
The Truck Stops Here: Closing the Holes in Loosely Written Public Company Advancement and Indemnification Bylaws

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Delaware public companies are confronting a tension regarding their officers' and directors' legal costs. Most public company bylaws broadly obligate the company to advance the attorneys' fees of company directors and officers during company-related investigations and litigations, and to indemnify them for liability arising out of those matters.^{1/} Companies adopt such provisions often based on the knee-jerk assumption that broad advancement and indemnification bylaws are always in the best interests of the company and its shareholders. But as evidenced by the many companies that have fought their executives' requests for advancement in court, such provisions can also result in unwarranted consequences for the company.

Chancellor Chandler of the Delaware Chancery Court has provided a wake-up call to boards of directors responsible for their companies' advancement and indemnification bylaws.^{2/} In *Tafeen v. Homestore*, he rejected Homestore's attempt to deprive its former officer of the legal-fee advancement rights provided in Homestore's bylaws. Like most public companies, Homestore's bylaws required it to advance its officers' legal fees in all company-related investigations and litigations merely upon receiving the officer's undertaking to repay the advanced sums if a court were ultimately to find that the officer were not entitled to indemnification, which would require a final judgment that the officer had engaged in bad faith conduct. Homestore argued that it should not be required to advance the legal fees because the officer (i) would likely be found ineligible for indemnification given the broad range of claims against him; and (ii) would unlikely have the financial ability to repay the advanced sums because much of the officer's assets were tied up in a Florida home that Florida's Homestead Act protected from seizure.

Chancellor Chandler scolded Homestore for distorting its liberal bylaws: "Content to adopt advancement and indemnification bylaws drafted with holes large enough to drive a truck through, the defendant company (like so many others in this Court of late) suddenly 'finds religion' -- insisting on a rigorous interpretation of its loosely written bylaws."^{3/} This remark more forcefully delivered the message that Chancellor Chandler had begun to express in adjudicating the 2003 fee-advancement dispute between Rite Aid and its former CFO.^{4/} There he noted that "perhaps" Rite Aid "should have" drafted its advancement provision so that the company would not have to continue advancing fees to a former officer who had pleaded guilty to

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a felony, but had not yet been sentenced./5/

In *Tafeen*, Chancellor Chandler acknowledged that company officers and directors have a strong incentive to arrange for broad mandatory advancement and indemnification bylaws. But he reminded those fiduciaries that such bylaws, as all related-party transactions, must be fair to the company's shareholders: "Care must be taken, however, that those incentives do not interfere with the obligation to ensure that the advancement and indemnification bylaws are written in a manner that is fundamentally fair to the company and its stockholders."/6/

The Delaware Supreme Court affirmed *Tafeen* in November 2005, although without mentioning Chancellor Chandler's admonition regarding the need for advancement and indemnification bylaws that are fundamentally fair to the company and its shareholders./7/ While the Court recognized that "advancement provides an individual benefit to corporate officials," it described advancement as a "desirable underwriting of risk by the corporation in anticipation of greater corporate-wide rewards for its shareholders."/8/ Thus, boards that exercise their judgment to stick with the broadest possible advancement and indemnification bylaws can cite strong public policy interests, recently reaffirmed by Delaware's highest court.

This article provides guidance to companies reexamining their bylaws in light of Chancellor Chandler's admonition in *Tafeen*, and the greater frequency of advancement and indemnification litigation. As a first step, we summarize Delaware's advancement and indemnification statutory framework. Next, we examine the liberal approach most public companies typically follow in their bylaws, and the rationale supporting that approach. We then describe some of the pitfalls inherent in the traditional approach, and identify reasons why companies should consider tightening their advancement and indemnification bylaws. Most importantly, we provide nine categories of modifications that companies should consider in reforming their advancement and indemnification bylaws.

I. Delaware's Statutory Framework for Indemnification and Advancement

Delaware, like other states, has an advancement and indemnification statute, Section 145 of the Delaware General Corporations Law./9/ Section 145 establishes rules under which various forms of advancement and indemnification are either mandatory, permissive, or forbidden.

Fiduciaries must be indemnified for their costs where they have been successful on the merits "or otherwise" in the defense of any claim, issue, or matter./10/ Thus, Delaware companies must reimburse vindicated officers or directors for their defense costs. This mandatory reimbursement applies regardless of the manner in which the fiduciary prevailed, and includes dismissals on so-called technicalities, such as a statute of limitations defense./11/

Permissive indemnification allows (but does not require) companies to reimburse fiduciaries who are sued (or threatened to be made a party to a suit) "by reason of the fact" that the person is or was the corporation's director, officer, employee, or agent, as long as there is no finding that the fiduciary did not act in "good faith."/12/ The Delaware statute bifurcates permissive indemnification between Section 145(a), which deals with all suits other than those "in the right of the corporation," and Section 145(b), which deals with suits "in the right of the corporation" (suits the company institutes or derivative suits that shareholders bring on the company's behalf). Indemnification for the latter category of cases is restricted so that the company does not "circularly" reimburse fiduciaries for judgments the company obtains against

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them./13/ As to suits other than those brought by the company or on its behalf, Section 145(a) allows indemnification of "expenses (including attorneys' fees), judgments, fines and amounts paid in settlement," as long as they were "actually and reasonably" incurred in the action for which the company official seeks indemnification.

Advancement is permissive under the statute./14/ Section 145(e) provides that the company "may" pay current officers' and directors' legal expenses in advance of the final disposition, as long as the fiduciary provides an undertaking to repay should he or she ultimately be found not entitled to indemnification. The statute, however, "provides corporations with flexibility to advance funds to *former* corporate officials, ... without an express undertaking."/15/

Section 145(f) allows companies to adopt broader indemnification and advancement provisions than required by the statute: "indemnification ... provided by ... this section shall not be deemed exclusive of any other rights to which [fiduciaries] may be entitled under any bylaw [or] agreement."/16/ Thus, bylaws can, and typically do, obligate the company to the full extent of the statute's "permissive" indemnification and advancement./17/ The result is that the company prospectively strips itself of the discretion the statute otherwise would allow to refuse to pay certain legal bills./18/ Companies cannot, however, override the public policy that forbids indemnifying fiduciaries found not to have acted in "good faith."/19/

A Delaware director or officer who is forced to sue the company to obtain advancement or indemnification is eligible to have the company pay the fees and costs of that suit. That is, the Delaware Supreme Court has ruled that Section 145 allows for "fees-on-fees" awards, requiring the company to indemnify legal costs not only of the underlying suit, but also of pursuing the indemnification suit./20/ The Delaware Chancery Court has applied *Stifel* to allow "fees-on-fees" in the advancement context./21/ "Fees-on-fees" never have to be repaid, even if the director or officer were ultimately found to have acted in bad faith in the underlying suit and, thus, were compelled to repay the advancements./22/

II. Reasons Companies Adopt Broad Advancement and Indemnification Bylaws

Several corporate interests support broad advancement and indemnification bylaws. Those interests are unquestionably valid, and boards may appropriately take them into account. But Chancellor Chandler's implicit message in *Tafeen* is that companies should not blindly rely on those valid corporate- policy interests in obligating the company prospectively to the fullest extent provided by law without restriction.

Broad advancement and indemnification bylaws help attract the best and most qualified officers and directors, who would be less inclined to accept a position from a company unwilling to hold them harmless for their company-related legal expenses./23/ And corporate officials should be encouraged to defend meritless litigation, rather than simply paying to settle for fear that they would be unable to fund a defense./24/

Broad advancement and indemnification also encourage corporate risk-taking. This policy interest similarly underlies both the venerable business judgment rule and the director exculpation provisions in Section 102(b)(7) of the Delaware General Corporations Law./25/ The theory is that it is in the company's interests for corporate executives not to worry that they would incur personal liability and expenses in the event the novel strategies they pursue in good faith on the company's behalf do not succeed.

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Imposing broad prospective advancement and indemnification obligations also allows companies to maintain their status as a "good corporate citizen," cooperating fully with government investigations, while still advancing the legal fees of those corporate officials who might be subjects or targets of those investigations. The government often considers uncooperative those companies that advance legal fees to criminal investigation subjects and targets without a pre-existing legal obligation.^{/26/} But if a company's bylaws already require it to advance legal fees, the government cannot (at least not credibly) penalize the company for complying with that obligation.

KPMG is a case in point. In June 2006, Southern District of New York Judge Kaplan found that prosecutors had violated the Fifth and Sixth Amendment rights of various indicted KPMG partners and employees by pressuring KPMG to stop advancing their fees.^{/27/} KPMG had a long-standing policy of advancing partners' and employees' fees, but its bylaws imposed no unambiguous obligation to do so.^{/28/} During the investigation, prosecutors were critical of KPMG's willingness to advance the legal costs to KPMG personnel the government was investigating, and informed KPMG, consistent with long-standing Department of Justice policy, that they would take into account the firm's advancement practices in deciding whether to indict the firm. Given the fate of Arthur Anderson following its indictment in the Enron matter, KPMG avoiding indictment was critical to KPMG's survival. So KPMG responded to the government's concerns by imposing monetary limits on advancements, and refusing to advance the fees of those personnel who had refused to cooperate with the government or were indicted. The court found that the government's pressure tactics violated the constitutional rights of the KPMG personnel. The court suggested that it would consider dismissing the indictments if the fees are not paid^{/29/} and, in a companion decision, suppressed the statements to the government of those KPMG personnel who had cooperated as a result of the government's pressure tactics.^{/30/} The government has indicated that it will appeal Judge Kaplan's ruling. But regardless of whether the government's tactics are ultimately deemed unconstitutional, the lesson of the case is that KPMG could have insulated itself from those tactics by having bylaws that already required it to advance legal fees.

Companies often recoup most advancements from their insurance carriers.^{/31/} Directors' and officers' insurance policies typically provide coverage on the same basis as corporations -- paying to defend legal proceedings and reimbursing for the costs of judgments as long as the insured is not found to have engaged in the type of wrongful conduct that would exclude coverage. In many situations, companies pay their executives' defense costs, after putting the insurance carriers on notice of the suit, and then obtain reimbursement from the insurers for some or all of those costs.

III. Reasons Companies Should Consider Limiting Their Advancement and Indemnification Obligations

Companies need to weigh in the balance significant potential downsides of broad advancement and indemnification bylaws. These risks are often never brought to the attention of most corporate boards. Rather, it is only after the company's board is faced with exorbitant legal bills, which the bylaws obligate the company to pay, that the directors realize those bylaws' inherent unfairness. Chancellor Chandler's admonition, however, is that corporate boards must scrutinize their companies' advancement and indemnification bylaws *before* the obligation arises, to protect the company's shareholders from that unfair result.

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The most significant downside of bylaws that mandate advancement to the fullest extent permitted by law is that they obligate the company to advance the attorneys' fees of current and former executives the company is suing for theft, fraud, or fiduciary duty breaches.^{/32/} In those circumstances, the company is in the difficult position of having to fund the defense of its own claims. To compound the problem, standard "insured vs. insured" provisions in directors' and officers' insurance policies exclude coverage for any suit the company brings against its officers and directors.^{/33/} The result is that officers and directors the company sues may have a perverse incentive to litigate unreasonably, thereby maximizing the company's uninsured litigation costs and squeezing it for a heavily discounted settlement.

In addition to requiring the company to fund faithless fiduciaries and adversaries, company advancement obligations are often open-ended, leaving companies exposed to doling out millions without any realistic hope of recovering the advancements. As provided in Section 145(e), companies require officers and directors to sign undertakings to repay advanced sums in the event the officer or director were ultimately found ineligible for indemnification, such as if the corporate official were found to have breached fiduciary duties or otherwise acted in bad faith. But without any built-in protection in the bylaws, companies cannot act to assure repayment, such as by requiring security for the repayment commitment. Yet, an officer who has engaged in serious criminal wrongdoing will often be judgment-proof by the time the conviction becomes final, leaving the company unable to recover on the officer's undertaking to repay the advanced amounts. And the insurance company's D&O policy coverage obligation -- to the extent the carrier has not already disclaimed coverage or sought to rescind the policy -- likely would also terminate with the criminal conviction.

Most bylaws also do not impose even minimal reciprocal obligations on the recipient of the company's generous advancements. That is, bylaws typically do not condition the company's advancement obligations on the corporate official's willingness to cooperate with the company or the investigating authorities. Thus, although public companies invariably portray themselves as good corporate citizens who cooperate fully with government investigations, they nevertheless obligate themselves to sponsor the legal defense of current and former officers who stand on their Fifth Amendment rights and refuse to cooperate. And to the extent an official refuses to cooperate with the government, he or she would likely also refuse to cooperate with the company for fear that the company would communicate the information to the government. While the company can (and most companies do) terminate the uncooperative officer's employment, its bylaws prevent terminating that officer's legal defense fund.

Another potential downside of broad advancement and indemnification bylaws is that they could obligate the company beyond merely its own officers and directors. That is, such provisions could require the company to advance the fees of even its subsidiaries' officers. Most companies' broad indemnification bylaws incorporate language similar to the permissive indemnification of Section 145(a) and (b), which covers not just officers and directors, but also any person "serving at the request of the corporation as a director, officer, employee or agent of another corporation or enterprise." The Delaware Supreme Court found in *Vonfeldt v. Stifel Financial Corp.*^{/34/} that a director of a wholly-owned subsidiary serves "at the request of" the parent corporation, thus entitling that director to indemnification. The Court stated that a subsidiary director should not be required to demonstrate an express "request" from the parent. Rather, the 100-percent stockholder's vote for the director is a "public expression of support" sufficient for the subsidiary to infer the parent company's indemnification request.^{/35/}

IV. Nine Potential Modifications to Broad Advancement and Indemnification Bylaws

Corporate boards should reexamine their advancement and indemnification bylaws against the backdrop of the various potentially countervailing corporate interests described above. The likely conclusion of any such analysis would be to modify the broadest advancement and indemnification obligations, at least in some respect. We have set forth below a nonexhaustive list of nine categories of modifications companies should consider. In the wake of Chancellor Chandler's admonition in *Tafeen*, corporate boards that fail at least to consider taking action in this regard leave themselves open not only to criticism from shareholder activists, regulators, and courts, but also to potential liability for failing to act in the company's best interests.

First, companies should consider having their bylaws provide different advancement rules for those claims the company brings. If an independent majority of the board were to decide that it is in the interests of the company's shareholders to sue a current or former officer or director, those same shareholders arguably should not be saddled with the burden of funding that person's defense of the company's claims. A similar process could be established for derivative actions. That is, the company would advance the fees of those officers and directors who are sued derivatively, unless and until an independent board committee were to determine that the company should take over the derivative suit or allows it to proceed. Mandatory indemnification rules would, of course, still apply if the defendant were successful on the merits "or otherwise."

Second, companies should consider making a pre-condition to advancement that the officer or director cooperate fully with the company, by being available for all interviews the company may reasonably request. Today, companies routinely bind themselves to advance legal fees to current and former officers and directors who refuse to provide important information to the company. As indicated above, the primary reason that an officer or director would be reluctant to submit to a company interview is fear that the company would waive the attorney-client privilege and communicate the substance of the interview to investigating criminal or regulatory authorities. Still, a board could deem it not necessarily unreasonable for the company to require the fiduciary to make the choice either to cooperate with the company and reap the attendant benefit of the company's advancements, or to play it safe and protect yourself from any self-incrimination, but surrender the company's advancements. A board could conclude that the company's shareholders should not have to bear a fiduciary's legal expenses without at least obtaining the fiduciary's information regarding the facts and transactions at issue.

Third, the company could even go so far as to require as a condition to advancement not only that officers and directors cooperate with the company, but also that they cooperate with investigating government authorities and self-regulatory organizations, such as the NYSE and NASD. The theory for imposing such a condition would be that if the company truly seeks to be a good corporate citizen, which some have characterized as essentially a "partner in law enforcement," it should refuse legal-defense funding to fiduciaries who refuse to answer law enforcement's questions. Companies already routinely terminate officers and directors who refuse to cooperate with regulators.³⁶ Companies might similarly consider the adverse implications of binding themselves prospectively to fund those terminated fiduciaries who refuse to cooperate with regulatory authorities. To date, as indicated above, the government has not openly held against companies the practice of advancing legal fees where the company has a pre-existing legal obligation to do so. But there could come a time in the not-too-distant future where regulators would interrogate company board members for not modifying their bylaws to give the company at least the discretion to stop advancing fees to officers and directors who refuse to

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cooperate with regulators.

This condition should not be enacted lightly, however, because it would severely restrict the ability of corporate fiduciaries to defend themselves. Unfortunately, most experienced defense counsel -- whether they have represented individuals, companies, or both -- have encountered misguided and wasteful government investigations. In some instances, the only meaningful check against a misguided regulator is for the corporate executive to refuse to answer that regulator's questions. Even though companies are often compelled to terminate the executive for not cooperating with the government, fairness suggests not further eviscerating the executive's leverage against the misguided regulator by cutting off defense funding. Perhaps then, only a limited set of companies would seriously consider this type of draconian advancement condition, such as companies in highly regulated industries that need to impress regulators with their commitment to law enforcement, because they have repeatedly been disciplined or are negotiating or subject to a deferred prosecution agreement.

Fourth, bylaws should give the company discretion not to indemnify officers and directors for certain criminal or regulatory fines or penalties. Indemnifying officers and directors for fines could arguably frustrate the regulatory and deterrence purposes, and thus could be inconsistent with good corporate citizenship, depending on the severity of the violation. The SEC, in fact, recently adopted a policy requiring settling individuals to forego any rights they may have to indemnification, insurer reimbursement, or favorable tax treatment of penalties.^{/37/}

Fifth, companies should consider having the equivalent of a "co-insurance" or "other insurance" provision in their bylaws. There are certain situations where a company officer is affiliated with another entity that has a parallel advancement or indemnification obligation. In those circumstances, courts have sometimes applied principles of "equitable apportionment" so that the concurrent obligors share equally in advancing and indemnifying.^{/38/} But companies are free to legislate equitable apportionment in their bylaws. Thus, for example, the company could require as a condition to advancement that the officer identify any other entity that has an obligation to advance the officer's legal fees for the subject matter, or attest that there is no such other co-obligor. The bylaws could also provide that in the event the company were to discover that another entity has an advancement or indemnification obligation, it would have the right to reduce the advancements by 50 percent as a form of equitable self-help apportionment.

Sixth, companies should consider whether to require more than just an undertaking to repay advanced funds, as provided under Section 145(e). Some courts have characterized advancing fees as similar to lending money.^{/39/} Therefore, companies should consider imposing at least minimal lending requirements or guidelines. For example, the bylaws could delegate to an independent board committee the discretion to require security for the advanced funds and financial statements demonstrating an ability to repay, and to stop advancing funds if the committee were to find an unreasonable risk that the recipient will both (i) ultimately be found obligated to repay the advancements, and (ii) would not have the financial means to do so. Another safeguard companies should consider is requiring the advancement recipient to provide with the undertaking a statement, under penalty of perjury, that he or she, at all times, acted in good faith and in the company's best interests. Similarly, companies could have their bylaws stipulate that if an officer were found to have violated fiduciary duties to the company or committed a felony in any matter, that officer would be ineligible for advancement on other, even unrelated, matters.^{/40/} And to shore up the loophole Rite Aid's former CFO took advantage of in *Bergonzi*, bylaws should terminate the advancement obligation upon entry of a guilty plea, even though sentencing has not yet been imposed.

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Seventh, a small minority of companies have gone so far as to make indemnification and advancement discretionary. These companies only advance fees or indemnify those executives whom independent directors or legal advisors find have acted in good faith.^{41/} This discretionary approach has at least three significant downsides: (i) it renders the prospect of advancement and indemnification too uncertain, which in turn impairs the company's hiring ability and could cause those officials the company does hire to be unduly risk averse; (ii) it imposes time-consuming and expensive mini-investigations to determine whether officials qualify under the good faith standard; and (iii) it makes advancing fees difficult for public companies under criminal investigation, because regulators and prosecutors will be able to exert undue pressure on the company not to advance the fees of certain criminal subjects and targets. Although the recent KPMG decision might restrain such government pressure tactics,^{42/} that arguably aggressive decision could be reversed or limited on appeal.

Eighth, companies should consider imposing bylaw limitations on the circumstances under which the company would advance fees or indemnify officers and directors of subsidiaries and affiliates. One possibility, for example, would be for the bylaws to preclude advancement and indemnification of subsidiary and affiliate officers and directors unless and until an independent board committee were to deem it appropriate in a particular case.^{43/}

Ninth, companies should consider changing the "fees-on-fees" landscape in their bylaws. As described above, current company bylaws that provide for advancement and indemnification to the fullest extent provided by law, in effect, grant the fiduciary the right to an attorneys' fee award in the event the corporate official were to prevail in compelling compliance with the company's advancement obligation. While this rule seems fair, a company might also deem fair rendering the obligation reciprocal; thus, if the officer were unsuccessful, he or she would have to pay the fees the company incurred in defending the advancement or indemnification lawsuit. Similarly, the bylaws could provide that if the suit were only partially successful, the claimant would be barred from recovering some or all "fees-on-fees."^{44/}

V. Conclusion

Some of the modifications discussed above would make a criminal defense lawyer cringe, if not scream bloody murder. Corporate officials are already significantly disadvantaged in defending government investigations. The companies with which they are affiliated often respond to such investigations in the most accommodating ways, such as by waiving the attorney-client privilege and terminating employees who refuse to testify or be interviewed. If the companies were also to pursue a legally enforceable policy of denying legal fees to those corporate officials who exercise their Fifth Amendment right to remain silent, effective defenses would become even more difficult. And as one court recently stated, "it is precisely in the circumstance when a business official is accused of serious wrongdoing that the right to advancement is critical, as that right secures the funds for the official to defend herself."^{45/}

But the criminal defense lawyer's lament could be the shareholders' cause for rejoice. In hindsight, the shareholders of Homestore, Rite Aid, and other recent unsuccessful advancement litigants would have crafted more restrictive advancement and indemnification bylaws. The key question in considering any advancement or indemnification restriction is whether the restriction would materially impair the company in recruiting high caliber officers and directors. Entrusting advancement decisions to a committee of independent directors might be cold comfort to prospective and current officers. Such committees may be viewed as being inherently predisposed

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against spending the company's funds. "Independence" is often in the eyes of the beholder, and adverse committee determinations could lead to collateral litigation regarding whether the committee was truly independent and acted in good faith. And restrictive advancement and indemnification bylaws could lead to more intense negotiations over individual employment agreements. Boards could face pressure to provide highly-prized recruits an advancement or indemnification benefit in their employment agreements that the bylaws otherwise deny. Those boards would have to be on guard to the potential inequity in granting greater advancement and indemnification rights to certain officers just because of their bargaining power at the time they encountered the company.

In the end, the determination as to any restriction would necessarily entail business judgments that would vary from board-to-board, industry-to- industry. Hedge funds seeking prized portfolio managers, for example, might have insufficient bargaining power to impose significant advancement and indemnification restrictions. But established public companies with large management teams and independent boards would likely have greater leverage. Some of the modifications discussed above may be less controversial than others. For example, prohibiting advancement to officers the company sues for fraud or fiduciary duty breaches should be less controversial than denying advancement to officers who refuse to cooperate with government investigations. Similarly, companies should readily give themselves the discretion to decline indemnifying the costs of fines and penalties, but might have more pause when it comes to adding conditions to the company's advancement obligation. The lesson of *Tafeen*, however, is that boards would be well-advised to make those business judgments, rather than reflexively defaulting to the broadest possible advancement and indemnification obligations.

ENDNOTES

- /1/ In the authors' random sampling of fifteen Fortune 500 Delaware companies' bylaws, all but two required the company to advance fees and indemnify to the fullest extent provided by law; *see also Advanced Min. Systems, Inc. v. Fricke*, 623 A.2d 82, *83 (Del. Ch. 1992) (Allen, C.) ("in fact most corporations and virtually all public corporations have by bylaw exercised the authority ... so as to mandate the extension of indemnification rights in circumstances in which indemnification would be permissible"); R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Corporations* Section 4.22 (3d ed. Supp. 2004) ("Many Delaware corporations have entered into comprehensive programs of indemnification ... to provide maximum benefits to directors").
- /2/ *Tafeen v. Homestore, Inc.*, 2004 WL 556733 (Del. Ch. Mar. 22, 2004) (*Chancery Court Tafeen*).
- /3/ *Id.* at *1. *See also DeLucca v. KKAT Management, LLC*, C.A. No. 1384-N (Del. Ch. Jan. 23, 2006) (Strine, V.C.), slip. op. at 20 (noting that companies often look for ways to reject advancement demands); *Radiancy, Inc. v. Zion Azar et al.*, C.A. No. 1547-N (Del. Ch. Jan. 23, 2006) (Lamb, V.C.), slip. op. at 1 (same).
- /4/ *Bergonzi*, 2003 WL 22407303.
- /5/ *Id.* at *3.
- /6/ *Chancery Court Tafeen* at *1, n.1.
- /7/ *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 2005 WL 3091887 (Del. Nov. 17, 2005) (*Supreme Court Tafeen*).
- /8/ *Id.* at *13, quoting *Scharf v. Edgcomb Corp.*, 1997 WL 762656, at *4 (Del. Ch. Dec. 4, 1997).
- /9/ 8 Del. C. Section 145.
- /10/ *Id.* Section 145(c).
- /11/ *Cochran v. Stifel Financial Corp.*, 2000 WL 286722, *18, n.73 (Del. Ch. Mar. 8, 2000), citing E. Norman Veasey, J.A. Finkelstein, and C. Stephen Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and*

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- Insurance*, 42 *Bus. Law.* 399, 406 (1987) ("The phrase found in Section 145(c), 'on the merits or otherwise,' permits the indemnitee to be indemnified as a matter of right in the event that he wins a judgment on the merits in his favor or if he successfully asserts a 'technical' defense, such as a defense based on the statute of limitations."); *see also Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87 (2d Cir. 1996) (applying Delaware law) (awarding indemnification of legal fees to former officer after company paid shareholders \$35 million as settlement to dismiss claims regarding the officer's trading in the silver market -- indemnity found mandatory because officer did not have to accede or contribute to settlement and, thus, was "successful on the merits or otherwise"); *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 141 (Del. Super. 1974) (in criminal prosecution, success under Section 145(c) does not mean dismissal only because of "innocence" but rather, "any result other than conviction must be considered success").
- /12/ 8 Del. C. Section 145(a), (b).
- /13/ *See* E. Norman Veasey, Jesse A. Finkelstein, "New Delaware Statute Allows Limits on Director Liability and Modernizes Indemnification Protection," 6:6 *Bus. Lawyer Update*, July/Aug 1986, at 1-2 (Delaware legislature rejected as "circular" an amendment to Section 145(b) that would have allowed indemnification for derivative suit judgments and settlements).
- /14/ 8 Del. C. Section 145(e).
- /15/ *Supreme Court Tafeen*, 2005 WL 3091887, at *7.
- /16/ 8 Del. C. Section 145(f); *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 344 (Del. 1983) ("The corporation can also grant indemnification rights beyond those provided by the statute [under] Section 145(f)").
- /17/ R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Corporations* Section 4.22 (3d ed. Supp. 2004).
- /18/ *See Chancery Court Tafeen*, 2004 WL 556733, *1.
- /19/ *See Waltuch*, 88 F.3d at 92-95 (holding that broad bylaws may not circumvent the statute's good faith requirement); *Mayer v. Executive Telecard, Ltd.*, 705 A.2d 220 (Del. Ch. 1997) (same; agreeing with *Waltuch*), *overruled on other grounds by Fasciana v. Electronic Data Systems Corp.*, 829 A.2d 178 (Del. Ch. July 1, 2003).
- /20/ *Stifel Financial Corp. v. Cochran*, 809 A.2d 555 (Del. 2002); *Fasciana*, 829 A.2d 178. *But see Baker v. Health Management Systems*, 98 N.Y.2d 80 (N.Y. 2002) (no "fees-on-fees" for New York corporations unless bylaws explicitly so provide).
- /21/ *Reddy v. Electronic Data Systems Corp.*, 2002 WL 1358761 (Del. Ch. June 18, 2002).
- /22/ *Fasciana*, 829 A.2d 178, at 183 ("fees-on-fees" is an award of indemnification for successful advancement suit, and does not need to be repaid; ultimate lack of success in the officer's criminal and civil actions would not alter the fact that officer was successful in advancement suit).
- /23/ *Supreme Court Tafeen*, 2005 WL 3091887, at *6 ("Indemnification encourages corporate service by capable individuals by protecting their personal financial resources from depletion by the expenses they incur during an investigation or litigation that results by reason of that service Advancement is an especially important corollary to indemnification as an inducement for attracting capable individuals into corporate service."); *Shearin v. E.F. Hutton Group, Inc.*, 652 A.2d 578, 593 (Del. Ch. 1994).
- /24/ *Stifel Financial*, 809 A.2d at 561 ("[t]he invariant policy of Delaware legislation on indemnification is to 'promote the desirable end that corporate officials will resist what they consider unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation ... if they are vindicated' "); *Weaver v. ZeniMax Media Inc.*, 2004 WL 243163, at *7 (Del. Ch. Jan. 30, 2004) (advancement policy is to encourage "corporate officers to defend suits they consider unjustified without the worry of how to fund their defense").
- /25/ *Shearin*, 652 A.2d at 593; E. Norman Veasey *et al.*, "Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance," 42 *Bus. Law.* 399.
- /26/ U.S. Dep't of Justice, *Federal Prosecution of Business Organizations*, available at http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00162.htm at part

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- VI (stating that a corporation's advancing of attorneys' fees and "protecting its culpable employees and agents" is a factor to be weighed by a prosecutor in considering whether to charge the corporation, although providing an exception for corporations that are required to advance fees under state law); Memorandum from Larry Thompson, Deputy Attorney General, U.S. Dep't of Justice, to Heads of Department Components and United States Attorneys, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm at Section VI(B) (same). *But see* Lynnley Browning, *Judges Press Companies That Cut Off Legal Fees*, N.Y. Times, April 17, 2006 (stating that some federal judges have questioned the validity of the government policy in pressuring companies not to advance legal fees).
- /27/ *U.S. v. Jeffrey Stein, et al.*, 435 F. Supp. 2d 330, 362-63, 365-66 (S.D.N.Y. June 26, 2006) (holding that a criminal defendant has a "fundamental right" to "obtain and use in order to prepare a defense resources lawfully available to him or her, free of knowing or reckless government interference," and that the government was unable to carry its burden of showing that its conduct infringing on that right was sufficiently narrowly tailored to any compelling government objective that would justify infringing that right.).
- /28/ *Id.* at 340, 367.
- /29/ *Id.* at 380 (opening a companion civil case, *In Re: United States of America*, 1:06-cv-05007-LAK (S.D.N.Y.) to allow the defendants to sue KPMG for advancement. The resulting motion to compel these payments and KPMG's motion to dismiss in favor of arbitration have been scheduled for argument in early September, 2006).
- /30/ *U.S. v. Jeffrey Stein, et al.*, 2006 WL 2060430, **12-13, 16 (S.D.N.Y. July 25, 2006) (suppressing certain KPMG employees' statements, and attributing KPMG's coercive tactics to the government).
- /31/ *See, e.g., Fasciana v. Electronic Data Sys. Corp.*, 829 A.2d 160, 177 (Del. Ch. Feb. 27, 2003).
- /32/ *See, e.g., DeLucca*, C.A. No. 1384-N, slip op. at 4-5 (requiring fund investment manager and affiliate to advance attorneys' fees to former money manager they were suing for fiduciary duty and contract breaches); *Weinstock v. Lazard Debt Recovery GP, LLC*, 2003 WL 21843254, at *5 (Del. Ch. Aug. 1, 2003) (requiring fund general partner and investment manager to advance attorneys' fees of former fund portfolio managers they were suing for fraud and fiduciary duty and contract breaches).
- /33/ *See, e.g., Niemuller v. National Union Fire Ins. Co. of Pittsburgh, Pa.* 1993 WL 546678 (S.D.N.Y. Dec. 30, 1993) (denying D&O coverage for director sued by the company, under the "insured vs. insured" exclusion to indemnification coverage); *Cirka v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 2004 WL 1813283, *2 (Del. Ch. Aug. 6, 2004) (allowing coverage to directors sued by the Committee of Unsecured Creditors of their company in bankruptcy, since the Committee's standing is derivative and not direct, and thus not covered by the "insured vs. insured" provision).
- /34/ 714 A.2d 79 (Del. 1998) (Veasey, C.J.).
- /35/ *Id.* at 85.
- /36/ *See Hollinger*, 844 A.2d at 1077 (as an "experienced businessman, [former Hollinger International CEO and Chairman Conrad] Black had to know that his decision to refuse to provide evidence to federal investigators made it impossible for the [company] to retain him A company cannot 'cooperate fully' when its chairman refuses to answer the SEC's questions.").
- /37/ Stephen Cutler, Director of the Division of Enforcement of the SEC, 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), available at www.sec.gov/news/speech/spch042904smc.htm. *See, e.g.,* Consent of Defendant Merrill Lynch, Pierce, Fenner & Smith Inc., available at <http://www.sec.gov/litigation/litreleases/consent18115.htm> at Section 6 (April 2003); Consent of Defendant Henry Blodget, Case No. 03-CV-2947 (S.D.N.Y. 2003), available at <http://www.sec.gov/litigation/litreleases/consentblodget.pdf> at Section 6 (defendant "agrees that it shall not seek or accept ... indemnification ... for any penalty amounts").
- /38/ *See, e.g., Chamison v. HealthTrust, Inc.*, 735 A.2d 912 (Del. Ch. 1999) (requiring that a subsidiary's present parent under the merger agreement, and the former parent

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- corporation, share equally in indemnifying former subsidiary director in derivative action).
- /39/ See *Chancery Court Tafeen*, 2004 WL 556733, *9 (discussing possible effect on advancement of prohibition against personal loans to current directors and officers in Section 402 of the Sarbanes-Oxley Act of 2002); *Reddy*, 2002 WL 1358761 (considering advancement as loan to be repaid should fees ultimately be found unindemnifiable); *In re Central Banking System, Inc.*, 1993 WL 183692 (Del. Ch. May 11, 1993) (corporations can provide in bylaws or private contracts for security as condition to advancement obligation).
- /40/ Cf. *Green v. Westcap Corp. of Delaware*, 492 A.2d 260, 264 (Del. Super. 1985) (potential disqualifying effect of wrongdoing is confined to specific matter for which indemnification is sought); *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. Super. 1974) (officer can be indemnified for defending dismissed charges, even though he was convicted on other charges).
- /41/ For example, at least one company's bylaws provide: "Any indemnification of a director or officer of the Corporation (unless ordered by a court) shall be made by the Corporation unless a determination is made that indemnification of the director or officer is not proper in the circumstances because he has not met the applicable standard of conduct. Any such determination shall be made (1) by the Board of Directors by a majority vote of the directors who were not parties to such action, suit or proceeding, or (2) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, or (3) by the stockholders."
- /42/ See *supra* note 27 and accompanying text.
- /43/ For example, the Revised Model Business Corporation Act requires independent directors or special legal counsel to determine that a director seeking voluntary indemnification has met the standards of conduct required for indemnification. Rev. Model Bus. Corp. Act Section 8.55. The Revised Model Business Corporations Act was drafted and adopted by the American Bar Association's Committee on Corporate Laws of the Section of Business Law, and serves as a model for several states' business corporations acts, although it has not been adopted in Delaware. See, e.g., Minn. Stat. Section 302A (Minnesota Business Corporation Act); Ill. Rev. Stat. ch. 32 (Illinois Business Corporation Act). The committee members are seen as a "permanent editorial board," reviewing and revising the Act, and promoting uniformity in the development of state corporations statutes, as well as making recommendations based on evolving standards. R. Franklin Balotti, Joseph Hinsey IV, "Director Care, Conduct, and Liability: the Model Business Corporation Act Solution," 56 *Bus. Law.* 35, *58 (2000).
- /44/ See *Fasciana*, 829 A.2d 178, at 184 (limiting the extent of "fees-on-fees" in proportion to success of indemnity suit -- where former officer sought and received partial indemnification for defending criminal and civil suits after allegedly conspiring to defraud company, Vice Chancellor Strine held that officer's "fees-on-fees" award should be proportionate to officer's indemnification success).
- /45/ *DeLucca*, C.A. No. 1384-N, slip op. at 23.