, in collectively bargained Taft-Hartley plans, in the absence of fraud or duress, neither the employers nor unions are prohibited from indemnifying employer or employee trustees selected by them. See 29 U.S.C. § 186(c) (1959). These provisions are of interest because they tend to undercut the argument that an ERISA plan needs to offer generous indemnification provisions in order to attract the ablest managers. In most instances the corporation or other entity sponsoring an employee benefit plan, rather than the beneficiaries, selects the managers. This suggests that the policy of obtaining able fiduciaries may be best served by limiting the indemnification powers of ERISA plans. This will shift the risk of having to indemnify well-meaning but legally derelict managers to the corporation or other entity which selected them, and will encourage the corporation or other entity to supply its most qualified people as managers.

appropriate.²⁰⁸ Significantly, trust and union law both subject their respective fiduciaries to the highest standards of care in order to encourage financial responsibility with respect to asset management.

A second distinction suggesting a more stringent indemnity policy for ERISA fiduciaries concerns the difference between the relationships of fiduciary-beneficiary and director-shareholder. An objectionable indemnity agreement is, to a certain extent, self-correcting with regard to a shareholder-director relationship. Shareholders can vote for new directors or sell their shares to one willing to accept the indemnity situation. A beneficiary of an employee benefit plan, however, like a beneficiary of a private trust or a union member, has far less opportunity to remedy what he perceives to be a dangerously lenient indemnity arrangement.²⁰⁹ Specifically, the beneficiary neither chooses the ERISA fiduciary, nor has the opportunity of changing to a different ERISA plan if he is unhappy with the indemnity situation.

These two factors — the trustee's goal of fiscal conservation and the beneficiary's lack of choice — liken the ERISA fiduciary to the union and trust fiduciary, and distinguish the ERISA fiduciary from the corporate director. These two reasons, therefore, provide support for the conclusion that reference to the law of unions and trusts is more helpful than reference to the law of corporations in formulating indemnification guidelines for ERISA funds.²¹⁰

Finally, the public policy behind corporate indemnification provisions is different from the public policy underlying ERISA indemnification provisions. When enacting corporation indemnification laws, state legislatures are frequently motivated by the desire to encourage corporations to incorporate in their respective states in order to obtain more franchise tax revenues.²¹¹ Consequently, legislatures often adopt liberal indemnification standards to provide a favorable incorporation atmosphere. In contrast, the fiduciary responsibility provisions of ERISA were enacted in part to protect the security of employees' benefits from the widespread fiduciary abuse and misuse of employee benefit plan assets which had historically permeated such programs.²¹² Given these different policies

²⁰⁸ There is a historical distinction between the role of an industrial or mercantile corporate director and the role of a trust-like fiduciary. For example, officers of money-holding institutions were often denied the protection traditionally afforded corporate directors by the business judgment rule on the basis that the public did not assume the same degree of risk with a financial institution as it did with a corporation. See e.g., *Williams v. Fidelity Loan & Sav. Co.*, 142 Va. 43, 69-70, 128 S.E. 615, 623 (1925); *New Haven Trust Co. v. Doherty*, 75 Conn. 555, 562, 54 A. 209, 212 (1903). See generally *Note, Public Policy and Directors' Liability Insurance*, 67 COLUM. L.REV. 716, 726-27 (1967). But see, e.g., ILL. ANN. STAT. ch. 17, § 3405(15) (Smith-Hurd Supp. 1982) (banks may indemnify directors to the same extent as may other corporations) (the modern rule).

²⁰⁹ See generally, *Morrissey v. Curran*, 650 F.2d 1267 (2d Cir. 1981). The *Morrissey* court noted that "unlike shareholders, who can sell their ownership interest if dissatisfied with management's conduct, union members dissatisfied with an unresponsively-managed union cannot sell their membership rights nor, in most cases, is it realistic to expect them to resign from membership or to change to another union." *Id.* at 1273.

²¹⁰ Arguably, reference to trust law in defining the scope of ERISA indemnification principles is congressionally mandated insofar as Congress expressly stated that the ERISA fiduciary responsibility provisions codify principles of trust law. See *supra* note 2 and accompanying text for a discussion of the relevant legislative history of ERISA.

²¹¹ See, e.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 88 YALE L.J. 663, 668 (1974).

²¹² See H.R. REP. NO. 93-533, 93d Cong., 2d Sess. 323, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4649. See also *Committee Report*, *supra* note 162 at 5, which points to the similar abuses LMRDA was enacted to prevent.

behind corporate indemnification laws and ERISA fiduciary principles, corporate indemnification policies should not serve as a model for ERISA indemnification standards. Application of liberal corporate indemnification principles to ERISA fiduciaries would have the effect of lessening the threat of personal liability, thereby encouraging the very abuses ERISA was designed to prevent.²¹³

*G. The Express Provisions of ERISA Limit Application of Trust Law
Indemnification Principles*

While union and trust law precedents provide a helpful background for developing indemnification guidelines for ERISA fiduciaries, any adopted standards must comport with the fiduciary responsibility provisions of ERISA. The legislative history of ERISA indicates clearly that the fiduciary duties of ERISA trustees are to be interpreted in light of the special nature, purpose and importance of employee benefit plans.²¹⁴ Section 404 of ERISA requires a fiduciary to discharge his duties for the exclusive purposes of providing benefits to the plan participants and defraying the reasonable expenses of administering the trust.²¹⁵ Additionally, section 404 dictates that the fiduciary act with the care, skill, and diligence of a prudent man in the same or similar circumstances.²¹⁶ If a fiduciary breaches any of these fiduciary duties, section 409 subjects him to personal liability for all losses sustained by the plan as a result of his breach.²¹⁷ Any agreement which attempts to relieve or exculpate a fiduciary from such personal liability is void under section 410.²¹⁸ In light of these provisions, it is clear that any trust or union law indemnification principle purporting to relieve an ERISA fiduciary from personal liability arising from a breach of his fiduciary duties would be void as well. Trust or union law indemnification principles, therefore, can be applied to ERISA fiduciaries only to the extent that such principles are consistent with the terms of sections 409 and 410.²¹⁹

1. An ERISA Fiduciary's Right of Indemnification and Exoneration

As a general rule, an ERISA fiduciary is entitled to indemnification for any expenses "properly and actually" incurred in the administration of the plan.²²⁰ As is the case with

²¹³ *Accord* N.J. STAT. ANN. § 14A, at x-xi (West 1969) ("It is clear that the major protections to investors, creditors, employees, customers, and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts").

²¹⁴ See H.R. REP. NO. 93-533, 93d Cong., 2d Sess. 323, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4651. See also, *N.L.R.B. v. Amax Coal Co.*, 453 U.S. 322, 330-31 (1981); *Marshall v. Glass & Glassworker's Pension Plan*, 507 F. Supp. 378, 383 (D. Hawaii 1980).

²¹⁵ For the full text of Section 404, see *supra* note 4 and accompanying text.

²¹⁶ *Id.*

²¹⁷ For the full text of Section 409, see *supra* note 13 and accompanying text.

²¹⁸ For the full text of Section 410, see *supra* note 14 and accompanying text.

²¹⁹ See 29 U.S.C. § 1144(a) (1976), which provides that the provisions of ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan. . . ." This language supports the conclusion that trust law indemnification principles are not applicable to ERISA fiduciaries to the extent such principles are inconsistent with ERISA. See also *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 522-23 (1981) (state law governing pension funds which is inconsistent with the provisions of ERISA is preempted). In addition, since ERISA fiduciary duties are to be interpreted "in light of the special problems" of employee benefit plans, LMRDA principles are applicable only to the extent that they are also consistent with ERISA.

²²⁰ See *supra* note 11 and accompanying text for a discussion of Section 408, which permits an ERISA fiduciary to receive "reimbursement of expenses properly and actually incurred."

private trusts, this indemnification right should encompass not only a right of reimbursement where the fiduciary has made payment out of his own funds, but also a right of exoneration which allows the fiduciary to use the plan assets in the first instance to discharge an obligation.²²¹ The right of exoneration exists, however, only if the liability in question is properly incurred. If, for example, the fiduciary exercised his right of exoneration and it was later determined that the expense was not justified, section 409 of ERISA would require the expense to be a personal liability of the fiduciary. Furthermore, section 406 of ERISA²²² deems the fiduciary's exoneration of a personal expense to constitute an act of self-dealing insofar as he uses plan assets for his own benefit.²²³ Section 406 expressly prohibits self-dealing and, therefore, exoneration of an expense improperly incurred is outlawed as well. In light of these general principles, an ERISA fiduciary's right to reimbursement and exoneration will be discussed separately.

An ERISA fiduciary's right to reimbursement for legal expenses is very similar to reimbursement rights granted under the law of unions and trusts. In a suit which benefits the plan,²²⁴ the fiduciary is entitled to reimbursement, pursuant to section 408 of ERISA, for all proper legal expenses.²²⁵ In a suit charging the fiduciary with breach of his fiduciary duties, a successful defense of such charges would entitle the fiduciary to reimbursement for legal expenses, while an unsuccessful defense would not.²²⁶ As previ-

²²¹ See *supra* note 25 and accompanying text for a discussion of a trustee's right of exoneration.

²²² See *supra* note 6 and accompanying text for a full discussion of Section 406.

²²³ It should be noted that potential co-fiduciary liability exists pursuant to Section 405, where a fiduciary improperly exercises his right of exoneration and a co-fiduciary permits the exoneration to occur without making a prior determination that the expense exonerated is proper. Section 405 states in relevant part:

(a) In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:

- (1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
- (2) if, by his failure to comply with section 1104(a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or
- (3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

29 U.S.C. § 1105 (1976).

²²⁴ An example of a suit which benefits the plan would be one where the trust instrument is interpreted or where there is an action and the interests of the trust and fiduciary are identical.

²²⁵ Legal expenses incurred in litigation which benefit the fund are "proper," according to trust law principles. See *supra* note 30 and accompanying text. Therefore, Section 408 of ERISA should operate to permit reimbursement of such expenses. The principles of reimbursement and exoneration discussed with respect to benefit litigation are equally applicable to third party actions which involve activities or transactions entered into by the fiduciary in his representative capacity on behalf of the plan. As used, herein, third party claims do not involve ERISA liabilities as far as the claimant is concerned.

²²⁶ *Accord*, Department of Labor, Op. 77-66/67A, ERISA Update (Washington Service Bureau) (1977). See also Department of Labor, Op. 77-64/65A, ERISA Update (Washington Service Bureau) (1977).

Significantly, while traditional private and charitable trust law permits indemnification of a trustee who, although guilty of a breach of trust, has taken action in good faith which benefits the estate, such a principle is not applicable to an ERISA fiduciary. Section 409 of ERISA renders the fiduciary personally liable for all expenses incurred as a result of a breach of trust, and Section 410 operates as a prohibition of any indemnification principle which would relieve the fiduciary of that personal liability regardless of the fiduciary's good faith. *Accord*, Department of Labor, Interpretive Bulletin, 29 C.F.R. § 2509.75-4 at 476-77.

ously noted, legal expenses incurred in successfully defending breach of trust charges are "proper," according to trust and union law principles.²²⁷ Therefore, section 408 of ERISA should operate to permit reimbursement of such expenses. Legal expenses incurred in unsuccessfully defending breach of trust charges are not, according to trust law and union principles, "proper"²²⁸ and, therefore, use of plan funds to pay for such expenses would constitute an act of self-dealing in violation of section 406 of ERISA.

The extent to which an ERISA fiduciary's right of exoneration entitles him to advance payments from the fund to satisfy legal expenses incurred in defending trust related litigation depends upon the context in which the litigation arises. In an action seeking a construction of the terms of an employee benefit plan, the fiduciary's legal fees are "proper" under trust law because the litigation involves rights and therefore benefits, under the plan itself.²²⁹ Furthermore, such an action involves the fiduciary only in his representative capacity. Thus, the fiduciary's right of exoneration would clearly entitle him to use the plan's assets in the first instance to satisfy any reasonable legal fees incurred in his own defense. Moreover, any legal fees incurred by the plan's own counsel in furthering the plan's interests are incontestably a "proper" expense of the plan and, as such, could be satisfied with plan assets.

The fiduciary's right to exoneration of legal expenses, however, is not as evident in an action alleging breach of trust. If the fiduciary is successful in defending the litigation, then the legal expenses incurred are "proper" and subject to exoneration. If, however, the fiduciary does not successfully defend the breach of trust charges, then the legal expenses incurred are not "proper" and therefore are not subject to exoneration. The obvious analytical problem presented by this exoneration concept is that the fiduciary is seeking to exonerate the expense before there has been a determination on the merits. This concept is inherently flawed because it requires the fund to determine whether such expense is "proper" prior to trial. Whether plan assets can be advanced to a fiduciary for payment of legal expenses in a breach of trust action cannot, therefore, depend upon whether such expenses are "proper," but must instead depend upon whether an advance would be consistent with the fiduciary's duty to manage litigation prudently.²³⁰

Trust and union law precedents do not squarely embrace a fiduciary's right to receive advances for legal fees incurred in defending breach of fiduciary duty charges. There are, however, suggestions in trust and union law that such advancements may be proper under certain circumstances. For example, in *Ball v. Mills*,²³¹ the Florida District Court of Appeals for the First District denied the trustee's request for an interim award of

²²⁷ See *supra* notes 40 and 187.

²²⁸ See *supra* note 30 and accompanying text.

²²⁹ *Id.*

²³⁰ The District Court for the Northern District of Illinois has expressly recognized that an advancement is not *per se* violative of ERISA Section 410, 29 U.S.C. § 1110 (1976). This provision prohibits the fiduciary from being relieved of a personal liability. See *Central States, Southeast and Southwest Areas Pension Fund v. American Nat'l Bank and Trust Co.*, No. 77 C 4335, slip op. at 6 (N.D. Ill. Oct. 26, 1979) (available on LEXIS, Genfed library, Dist. file). This conclusion is undoubtedly correct insofar as it recognizes that prior to a determination on the merits of breach of fiduciary duty litigation, an advance cannot, by definition, relieve the fiduciary of a responsibility or liability. The fact that an advancement does not *per se* violate ERISA Section 410 does not, however, relieve the fiduciary of his duty under ERISA Section 404 to determine whether such an advancement is prudent.

²³¹ 376 So. 2d 1174 (Fla. 1979), *cert. denied sub nom. Mills v. Ball*, 388 So. 2d 1116 (Fla. 1980).

attorneys' fees, but noted that "an award of interim attorney's fees [may] be made prior to conclusion of the litigation" under circumstances where the trustee could demonstrate that he would eventually be entitled to reimbursement.²³² Similarly, in *Milone v. English*,²³³ the court, while rejecting the general concept of union advancement, noted that "[w]here there is no substance to a charge of wrongdoing it may be that the union is not barred from standing the cost of the defense. . . ."²³⁴ In both these cases, the courts indicated that an advancement might be proper given a prior determination that the fiduciary would eventually be entitled to reimbursement from the trust or union assets.²³⁵ This reasoning is applicable to the case of ERISA fiduciaries. An advancement to an ERISA fiduciary for legal expenses incurred in defending breach of trust charges might well be consistent with the provisions of ERISA and, therefore, prudent, if there exists a prior determination that the fiduciary would eventually become entitled to reimbursement.

2. The Duty of an ERISA Fiduciary to Manage Litigation Expenses Prudently

Section 404 of ERISA charges fiduciaries with the duty of defraying the "reasonable" expenses of administering the plan with the "care, skill, prudence, and diligence" of a prudent man "under the circumstances then prevailing."²³⁶ This duty necessarily encompasses an obligation to manage all litigation affecting the plan in a prudent manner, and to keep all legal expenses relating to such litigation reasonable in amount. A fiduciary would appear authorized, therefore, to advance legal fees incurred in litigation relating to the plan, pursuant to his duty to manage such litigation, if the advancement is both prudent under the circumstances and reasonable in amount.

The issue of whether the advancement is prudent under the circumstances depends upon a reasonable determination by the fiduciary authorizing the advance that the fiduciary receiving the advance will eventually become entitled to reimbursement from the fund. Although it may often be difficult for a fiduciary to assess accurately the probable outcome of litigation, the problem becomes especially acute where the fiduciary is also the defendant. In such a circumstance, the fiduciary must determine the merits of his own case, and, on this basis, decide whether it would be prudent to advance funds to himself. Quite obviously, the fiduciary's role as a defendant conflicts with his role as a fiduciary. The extent of this conflict is especially apparent when some, but not all, of the fiduciaries are defendants. A nondefendant fiduciary may have conflicting loyalties in making a determination whether to advance.²³⁷ The nondefendant fiduciary not only has a loyalty to the plan but also most certainly will feel a loyalty to the defendant fiduciary with whom he works.

An example of the conflicting roles of a trust fiduciary is presented in *Donovan v.*

²³² 376 So. 2d at 1181.

²³³ 306 F.2d 814 (D.C. Cir. 1962).

²³⁴ *Id.* at 817 n.2.

²³⁵ See also Department of Labor, Op. 77-66/67A, ERISA Update (Washington Service Bureau) (1977) (payment by ERISA fund of legal expenses incurred in settlement of litigation, i.e. in advance of merits determination, proper if independent legal counsel opines that fiduciary did not breach his fiduciary obligations).

²³⁶ See *supra* note 4 and accompanying text.

²³⁷ See generally *NLRB v. Amax Coal Co.*, 453 U.S. 322, 333-34 (1981) ("The legislative history of ERISA confirms that Congress intended in particular to prevent trustees 'from engaging in actions where there would be a conflict of interest with the fund. . . .'").

Bierwirth,²³⁸ where directors of Grumman Corporation, who were also officers of Grumman and the trustees of the Grumman pension plan, voted, along with other directors, to have the corporation oppose a tender offer of LTV Corporation.²³⁹ These officers and directors thereafter met as trustees, and caused the pension plan not to tender its shares of Grumman, and to purchase additional shares so as to make it more difficult for LTV to gain control of Grumman.²⁴⁰ The Secretary of Labor brought an action against the trustees alleging that they had breached their fiduciary duties.²⁴¹ The Secretary charged that the trustees' decision to purchase additional Grumman stock was not for the exclusive benefit of the plan, but rather for the benefit of Grumman Corporation.²⁴² In addition, he alleged that the trustees breached their fiduciary duty to act prudently when they failed to resign as trustees once it was apparent that their roles as director-officers and trustees conflicted.²⁴³

In finding that the trustees had breached their fiduciary duty, the Second Circuit Court of Appeals criticized the trustees' failure to explore where their primary duty lay.²⁴⁴ According to the court, the trustees had two permissible alternatives when faced with conflicting loyalties. First, the court suggested that the trustees' duty to act prudently in administering the plan might have required them to resign their posts as trustees for the duration of the tender offer.²⁴⁵ Alternatively, the court noted, it would have been prudent for the trustees to solicit the advice of independent counsel to determine what course of action the plan should have taken.²⁴⁶ Having failed to exercise either of these options, the court found that the trustees breached their fiduciary responsibility to act prudently.²⁴⁷ The court noted:

We do not mean by this either that trustees confronted with a difficult decision need always engage independent counsel or that engaging such counsel and following their advice will operate as a complete whitewash which, without more, satisfies ERISA's prudence requirement. But this was, and should have been perceived to be, an unusual situation peculiarly requiring legal advice from someone above the battle.²⁴⁸

Applying the logic of *Bierwirth* to the advancement issue, it appears that the defendant-fiduciary should either allow the remaining neutral fiduciaries to make the determination, or resign for the duration of the litigation and allow a newly appointed temporary fiduciary to act. Alternatively, the fiduciary should solicit the advice of independent legal counsel²⁴⁹ to determine whether an advance under such circumstances

²³⁸ 680 F.2d 263 (2d Cir. 1982), *cert. denied sub nom.* *Bierwirth v. Donovan*, 103 S. Ct. 488 (1982), *complaint dismissed*, *Donovan v. Bierwirth*, 5 E.B.C. 1065 (Feb. 21, 1984) (fiduciary violations caused no loss to the plan).

²³⁹ 680 F.2d at 266-67.

²⁴⁰ *Id.* at 267-68.

²⁴¹ *Id.* at 270.

²⁴² *Id.*

²⁴³ *Id.*

²⁴⁴ *Id.* at 271.

²⁴⁵ *Id.* at 271-72.

²⁴⁶ *Id.* at 272.

²⁴⁷ *Id.* at 276.

²⁴⁸ *Id.* at 272-73. See also *N.L.R.B. v. Amax Coal Co.*, 453 U.S. 322, 329 (1981), where the Supreme Court stated that a Taft-Hartley ERISA trustee has "an unwavering duty of complete loyalty to the beneficiar[ies]. . . ."

²⁴⁹ It is imperative that the independent legal counsel be truly independent and have no loyalties to either the fiduciary, the beneficiaries or the plan itself. The Department of Labor appears to share this view by requiring counsel which determines the merits of a settlement to be independent

would be consistent with the fiduciary's duty to manage all litigation prudently.²⁵⁰ In giving such advice, independent legal counsel should focus on three factors: the likelihood that the fiduciary will successfully defend the suit, the fiduciary's ability to repay the advances if he loses the action, and whether a failure to advance legal fees would expose the fund to losses in excess of the probable cost of such fees.²⁵¹

The importance of focusing on these three factors can best be illustrated by looking at a specific example. Assume, for instance, that a fiduciary is sued for breach of his duties, and independent legal counsel determines that there is a great probability the fiduciary will successfully defend the action. In light of such a favorable opinion, assuming there is no reason for the fiduciary to believe independent legal counsel's opinion is erroneous, it might be prudent for the fund to advance legal fees to the fiduciary. If, in addition to the favorable opinion of independent legal counsel, the fiduciary demonstrates an ability to repay all amounts advanced, then an advance under such circumstances would undoubtedly be prudent.²⁵² Under these circumstances, eventually the fiduciary is likely to be entitled to reimbursement from the fund, and the fund is in little danger of not being able to recoup its advancement.

A more difficult question is presented when the fiduciary does not demonstrate an ability to repay the advanced litigation expenses. Under these circumstances, the issue of whether an advance would be prudent depends to a much greater extent upon the strength of independent counsel's opinion, and also upon a consideration of whether the trust's failure to advance expenses exposes the plan to losses in excess of the probable cost of such fees. For example, if independent legal counsel determines that a breach of trust suit is frivolous and there is a strong probability the fiduciary will prevail on the merits, then an advancement might be prudent even in the absence of an ability to repay.²⁵³ Similarly, if independent legal counsel opines that the fiduciary has only a reasonable chance of succeeding on the merits and an unsuccessful defense would potentially expose the plan to substantial losses,²⁵⁴ then it might be prudent for the plan to advance defense costs to the fiduciary or have its counsel undertake the defense directly notwithstanding a fiduciary's inability to repay. Although the fiduciary's chance of success may not be high,

of the plan and its fiduciaries. See Department of Labor, Op. 77-66/67A, ERISA Update (Washington Service Bureau) (1977).

²⁵⁰ The "prudence" of an advancement turns, to a great extent, upon the fiduciary's chances of successfully defending the charges. Even if the fiduciary defendant resigned for the duration of the litigation, prudence would dictate that the remaining neutral fiduciaries or a temporary fiduciary, given the potential for conflicting loyalties, obtain the advice of independent legal counsel prior to making an advance. Once having obtained independent legal counsel, the neutral fiduciaries' objectivity or ability to assess the merits of legal issues would not be as open to question.

²⁵¹ Significantly, the following discussion of whether to advance legal fees to a fiduciary relates only to civil litigation. In criminal litigation arising out of a fiduciary's relationship to the plan, given the serious nature of criminal charges, an advancement would probably never be prudent and, therefore, would violate ERISA Section 404. For a discussion of this issue in the union situation, see *Union Fiduciaries* *supra* note 170 at 268-320.

²⁵² See Department of Labor, Op. 77-66/67A, ERISA Update (Washington Service Bureau) (1977) where the DOL supports the idea of advancing legal fees to a fiduciary if the fiduciary demonstrates an ability to repay such advances if his defense of breach of trust charges is ultimately unsuccessful.

²⁵³ See *Milone v. English*, 306 F.2d 814, 817 n.2 (D.C. Cir. 1962); *Ball v. Mills*, 376 So. 2d 1174, 1181 (Fla. 1979), *cert. denied sub nom. Mills v. Ball*, 388 So. 2d 1116 (Fla. 1980).

²⁵⁴ For example, in a breach of contract suit where the fund is vicariously liable for the trustee's wrongdoing.

the duty to manage litigation prudently, given the potential of significant losses to the plan, might require that advancements be made to enable the fiduciary to put forth the best possible defense in an effort to avoid such losses. In instances where the plan is not exposed to significant losses, an advancement would not be prudent in the absence of an ability to repay.

The next situation to be considered is where independent legal counsel opines that the fiduciary has breached his fiduciary duties. In such instances, it is never prudent to advance funds, even if the fiduciary has the ability to repay and a failure to advance such expenses might expose the fund to potential losses. In fact, when presented with an adverse opinion from independent counsel, prudent litigation management may require that the plan retain legal counsel to institute suit against the breaching fiduciary.²⁵⁵

A related question is whether a fiduciary may prudently authorize the fund to pay amounts in settlement of pending or threatened litigation involving breach of trust allegations. The problem presented by settlement is similar to the problem presented by fee advancement, because in both situations it is impossible to determine whether an expense is "proper" before a determination on the merits is made.²⁵⁶ Given the fact that the payment of settlement costs is also a question of prudent litigation management, the use of independent legal counsel to opine on the merits of the fiduciary's defense is suggested here as well. In this regard, it is significant to note that the Department of Labor has expressly permitted a fund to make payments in settlement of pending or threatened litigation if the fund obtains a written opinion of independent legal counsel that the fiduciary has not breached his fiduciary responsibilities.²⁵⁷ Although the Department of Labor did not specify its reasoning, this "settlement principle" is undoubtedly based upon the conclusion that the fiduciary would be entitled to reimbursement if the case went to trial and he was found not to have breached his duties.

A fiduciary's duty to manage prudently all litigation affecting the plan necessarily imposes upon him a duty to insure that all fees expended in litigation are reasonable.²⁵⁸ Stated another way, a fiduciary is only entitled to advancement of, or reimbursement for, reasonable attorneys' fees.²⁵⁹ If he allows the plan to incur unreasonable attorneys' fees, he would be breaching his fiduciary duties and would be personally liable, pursuant to ERISA section 409, for all fees in excess of those which are reasonable.²⁶⁰ The question of whether litigation expenses are "reasonable" depends to a great extent upon the context of the litigation. In an action brought solely to determine the proper construction of the plan agreement, the fiduciary is only a nominal party to the action because he is exposed to no potential personal liability. The plan is the real party in interest, because an unfavorable construction of its terms might require it to pay out additional funds. For example, in an action brought by a group of persons who claim that the terms of the plan

²⁵⁵ If there are other fiduciaries not charged with breaching their duties, prudent litigation management would dictate that they institute a suit against the wrongdoing trustee in order to avoid the potential co-fiduciary liability of ERISA Section 405. For the full text of ERISA Section 405 see *supra* note 223.

²⁵⁶ Research to date has found no trust law dealing with the settlement issue and, as noted before, union law has given the settlement issue uncertain treatment. See *supra* note 202 and accompanying text.

²⁵⁷ Department of Labor, Op. 77-66/67A, ERISA Update (Washington Service Bureau) (1977).

²⁵⁸ See *supra* note 4 and accompanying text.

²⁵⁹ *Id.*

²⁶⁰ See *supra* note 13 and accompanying text.

entitle them to plan benefits, a construction of the plan terms which adopts their claimed interpretation would require the fund to pay out additional monies. In such a circumstance, the fiduciary requires only nominal representation, and legal expenses incurred by him ought to be considered reasonable only to the extent that they cover such nominal representation. The plan, however, does need separate counsel to defend the litigation actively. Consequently, the plan's legal expenses are reasonable to the extent such expenses are necessary to such active representation.²⁶¹

In contrast to actions brought to determine proper plan construction, in a breach of fiduciary duty action, the plan is only a nominal party if it has suffered no loss. In such an instance, the plan requires only nominal representation, and its legal expenses are reasonable only to the extent they cover such nominal representation. The fiduciary is the active party in such litigation because he is exposed to potential personal liability. Accordingly, the fiduciary needs separate counsel to play an active role in his defense, and his legal expenses are reasonable to the extent they cover such representation.

Finally, in a breach of fiduciary duty suit where there is potential harm to the plan, both the plan and the fiduciary are real parties in interest because both are exposed to loss. Under such circumstances, both the fiduciary and the plan need separate counsel and the legal fees incurred by them are reasonable to the extent they are necessary to assert their respective positions.

II. EMPLOYEE INDEMNIFICATION PRINCIPLES

A. *The Provisions of ERISA Relevant to Employee Indemnification*

An employee of an ERISA benefit plan is a "party in interest" in all related litigation.²⁶² An ERISA fiduciary is literally prohibited from authorizing employee indemnification payments because section 406 prohibits the transfer of plan assets or an extension of credit to a party in interest.²⁶³ Section 408 of ERISA, however, provides a statutory exemption from section 406 which validates employee indemnification arrangements in certain circumstances.²⁶⁴ In pertinent part, section 408(b) provides that the prohibitions contained in section 406 do not apply to contracting with a party in interest for his services if no more than reasonable compensation is paid for the services.²⁶⁵ The Labor Department's regulations provide that "reasonable compensation" includes advances of expenses "properly and actually" incurred by an employee in the performance of his duties.²⁶⁶ A problem similar to that encountered in fixing the scope of an ERISA fiduciary's right to indemnification arises with respect to ERISA employee indemnification, however, because neither the statutory language nor the legislative history of ERISA defines the term "proper." Given this absence of congressional guidance, an examination

²⁶¹ The term "active representation" contemplates representation by an attorney who takes the lead role in prosecuting or defending the litigation as the interests of his clients are the most directly affected. The term "nominal representation" contemplates representation by an attorney who takes a passive role in defending or prosecuting the litigation as the interests of his client are only secondarily affected by those of the real party in interest.

²⁶² 29 U.S.C. § 1002(14)(A) (1976).

²⁶³ 29 U.S.C. § 1106 (1976). For the full text of Section 406 see *supra* note 6 and accompanying text.

²⁶⁴ 29 U.S.C. § 1108(b)(2) (1976).

²⁶⁵ *Id.*

²⁶⁶ 29 C.F.R. § 2550.408C-2(b)(4) (1982).

of the analogous employee indemnification principles in the law of agency is helpful in formulating a workable standard for when, and under what circumstances, indemnification of an ERISA employee is warranted.

The relationship of a principal and agent is essentially contractual.²⁶⁷ An agent's right to indemnification for expenses incurred in performing his duties is, therefore, primarily dependent upon the contractual agreement reached between the parties.²⁶⁸ Subject to the terms of the agreement, an agent is entitled to indemnification for all expenses incurred in performing acts authorized by the principal.²⁶⁹ Conversely, an agent is generally not entitled to indemnification for expenses resulting from unauthorized acts, unless the acts benefit the principal.²⁷⁰ Indemnification is also unavailable to an agent where losses result solely from the agent's negligence or personal fault,²⁷¹ or for losses or expenses incurred following an illegal transaction if the agent knew of the illegality.²⁷²

In applying these general rules, courts have uniformly authorized reimbursement of an agent's attorneys' fees and other costs of litigation incurred in defending an action brought against him by third persons, where the action arises out of authorized acts done in furtherance of his agency.²⁷³ Significantly, an agent against whom an action has been

²⁶⁷ RESTATEMENT (SECOND) OF AGENCY § 438 (1958) (hereinafter cited as AGENCY) ("A principal is under a duty to indemnify the agent in accordance with the terms of the agreement with him.").

²⁶⁸ See *Shell Oil Co. v. Hunt*, 124 F.2d 482, 483 (10th Cir. 1941); *Schmitt v. Continental-Diamond Fibre Co.*, 116 F.2d 779, 786 (7th Cir. 1940). See also AGENCY, *supra* note 267, at § 438.

²⁶⁹ See *Minnesota Farm Bureau Mktg. Corp. v. North Dakota Agricultural Mktg. Ass'n*, 563 F.2d 906, 913 (8th Cir. 1977); *McKinnon and Mooney v. Fireman's Fund Indemnity Co.*, 288 F.2d 189, 190 (6th Cir. 1961); *Toombs v. Lewis*, 362 Ill. 181, 189, 199 N.E. 127, 130 (1935); *Blank v. Rodgers*, 82 Cal. App. 35, 45, 255 P. 235, 239 (1927). See also AGENCY, *supra* note 267, at § 438(2)(a).

An agent is entitled to indemnification for expenses incurred in an authorized transaction even if he committed a breach of duty in carrying out the transaction. The principal would, of course, be entitled to set off against any indemnification payments all losses arising from the agent's breach of duty. See *Antle v. Haas*, 251 S.W.2d 290, 295 (Ky. 1952); *Schwartz v. Artel*, 40 Cal. App. 2d 433, 441-42, 105 P.2d 380, 384 (1940). But see *Feiger v. Iral Jewelry, Ltd.*, 41 N.Y.2d 928, 928-29, 363 N.E.2d 350, 351, 394 N.Y.S.2d 626, 626 (1977).

²⁷⁰ *Craven v. Craven*, 407 Ill. 252, 263, 95 N.E.2d 489, 495-96 (1950); *Ross v. Clark*, 18 Colo. 90, 92-93, 31 P. 497, 498 (1892). See also AGENCY, *supra* note 267, at § 440 (comment b).

²⁷¹ See *Hopkins v. Hacker*, 105 N.H. 150, 151, 195 A.2d 587, 588 (1963); *Blair v. United Finance Co.*, 235 Or. 89, 92, 383 P.2d 72, 74 (1963); *Hagen v. Koerner*, 64 N.J. Sup. 580, 585, 166 A.2d 784, 786 (1960).

²⁷² See *Bibb v. Allen*, 149 U.S. 481, 490 (1893); *Mills Novelty Co. v. Dupouy*, 203 F. 254, 259 (7th Cir. 1913); *Hagen v. Koerner*, 64 N.J. Sup. 580, 586-87, 166 A.2d 784, 787 (1960); *Samuels v. Oliver*, 130 Ill. 73, 84-5, 22 N.E. 499, 503 (1889). See also AGENCY, *supra* note 267, at § 467; 3 AM. JUR. 2d AGENCY § 245 (1962).

Significantly, an agent's right to indemnification can include both a right to reimbursement and a right to exoneration depending upon the terms of the agency agreement. See *Hornstein v. Kramer Bros. Freight Lines*, 133 F.2d 143, 147 (3d Cir. 1943); *Stromerson v. Averill*, 22 Cal. 2d 808, 816, 141 P.2d 732, 737 (1943); *Evans, Coleman & Evans v. Pistorino*, 245 Mass. 94, 99, 139 N.E. 848, 851, (1923); see also AGENCY, *supra* note 267, at § 438 (comment b). In the absence of an agreement to exonerate, the law of agency appears to limit an agent to a right of reimbursement.

²⁷³ *Johnston v. Suckow*, 55 Ill. App. 3d 277, 281, 370 N.E.2d 650, 653 (1977); *Virginia Corp. v. Russ*, 27 Ill. App. 3d 608, 611, 327 N.E.2d 403, 405 (1975); *Dailey Bros. v. W. A. Clements Co.*, 120 Misc. 310, 311, 198 N.Y.S. 387, 389 (1923); *First Nat'l Bank v. Tenny*, 43 Ill. App. 544, 554 (1892). See also AGENCY, *supra* note 267, at § 439(d).

The Restatement (Second) of Agency limits an agent's indemnification right for third party litigation expenses to suits brought in good faith. AGENCY, *supra* note 267, at § 439(d). The treatise points out that it is not clear whether an agent would be entitled to indemnification for expenses incurred in defending third party actions brought in bad faith. *Id.* at § 439 (comment a). As a

brought for conducting an authorized activity is entitled to indemnification for reasonable expenses incurred in defending the action regardless of his success or failure.²⁷⁴ In order to entitle himself to indemnity, the agent need only demonstrate that he acted in good faith and that the expenses incurred were reasonable and necessary.²⁷⁵ This right to indemnification also extends to litigation expenses incurred in reasonably settling such an action in good faith.²⁷⁶

The principal's duty to indemnify the agent for expenses incurred in defending a third party action does not arise until the principal is given notice of the third party claims and declines to assume their defense.²⁷⁷ If the agent fails to notify the principal and thereby denies the principal an opportunity to defend, the agent is entitled to indemnity for expenses incurred in defending the action only if the agent establishes he made a reasonable defense. If the principal has been prejudiced by the agent's failure to notify him of the suit, however, the agent loses his right to indemnification to the extent of the prejudice.²⁷⁸

There are two further qualifications on an agent's right to indemnification. First, an agent may not recover expenses incurred in an action brought by the principal if the

practical matter, however, it is not logical to condition the agent's indemnification right on the good or bad faith of the third party bringing the suit, and a stronger argument for allowing indemnification exists when the action is grounded in bad faith.

²⁷⁴ See *McKinnon and Mooney v. Fireman's Fund Indemnity Co.*, 288 F.2d 189, 190 (6th Cir. 1961); *Admiral Oriental Line v. United States*, 86 F.2d 201, 202 (2d Cir. 1936); *Western Smelting & Refining Co. v. First Nat'l Bank*, 150 Neb. 477, 482-83, 35 N.W.2d 116, 121 (1948); *Abrams v. Harry A. Roth & Co.*, 310 Ill. App. 490, 494-95, 34 N.E.2d 725, 726-28 (1941); *Sanitary Dist. v. United States Fidelity & Guaranty Co.*, 392 Ill. 602, 612, 65 N.E.2d 364, 368-69 (1946). See also AGENCY, *supra* note 267, at § 438 (comment e) (Appendix).

²⁷⁵ See *Long v. Vlastic Food Products Co.*, 439 F.2d 229, 233 (4th Cir. 1971); *McKinnon and Mooney v. Fireman's Fund Indemnity Co.*, 288 F.2d 189, 190 (6th Cir. 1961); *Western Smelting & Refining Co. v. First Nat. Bank of Omaha*, 150 Neb. 477, 487, 35 N.W.2d 116, 121 (1948). Whether the agent has made a good faith defense and whether the expenses of such defense are reasonable are questions of fact. AGENCY, *supra* note 267, at § 438 (comment e).

²⁷⁶ *Long v. Vlastic Food Products Co.*, 439 F.2d 229, 232 (4th Cir. 1971); *Western Smelting & Refining Co. v. First Nat'l Bank of Omaha*, 150 Neb. 477, 487, 35 N.W.2d 116, 121 (1948). See also 3 C.J.S. Agency § 322 (1973). As stated in AGENCY:

[i]f an agent reasonably believes that he is, or may be, subject to liability because of an authorized transaction, he does not have to wait until an action is brought against him. After notifying the principal, he is entitled to indemnity for payments in a settlement made in good faith and reasonably if: (a) he is in justifiable ignorance of a defense, or (b) the extent of liability is uncertain, or (c) liability is doubtful.

AGENCY, *supra* note 267, at § 438 (comment c) (Appendix).

²⁷⁷ *Long v. Vlastic Food Products Co.*, 439 F.2d 229, 233 (4th Cir. 1971); *Differential Steel Car Co. v. MacDonald*, 180 F.2d 260, 270 (6th Cir. 1950); *Western Smelting & Refining Co. v. First Nat'l Bank*, 150 Neb. 477, 487, 35 N.W.2d 116, 121 (1948). The Restatement (Second) of Agency points out that:

[i]f the agent notifies the principal of action against him and asks him to defend it, the judgment against the agent who defended or submitted in good faith is res judicata as to the principal, with reference to the liability of the agent and the amount, and the agent is entitled to be indemnified for his expenses

AGENCY, *supra* note 267, at § 438 (comment e) (Appendix). See also 3 C.J.S. Agency § 322 (1973).

²⁷⁸ See *Sunset-Sternau Food Co. v. Bonzi*, 36 Cal. Rptr. 741, 748, 389 P.2d 133, 140 (1964). See also AGENCY, *supra* note 267, at § 438 (comment d).

agent is found guilty of nonperformance or misperformance of his duties.²⁷⁹ To hold otherwise would, in effect, require the principal to pay for the right to sue an agent who breached his duties. Second, in a suit by a third party against both the principal and the agent where the principal provides competent attorneys to defend both himself and the agent, the agent is not entitled to hire separate counsel and receive indemnity for his attorneys' fees.²⁸⁰ To hold otherwise would require the principal to incur unnecessary expense.

Agency indemnification principles, unlike trust law indemnification principles, do not directly conflict with any express provisions of ERISA. Subject to the reasonableness requirement of ERISA, therefore, whenever an indemnification payment is deemed "proper" under traditional agency law, such a payment is also "proper" under ERISA. In authorizing an employee indemnification payment, however, an ERISA fiduciary must act in a manner that conforms with the prudence requirements of section 404.²⁸¹ The fiduciary can satisfy these requirements by first obtaining the advice of independent legal counsel that traditional principles of agency law would sanction an indemnification payment under the circumstances, and then by determining that the payment is reasonable in amount.²⁸²

III. SUGGESTED INDEMNIFICATION GUIDELINES FOR ERISA FIDUCIARIES AND EMPLOYEES

In light of the variety and complexity of indemnification situations faced by ERISA fiduciaries, it is impossible to develop a single standard that may be applied in all situations. It is possible, however, to develop guidelines or factors which should be considered in every indemnification situation. Each of these factors would, of course, take on a varying degree of significance depending upon the circumstances facing the fiduciary. The following guidelines are suggested as appropriate standards to be followed by trustees of an employee benefit plan when determining whether an ERISA fiduciary or employee is entitled to have the plan pay legal expenses incurred in litigation relating to the plan.

A. *Management of Litigation*

The ERISA trustees' duty to manage all litigation affecting the plan requires the trustees to keep the costs of such litigation "reasonable."²⁸³ There are a number of ways that fiduciaries may insure reasonable litigation costs. The plan's regular or in-house counsel should review all litigation matters at their outset. The purpose of this review is to make a preliminary determination of the type of litigation, its projected scope, and the nature and extent of legal services necessary for its prosecution, as well as an assessment of the probable outcome.

The type of litigation facing a fiduciary defendant will essentially fall into one or more of three categories. The first category is litigation which benefits the plan by

²⁷⁹ *Cory Bros. & Co. v. United States*, 51 F.2d 1010, 1013 (2d Cir. 1931); *Wyoming Bank & Trust Co. v. Waugh*, 606 P.2d 725, 731 (Wyo. 1980); See also AGENCY § 438 (comment k), *supra* note 267.

²⁸⁰ See *Adams v. North Range Iron Co.*, 191 Minn. 55, 59, 253 N.W. 3, 5 (1934).

²⁸¹ See *supra* note 4 and accompanying text.

²⁸² See generally *supra* notes 248-50 and accompanying text.

²⁸³ See *supra* note 4 and accompanying text.

construing the terms of the plan. Such "benefit litigation," in its pure form, does not involve the fiduciaries as individual defendants, although, as a practical matter, a breach of fiduciary duty may be alleged. The second category is third party litigation, which involves activities of the fiduciary undertaken in his representative capacity on behalf of the plan. For example, a claim by a third party which alleges that the fiduciary wrongfully breached a contract entered into for the benefit of the plan involves a third party action. As a rule, third party claims do not involve ERISA liabilities insofar as the claimant is concerned. The third category of litigation is that which involves an alleged breach of an ERISA fiduciary duty.

In benefit litigation or third party litigation a fiduciary's counsel should have a minimal or nominal role, because the fiduciary is not the real party in interest and is not exposed to personal liability. Any counsel fees paid to a fiduciary's counsel should be limited, therefore, to the amount of fees necessary to obtain nominal representation. Any work of a fiduciary's counsel beyond nominal representation should be subject to the approval of the other fiduciaries before the plan pays the fiduciary's counsel for such extra work. The plan's counsel, on the other hand, should take an active role in benefit litigation or third party litigation, as the plan is the real party in interest.

In breach of fiduciary duty litigation, the fiduciary defendant is the real party in interest. Consequently, the fiduciary's counsel should actively defend the suit. If there is no potential harm to the plan, the plan is only a nominal party and requires only nominal representation. If harm has occurred or may occur to the plan, the plan is also a real party in interest and requires separate representation in order to attempt recovery from the person or persons responsible for causing the loss.

The management of employee litigation also requires an initial review to determine the type of litigation involved, but the standards to be applied vary slightly. Generally, the type of litigation facing an employee will fall into one of two categories. The first category involves authorized activities of the employee, including activity involving illegal conduct provided the employee was unaware of the illegality. The second category involves the employee's unauthorized activity.

In authorized activity litigation, the employee is not the real party in interest because he has acted solely on behalf of and at the direction of his principal, the plan. Therefore, plan counsel may defend the employee in an authorized activity action. In contrast, in unauthorized activity litigation, the employee is the real party in interest because he is a party to the action as a result of his own alleged frolic. In such circumstances, the employee should retain his own counsel, and the plan should determine whether to bring a separate action against the employee if it has suffered any harm as a result of such frolic.

In both employee and fiduciary litigation, all litigation expenses payable by the plan should be billed on a monthly basis and subject to a monthly review by the trustees. In their review, the trustees should determine not only whether the expenses are "reasonable" but also whether all pre-approved expenses are within their established limits. In addition, one fiduciary counsel or one employee counsel should ordinarily represent all fiduciaries or employees who are similarly situated, so as to keep costs reasonable, unless there is a clear showing of conflict between the fiduciary or employee defendants.²⁸⁴

²⁸⁴ The extent to which such dual representation would be proper would be subject to the limitations imposed on multiple representation by Canon 5 of the Model Code of Professional Responsibility. For example, in DR 5-105(c) a lawyer is permitted to represent multiple clients only if it is obvious that he can adequately represent the interests of each and if each consents to such multiple representation after full disclosure of the possible effects such representation could have on

An additional factor to be considered in managing employee or fiduciary litigation is the existence of insurance. No fiduciary's or employee's legal expenses should be paid by the plan where there is insurance, whether paid for by the plan or otherwise, covering such expenses. Furthermore, when an insurance company is defending the action, the fiduciary or employee should be required to accept representation by the insurance company, and should not be allowed to have separate counsel paid for by the plan.

B. Advancement of Litigation Expenses Prior to a Determination on the Merits

1. Fiduciary Litigation

In deciding to advance litigation expenses in fiduciary litigation, the various types of such litigation must be distinguished. For example, in benefit or third-party litigation, where only nominal representation is involved, any litigation expenses may be immediately advanced because the fiduciary is really only a nominal party to the action and no charges of wrongdoing are being leveled against him.

The decision whether to advance legal expenses for fiduciaries in civil actions alleging breach of fiduciary duty, however, depends upon a balancing of several factors. The non-defendant fiduciary must consider the probable outcome of the suit, the ability of the defendant fiduciary to repay and the potential harm to the plan. As a general matter, the fiduciary defendant should never be advanced legal fees unless he undertakes to repay such advances with interest if he is unsuccessful in his defense. In this manner, the plan can minimize any losses it might otherwise suffer from an advancement that later turns out to be improper because the fiduciary is found to have breached his duties. Furthermore, all breach of fiduciary duty cases should be reviewed by independent legal counsel ("Counsel") to determine the probable outcome of the litigation and the potential exposure of the fund to liability if such expenses are not advanced. In this manner, the fiduciary can assess the defendant's likelihood of eventual entitlement to reimbursement and the overall harm that could result to the plan even if reimbursement seems unlikely. If Counsel opines that the fiduciary will defend the breach of trust charges successfully, and the fiduciary demonstrates an ability to repay all advances, the plan may properly advance reasonable litigation expenses. The risk to the plan is reduced as the fiduciary may likely be entitled to reimbursement and, if not, the fiduciary has the financial means to repay the money given to him. If, however, Counsel determines that the fiduciary will probably not successfully defend the breach of trust charges, the plan should not as a general practice advance legal expenses. With a low probability of success on the merits, the fiduciary's probability of being entitled to reimbursement is similarly low, so an advancement would be imprudent.

Where the fiduciary is unable to demonstrate an ability to repay, an advancement should generally not be authorized. Given the inherent difficulty of assessing the merits of any action, there is a substantial risk of loss to the plan if an advancement is made and the fiduciary is unsuccessful in his defense. Exposure to this risk might be prudent where counsel opines that there is a very low probability of the fiduciary being found liable, or where there would be substantial exposure of plan assets to liability by a decision not to advance. Given such extraordinary circumstances, a decision to advance without a demonstrated ability to repay could be prudent.

In any case where the decision to advance is made, the neutral fiduciaries should review the status of the litigation, as frequently as necessary, to ensure that the circumstances have not changed so as to render continued advancement imprudent. A regular review will give the fiduciaries an opportunity to terminate the advances before counsel's expenses become unreasonable in amount or unreasonable given some change in circumstances.

In instances where Counsel determines that the conduct of the fiduciary involves a clear violation of ERISA, there should never be an advancement of expenses. This is so regardless of the fiduciary's ability to repay or the potential for harm to the plan from a failure to advance. In such cases, the plan is likely to have a claim against the fiduciary and an advancement under such circumstances would clearly be imprudent and, consequently, a violation of ERISA Section 404.²⁸⁵

The plan should not advance the fiduciary legal fees in criminal cases involving alleged breaches of fiduciary duties regardless of the fiduciary's ability to repay the fees or the potential harm to the plan by a failure to advance. Given the serious nature of criminal charges, any advancement cannot be justified as prudent under the circumstances and, therefore, would violate ERISA section 404.²⁸⁶

2. Employee Litigation

In deciding whether to advance litigation expenses in employee litigation, the considerations vary from those attendant upon the advancement decision in fiduciary litigation. For example, in authorized activity litigation the employee defendant may be advanced all reasonable litigation expenses incurred in defending the litigation. The employee is being sued as a result of acts undertaken for the benefit of his employer, and the employer should bear the expenses arising from the employee's activities regardless of the outcome of the litigation.

In unauthorized activity litigation, however, the same rule does not apply. Where the unauthorized activity has benefited the plan, the employee defendant may be advanced all reasonable litigation expenses incurred in defending the litigation, provided Counsel opines that the employee acted in good faith and that the unauthorized activity did not violate the express provisions of ERISA. The employee was still acting in furtherance of his employer's goals and the employer should bear the expenses arising from such activities. Where the unauthorized activity does not benefit the plan, however, the employee defendant should not receive an advancement for any legal costs incurred in defending the litigation. The employee has acted on his own behalf, and there is no reason the employer should be required to bear the cost of defense.

C. Reimbursement of Legal Expenses After a Determination on the Merits

Reimbursement of legal expenses, like advancement, depends upon the type of litigation involved. In fiduciary benefit and third party cases, the fiduciary defendant should be reimbursed for all reasonable legal expenses incurred in nominally defending

²⁸⁵ See *supra* note 4 for the text of Section 404.

²⁸⁶ *Id.* This rule assumes, of course, that the prosecuting governmental agency has satisfied the requirements of obtaining an indictment in good faith so that a valid basis exists for the charges. Further, if the fiduciary is ultimately successful in defending said criminal charges he will be able to obtain reimbursement later.

the litigation. In civil breach of fiduciary duty cases, however, charges of wrongdoing are aimed at the fiduciary. If the fiduciary successfully defends the breach of trust charges, the fiduciary is entitled to reimbursement of reasonable legal expenses. The fiduciary's expenses are an ordinary cost of doing business which ought to be absorbed by the fund. In criminal breach of fiduciary cases, where the fiduciary successfully defends breach of trust charges, the fiduciary is entitled to reimbursement of reasonable legal expenses only if the fiduciary also successfully defends charges in any related civil litigation, or if none, Counsel opines that there has been no civil breach of fiduciary duty. This rule insures consistency in the reimbursement area, and takes into account the fact that the standard of proof in a criminal case is higher than that required in a civil suit.

Reimbursement is never proper, however, where the fiduciary does not successfully defend the breach of trust charges. In such an instance the fiduciary has acted for his own benefit, and his litigation expenses are not properly chargeable as expenses but rather are personal liabilities.

In employee litigation, an employee's right to reimbursement is governed by the same principles governing the propriety of an advancement, because employee indemnification does not depend upon the success or failure of the employee in defending the litigation.

D. Payment of Settlement Amounts

The law is not clear when amounts paid in settlement may be properly advanced or reimbursed. Applying the same principles discussed above, however, a number of guidelines may be formulated. Assuming the decision to contribute to the settlement is otherwise prudent, a fiduciary should be indemnified for contributions made to the settlement of fiduciary litigation if Counsel opines that the fiduciary has not breached his fiduciary duty. Similarly, an employee should be indemnified for contributions made to the settlement of litigation, if Counsel opines that the employee has not engaged in unauthorized activity not resulting in a benefit to the plan. Not to allow indemnification under such circumstances would discourage settlements and would, in effect, force the fiduciary or employee to proceed with a more costly trial even where he is certain to be exonerated. Public policy, therefore, should encourage settlement of employee and fiduciary litigation, and indemnification of settlement amounts aids in achieving that result.

CONCLUSION

The extent to which a fiduciary or employee of an ERISA plan is entitled to indemnification for litigation costs incurred in his official capacity is subject to varied interpretation. While the statutory language of ERISA provides for indemnification of such costs when they are "proper," the statute does not offer a definition of the term. The legislative history of ERISA is similarly devoid of any explanation or discussion of this term. Accordingly, indemnification requests are often subject to an ad hoc decision making process, which not only produces inconsistent results but also subjects the persons authorizing the payments to ERISA liability when the indemnification subsequently is determined not to have been "proper."

Such confusion makes managing an ERISA plan a difficult task, and may discourage qualified persons from becoming fiduciaries because they have a high likelihood of incurring personal liability under ERISA by authorizing indemnification payments without

standards as to what is proper or because they may be unable to obtain advancement or indemnification when sued themselves. There is, therefore, a need for a consistent, systematic approach for determining the propriety of ERISA¹ indemnification payments.

The guidelines suggested in this article are designed to fill that need by establishing an analytical framework to determine when litigation expenses are "proper" and, therefore, indemnifiable. The guidelines do not provide an easy answer to that question, but do set forth a number of factors which reflect on the propriety of an indemnification expense and which ought to be considered each time an indemnification request is received. By repeatedly and systematically considering these factors, fiduciaries will be equipped to make prudent and consistent indemnification decisions. In this manner, fiduciaries will have a greater likelihood of accurately assessing when a given expense is "proper," and therefore indemnifiable, than would be the case if they simply continued an ad hoc approach.

Each determination relating to indemnification is necessarily one of degree, but the guidelines, by adding some amount of certainty to the decision making process, will encourage qualified persons to serve as ERISA fiduciaries and may help reduce the number of instances where fiduciaries are subject to subsequent ERISA liability for having made an incorrect indemnification determination.

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