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NEW YORK COURT OF APPEALS CASE COMPILATIONS: HEALTH MANAGEMENT SYSTEMS, INC. V. SIEGEL

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HEALTH MANAGEMENT SYSTEMS, INC. V. SIEGEL[1] (decided April 25, 2002)

I. SYNOPSIS

In a 4-3 decision, the New York Court of Appeals held that an officer or director could not recover fees incurred while seeking indemnification for defending a derivative lawsuit in his corporate capacity absent a showing that the company disputed the indemnification claim in bad faith. The court relied on New York Business Corporation Laws (NYBCL) §§ 722-724 and the legislative history behind Business Corporation Law Article 7, which suggests that the statutes were not intended to go beyond the common law agency rule on indemnification.[2] The common law rule (American Rule) does not permit the recovery of legal fees incurred while enforcing indemnification rights.[3]

II. BACKGROUND

The appellant, Phillip Siegel, Chief Financial Officer of Health Management Systems (HMS), was joined as a party defendant in several securities fraud suits brought against HMS in the United States District Court for the Southern District of New York.[4] Rather than rely on legal representation provided by the company, Siegel hired his own attorney because his situation was different from other officers and directors of the company who were joined as co-defendants.[5] Siegel believed he was less culpable for any wrongdoing because he joined HMS three months after the alleged fraud began, and unlike other officers who sold their HMS stock at a profit, Siegel purchased HMS stock at the allegedly inflated price.[6]

Siegel submitted a written request for indemnification to HMS after all claims against him were dismissed. However, HMS denied his request on the ground that separate counsel was not reasonable

1. 98 N.Y.2d 80 (2002).
2. *Id.*
3. *Id* at 88.
4. *In re Health Mgmt. Sys., Inc. Sec. Lit.*, 82 F.Supp.2d 227 (S.D.N.Y. 2000).
5. *Id* at 232.
6. *Id* at 232.

or necessary.[7] Siegel then filed a motion in district court, pursuant to NYBCL § 724 and HMS by-laws, for indemnification of $67,636.73 incurred in legal fees and expenses[8] and for reimbursement of $17,147.64 incurred while attempting to secure indemnification or fees on fees.[9] In addition to citing statutory authority and HMS by-laws, Siegel argued that HMS should be liable for fees on fees because the company acted in bad faith when opposing indemnification.[10] A bad faith exception to the American Rule permits a court to award reasonable attorneys' fees to a prevailing party when the losing party has acted in bad faith.[11] The standard of proof required is extremely high, requiring clear evidence that the challenged actions are entirely without color and a high degree of specificity in the factual findings of the court.[12]

HMS opposed Siegel's motion, claiming that Siegel did not require separate counsel.[13] HMS offered Siegel $5,000.00 to cover his expenses.[14] Upon request by HMS counsel, the district court referred Siegel's motion to a United States magistrate judge.

After months of discovery battles, HMS conceded that Siegel was probably entitled to more than $5,000.00, and the United States magistrate judge recommended that Siegel recover the fees for his independent representation in the securities class action suits.[15] However, the magistrate judge rejected Siegel's request for recovery of fees on fees on the grounds that the general rule in New York was that "attorneys' fees may not be awarded unless there is specific statutory or contractual authorization."[16] The district court adopted the magistrate's findings on this point and rejected Siegel's argument that HMS acted in bad faith.[17] The district court admitted that the issue of HMS's bad faith was "regrettably a very

7. *Baker v. Health Mgmt. Sys., Inc.*, 264 F.3d 144, 147 (2d Cir. 2001).

8. *In re Health Mgmt. Sys., Inc. Sec. Lit.*, 82 F.Supp.2d 227.

9. *Id.*

10. *In re Health Mgmt. Sys., Inc. Sec. Lit.*, 82 F.Supp.2d 227.

11. *Oliveri v. Thompson*, 803 F.2d 1265, 1272 (2d Cir. 1986).

12. *Id.*

13. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 83.

14. *Id.*

15. *Id.*

16. *Id.* (citing *Hooper Assoc., Ltd. V. AGS Computers, Inc.*, 74 N.Y.2d 487, 491 (1989)).

17. *In re Health Mgmt. Sys., Inc. Sec. Lit.*, 82 F.Supp.2d 227.

close call."[18] However, the court cited HMS's decision to concede that Siegel did need to have individual representation as proof that bad faith was not present.[19] Siegel appealed the decision to the Second Circuit Court of Appeals.

The Second Circuit reviewed the findings of the district court using a de novo standard of review. Having found that the district court did not err in applying the law, the Second Circuit upheld the lower court's ruling that HMS did not act in bad faith; therefore, fees on fees could not be awarded on those grounds.[20] However, the court determined that a question existed as to whether NYBCL §§ 722–724 authorized reimbursement for fees incurred in litigating the right to indemnification, absent a showing of bad faith. Because the outcome of the case required interpretation of NYBCL Article 7 and the New York Court of Appeals had not yet determined the scope of the statute, the Second Circuit certified the issue to the state court. When faced with a state law question, federal courts defer to state court interpretation either by relying on state court precedent or by certifying the issue to the state court to resolve. With no clear precedent to rely on, the Second Circuit asked the New York Court of Appeals to interpret the statutory scope of NYBCL Article 7.

The Second Circuit presented the following certified question to the New York Court of Appeals: Where a corporate officer successfully defends an underlying action, within the meaning of NYBCL § 723(a) and where there is no bad faith on the part of the corporation, does the phrase "attorneys' fees actually and necessarily incurred as a result of such action or proceeding," as used in NYBCL § 722(a), provide for recovery of reasonable fees incurred by the officer in attempting to secure indemnification?[21]

III. Discussion

The Court of Appeals answered the Second Circuit's question in the negative. The court's analysis included examining the legislative intent of NYBCL Article 7 and the American rule regarding

18. *In re Health Mgmt. Sys., Inc. Sec. Lit.*, 82 F.Supp.2d 231.
19. *Id.*
20. *Baker*, 264 F.3d 154.
21. *Id.* at 146.

indemnification of attorneys' fees.[22] Relying on United States Supreme Court case law[23] and New York case law,[24] the court held that it was a general common law practice not to award attorney's fees to a prevailing party absent explicit statutory authority.[25]

Siegel argued that NYBCL Article 7 was "a remedial statute with the purpose of shifting all costs and personal liability away from a corporate official sued in that capacity."[26] Therefore, the statue should be read expansively. Siegel suggested that a "but for" test should have been applied pursuant to NYBCL § 722(a), entitling him to reimbursement of all fees that he would not have spent had he not been made a party to the securities fraud suit.[27] The court, however, disagreed.

The majority read NYBCL § 722(a) very narrowly and held that recovery of fees is limited to only those expenses that were "actually and necessarily incurred as a result of an action or proceeding."[28] In other words, there must have been a substantial nexus between the expenses and the underlying suit.[29] The court viewed reimbursement of fees on fees as an attenuated link to the underlying suit, and outside the scope of the legislature's intent when drafting NYBCL Article 7.[30]

The court performed an expansive review of the legislative history of NYBCL Article 7.[31] The court determined that the legislative objective was to apply indemnification principles, similar to those of common law agency rules, in the context of suits against corporate officials based on their conduct undertaken "in the good faith belief that they were acting properly in the best interests of the corporation."[32] The court emphasized the fact that the New York legislature revised Article 7 numerous times, but never changed the

22. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 80.

23. *Buckhannon Bd. & Care Home, Inc. v. West Virginia Dept. of Health & Human Res.*, 532 US 598, 602 (2001).

24. *Hooper Assoc., Ltd. V. AGS Computers, Inc.*, 74 N.Y.2d 487, 491 (1989).

25. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 88.

26. *Id.* at 84.

27. *Id.* at 85.

28. *Id. See also* NYBCL § 722(a) (McKinney 2001).

29. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 85.

30. *Id* at 87.

31. *Id* at 86-7.

32. *Id* at 86.

operative language in question.[33] Furthermore, the legislature examined several state statues similar to NYBCL Article 7[34] to aid them in drafting the indemnification provisions, including state statutes with provisions expressly authorizing the recovery of fees incurred to enforce indemnification rights; however, the legislature chose not to include similar provisions in NYBCL Article 7.[35]

The court did not only rely on legislative history to interpret NYBCL Article 7; they also relied on the common law American Rule of indemnification.[36] The American Rule recognizes attorney's fees as an incident of litigation, and prohibits a prevailing party from collecting such fees unless an award is authorized by a contract, statute or court order (i.e., in instances where bad faith is found.)[37] The Court emphasized previous cases decided by both the New York Court of Appeals and the United States Supreme Court where the courts held that absent explicit statutory provision, enforcement fees were not to be awarded and statutory provisions must be strictly construed.[38] However, none of the precedent cited interpreted the scope of Article 7. Rather, the cases dealt with indemnification disputes arising from contractual provisions.[39]

The court noted that its ruling did not leave corporate officials, like Siegel, without indemnification protection. Citing NYBCL § 721, the court stated that Article 7 was not an exclusive remedy and that "corporations remain free to provide indemnification of fees on fees in corporate by-laws, employment contracts or through insurance."[40]

In dissent, Chief Justice Judith Kaye argued that the phrase "fees reasonably and necessarily incurred as a result of such action

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33. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d at 87.

34. *Id* at 87. (*citing* California Business Corporation Law § 317(a) and Indiana Code Annotated § 23-1-37-11).

35. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 87. (*citing* Bill Jacket, L 1987, ch 367, at 16; Governer's Program Bill, Bill Jacket, L 1986, ch 513, at 11-12).

36. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 88.

37. *Id.* (*citing Hooper Assoc., Ltd. v. AGS Computers*, 74 N.Y.2d 487, 491 (1989)).

38. *Id. See also Buckhannon Bd. & Care Home, Inc. v. West Virginia Dept. of Health & Human Res.*, 532 U.S. 598, 602 (2001); *Hooper Assoc., Ltd. V. AGS Computers, Inc.*, 74 N.Y.2d 487, 491 (1989); *Diamond v. Diamond*, 307 N.Y. 263, 267 (1954).

39. *See Buckhannon Bd. & Care Home, Inc. v. West Virginia Dept. of Health & Human Res.*, 532 U.S. 598, 602 (2001); *Hooper Assoc., Ltd. V. AGS Computers, Inc.*, 74 N.Y.2d 487, 491 (1989); *Diamond v. Diamond*, 307 N.Y. 263, 267 (1954).

40. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 88.

or proceeding" should have been more liberally construed to include fees incurred in an indemnification recovery proceeding against a corporation.[41] Citing prior New York case law where courts provided for reasonable enforcement fees,[42] the dissent pointed out that the facts of the case did not raise concerns of covering expenses far removed from the underlying action, as the majority suggested.[43] Rather, enforcement was necessary after years of court battles over indemnification fees.[44]

The dissent stressed that there was no clear legislative history and attempted to discredit the precedent cited by the majority.[45] Kaye noted that the cases most heavily relied upon by the majority were cases dealing with contractual indemnification provisions, not statutory interpretation of Article 7.[46]

Kaye's dissenting opinion further criticized the lower court's determination that HMS did not act in bad faith. According to Judge Kaye, not only did the court's decision give defendant companies considerable leverage "in keeping individual directors in the fold of a common defense on pain of paying their own legal expenses if they seek to assert meritorious separate defenses," but it also significantly impaired the legislative mandate for indemnification.[47]

IV. Conclusion

In *Health Management Systems, Inc. v. Siegel,* the New York Court of Appeals held that New York Business Corporation Law §§ 722-724 does not provide for the recovery of fees incurred by a corporate officer or director in obtaining indemnification.[48] The court held that NYBCL §§ 722-724 lacked the explicit statutory authority

41. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d at 89.

42. *See Prof. Ins. Co. of New York v. Barry*, 303 N.Y.S.2d 556, affd. 302 N.Y.S.2d 722 (1st Dept. 1969); *Sierra Rutile Ltd. v. Katz,* 1997 WL 431119 (S.D.N.Y. 1997).

43. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 91.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id* at 90.

48. *Id* at 88.

necessary to permit the recovery of such fees due to the longstanding American rule that each party pays its own legal fees.[49]

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49. *Health Mgmt. Sys., Inc.*, 98 N.Y.2d 88.