

Directors' and Officers' Liability: Determining Indemnifiable Conduct

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Corporate advancement disputes often arise shortly after current management has concluded that the official seeking corporate funds for legal expenses has acted disloyally or even deliberately harmed the corporation. Must the board authorize payment of corporate resources to fund legal expenses of an official dismissed based on admitted criminal wrongdoing motivated by personal greed? Management understandably may be dismayed to learn the answer frequently is yes, because contractual advancement typically is provided under Delaware law granting corporations the power to indemnify and advance litigation expenses to any person made a party to a proceeding "by reason of the fact that the person is or was a director, officer, employee or agent of the corporation."

A claim is "by reason of" corporate service when the allegations challenge conduct by the proposed indemnitee in his or her official corporate capacity. A lawsuit alleging that directors breached their fiduciary duties to the corporation is the archetypal suit for which directors are parties "by reason of" board service. "By reason of" is not construed so broadly, however, as to encompass every claim against a corporate official. Claims brought against officials in their personal capacity (such as excessive compensation and breach of a non-compete agreement) are not "by reason of" official capacity, so that indemnification usually is unavailable. This column examines Delaware case law providing a framework for applying the "by reason of" standard to claims that may implicate breach of a corporate official's personal obligations owed to the corporation, as opposed to official capacity claims.

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First Principles

Under the Delaware General Corporation Law (and incorporated in virtually all company charters or bylaws) corporations may agree to provide indemnification and interim advancement of expenses with respect to proceedings to which a person “was or is made a party...by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation.”¹ Most corporations provide broad and mandatory advancement rights to any covered person who must defend a proceeding for which indemnification could be available at the conclusion.

When the advancement right provided is “to the fullest extent authorized by Delaware law,” it encompasses not only any proceeding for which an official is permitted to be indemnified under §145(a) or (b) of the Delaware Code, but also any proceeding for which indemnification could be required under §145(c) if the official is successful on the merits or otherwise in defending the proceeding. Officials’ indemnification and advancement rights do not extend to proceedings brought against them other than “by reason of the fact” of their corporate service. Because advancement of expenses is available only for proceedings in which an official has a colorable right to indemnification, an official’s advancement rights, like indemnification rights, applies only to actions brought against the official “by reason of” the corporate service.

Delaware courts have interpreted the “by reason of” language broadly, requiring only a nexus or causal connection between the official’s corporate capacity and the matter for which advancement or indemnification is sought. The key question in determining whether a causal nexus linked the underlying claims and corporate service is what capacity the official was acting in when he or she engaged in what is alleged to have been wrongful. This determination is dispositive of an advancement request too because officials, to be eligible for advancement, must establish that they were acting in their capacity as an “indemnification-eligible position,” whether that be director, officer, employee or agent of the company, when undertaking the conduct underlying the allegations against them. As long as the official’s corporate powers were used or necessary for the commission of the alleged misconduct, capacity-based challenges to advancement and indemnification have been rejected even when the underlying proceeding involves serious misconduct actuated by personal greed.

Thus in [*Perconti v. Thornton Oil Corp.*](#),² the Court of Chancery held that a former CEO was entitled to mandatory indemnification after criminal charges arising from his embezzlement of corporate funds were dropped after a mistrial, reasoning that the crimes with which the official was charged occurred because of his official position. “Without that status, he would not have had any obligation to provide ‘his honest services’ to Thornton or to report truthfully to Mr. Thornton about the Company’s financial status,” and it was his status as officer that enabled him to embezzle corporate funds.

In [*Tafeen v. Homestore Inc.*](#),³ the Delaware Supreme Court held that a broad advancement bylaw provision required payment of millions of dollars in expenses to a former officer whose alleged conduct had drawn a mountain of litigation, including a criminal indictment, arising from the officer’s fraudulent scheme to inflate the company’s revenues, which netted him \$15 million in sales of inflated stock. Homestore argued that the contractual requirement for advancement that the underlying suit arise “by reason of” corporate service was not satisfied because allegations in the underlying suits suggested that Tafeen was sued because of personal greed. The court rejected the argument as an inappropriate invitation to adjudicate the merits of the underlying suits, concluding that the official was named in the underlying proceedings because of his role in the scheme to inflate corporate financial results while serving as an officer of Homestore.

Personal Obligation Case Law

A corollary to this official capacity doctrine is that advancement and indemnification are not available if the alleged wrongdoing did not implicate the official’s use of corporate powers entrusted to him or her. The Delaware Court of Chancery’s and Supreme Court’s decisions in [*Cochran v. Stifel Fin. Corp.*](#),⁴ are the leading precedents establishing the non-indemnifiable nature of suits alleging that a corporate official breached a personal obligation to the corporation. There, a corporate officer, Cochran, sued to compel indemnification of costs incurred defending criminal proceedings against him arising from actions he took while serving as a director of a wholly owned subsidiary of Stifel, Stifel Nicolaus, at the request of Stifel, and also to compel indemnification of costs incurred in litigation brought by the corporation against him to recover (i) repayment of excess compensation, (ii) repayment of a loan the corporation extended to him which became due upon his termination for cause, and (iii) for violating a non-compete clause in Cochran’s employment agreement.

Stifel's bylaws undertook to indemnify any officer "to the full extent authorized by law" regarding any proceeding brought against him "by reason of the fact" corporate position. In ruling on Cochran's claims, the Court of Chancery distinguished between the costs he incurred in defending the criminal proceedings and the costs he incurred in connection with the corporation's lawsuit to recover excess compensation and loan proceeds, holding that while the corporation owed advancement for litigation costs in the criminal action, it did not have to advance costs incurred in the employment litigation.

The court determined that the excessive compensation, loan and non-compete claims of the corporation "were not brought against Cochran 'by reason of' his service in indemnification-eligible positions at Stifel; instead, those claims are alleged to have been brought solely to enforce contractual commitments Cochran made in his personal capacity." The court acknowledged the "linguistic plausibility" of Cochran's observation that his status as a director of Stifel Nicolaus was essential to these claims, but refused to interpret "by reason of" so broadly to sweep these contract-based claims into the indemnification obligation.

When corporate officials sign an employment contract committing to a specified position, they act in a personal capacity in an arms-length transaction. "To the extent [an official] binds himself to certain obligations under that contract, he owes a personal obligation to the corporation. When the corporation brings a claim and proves its entitlement to relief because the officer has breached his individual obligations, it is problematic to conclude that the suit has been rendered an 'official capacity' suit subject to indemnification." Such a conclusion, the court reasoned, "would render the officer's duty to perform his side of the contract in many respects illusory."

In electing Cochran as a member of a subsidiary's board of directors, the court continued, it was "inconceivable" that Stifel "requested" Cochran to serve Stifel "under employment contracts that, by operation of the Indemnification Bylaw, implicitly required Stifel to indemnify Cochran for any 'good faith' breaches of those contracts that *he committed*. Rather, the only plausible conclusion is that Stifel expected that the terms of Cochran's employment contracts with [the subsidiary] would be paramount and exclusive as to any claims for breach of those contracts, absent a provision in those contracts to the contrary."

The Delaware Supreme Court affirmed, reaffirming the Court of Chancery's view that it was "problematic to conclude" that Cochran was entitled to indemnification for any claim asserted by the corporation because if he were, it would effectively immunize him against liability for any such claim. The court held that the claims asserted by Stifel "were properly characterized as personal, not directed at Cochran in his 'official capacity' as an officer" of the corporation and therefore not indemnifiable.

In *Reddy v. Electronic Data Systems Corp.*,⁵ the Court of Chancery declined to interpret *Cochran* automatically to bar advancement whenever the proposed indemnitee was alleged to breach an employment agreement with the corporation. In *Reddy*, an employee sought advancement of expenses incurred in a suit the company brought against him alleging fraud, negligence and breach of an employment agreement, all arising from the employee's falsification of company records in order to boost his incentive compensation. The court rejected as "pleading formalism" EDS's argument that its election not to allege a breach of fiduciary duty claim removed the underlying suit from the official capacity realm. Regardless of labels, "the claims...all could be seen as fiduciary allegations," involving the charge that the employee breached his duties of loyalty and care to the corporation. At bottom, the court reasoned, all of the misconduct alleged "involved actions Reddy took on the job in the course of performing his day-to-day managerial duties."

Citing *Cochran*, EDS argued that at least its breach of employment agreement claim did not arise "by reason of" Reddy's official capacity. The court disagreed, tallying what it deemed *Cochran's* "very unusual circumstances" — a director serving at a subsidiary at the parent's request, who was determined in arbitration to have breached an employment agreement and an obligation to repay a loan—so that the director in *Cochran* had no reasonable expectation that the parent would indemnify him if he received contractually excessive compensation or failed to repay a loan to the subsidiary. Moreover, the *Reddy* court viewed it critical that *Cochran* sought indemnification, not advancement.

If the director in *Cochran* received indemnification, the court stated, he would have received a windfall defeating the parties' contractual expectations. Reddy's advancement request did "not present that same issue," the court stated, because if it was subsequently determined that Reddy's conduct was non-indemnifiable, he would have to repay to EDS any amounts advanced. The court also emphasized

that EDS did not allege breach of an express provision of Reddy's employment contract. Rather, the breach consisted of his "failing to have lived up to the implied covenant in his contracts that he would not engage in official misconduct to generate false financials." The court expressed concern that if a company could avoid advancement obligations simply by recasting as an employment contract breach various wrongful on-the-job acts, the legislative intent to encourage broad indemnification and advancement right might be frustrated.

In *Weaver v. ZeniMax Media Inc.*,⁶ the Court of Chancery showed that a *Cochran* argument can succeed and defeat both advancement and indemnification if the underlying suit alleges breach of a specific contract obligation by the official. There, the corporation brought a two-count complaint against a former official: Count One alleged breach of fiduciary duty based on the officer's failure properly to manage research and development projects for which he was responsible and about which he made repeated misrepresentations to management; Count Two alleged breach of contract based on the officer's excessive vacation time, and his wrongful receipt of corporate reimbursement for personal travel expenses. Conceding entitlement to advancement for the defense of Count One, the corporation successfully challenged the official's entitlement to advancement for defense of the claims relating to his receipt of benefits and payments to which he was not entitled.

Rejecting the official's argument that *Reddy* bars separate evaluation of employee or personal claims, the court held that "claims brought by a corporation against an officer for excessive compensation paid or breaches of a non-competition agreement are quintessential examples of a dispute between an employer and an employee and are not brought 'by reason of the fact' of" the official's corporate position. Under this standard, allegations that an official failed to devote his full attention to company business, was paid excessive vacation compensation and wrongly received reimbursement for travel expenses were "in the nature of an employment dispute, based on a personal obligation owed to the corporation" because the official did not need to make use of any "entrusted corporate powers" in order to engage in the conduct that gave rise to these claims.

In [*Zaman v. Amedeo Holdings*](#),⁷ the Court of Chancery reaffirmed the *Reddy* rationale in a case in which former officers sought advancement to defend corporate claims that they siphoned off corporate funds to pay themselves excessive fees, used corporate credit cards for improper personal expenses and otherwise "gorged themselves" at company expense. Rejecting the corporation's argument that none of

its claims implicated official capacities because breach of employment agreements were alleged, the court identified “the key inquiry” as “whether the claim depends on a showing that the official breached duties, quintessentially fiduciary duties, he owed to the corporation in that capacity or faces liability from a third party due to actions taken in his official capacity.”

The court concluded that the claims against the officers were “grounded in their alleged misuse of the substantial fiduciary responsibility they were given as key managerial agents.” The relevant corporate entities entrusted the former officers “with wide authority to incur expenses on the [corporate] dime,” so that whether they misused that authority, by using corporate funds for unauthorized purposes constituted an official capacity claim for which the former officers were owed advancement rights. The court acknowledged *Cochran*, stating its rule to be that “claims that hinge exclusively on compliance with contractual employment arrangements are not ‘by reason of’ acts in an official capacity,” that is, “a situation where they are alleged to have committed merely a breach of a specific term of a contract.”

In this manner the court further reconciled *Reddy* and *Weaver*, discussed above, observing that *Reddy* permitted advancement for “claims against a former employee that stated breaches of fiduciary duty but that were pled using other legal theories would not give rise to advancement rights under a bylaw extending advancement rights to former employees,” while *Weaver* denied advancement because the claim did not require the corporate official to discharge his authority as an officer or as a director.

Most recently, in [*Paolino v. Mace Sec. Intern. Inc.*](#),⁸ the Court of Chancery provided its most thorough review yet of the “by reason of” employment contract cases, and rejected the notion that “when an employment agreement is at issue, Section 145 goes out the window.” Rather, the court concluded, case law shows “that Section 145 will not apply when the parties are litigating a specific and personal contractual obligation that does not involve the exercise of judgment, discretion, or decision-making authority on behalf of the corporation.” This does not mean that a *Cochran* argument is unavailable in an advancement case, the court stated, but “it does mean that the claim for which the corporation seeks to avoid advancement must clearly involve a specific and limited contractual obligation without any nexus or causal connection to official duties.” *Cochran* made “perfect sense” in determining that a personal contractual obligation lacked the necessary nexus to official capacity in the

context of a specific contractual obligation, and identifying the circularity of a covered person being obligated to make the required payment, then obtaining it back through indemnification.

Applying these principles in *Paolino*, the court held that a former CEO was entitled to advancement for contractual, statutory and fiduciary duty claims by the corporation alleging that the CEO failed to discharge his oversight and supervisory duties. The fact that the CEO signed an employment agreement did not convert his “duties as CEO into a personal contractual obligation like the loan repayment or formula-based compensation reimbursement in *Cochran*.”

Conclusion

Corporate officials sign employment contracts in a personal capacity in an arms-length transaction, the breach of which ordinarily does not involve indemnifiable official capacity. Delaware courts, however, have decisively stopped short of ruling that an individual’s agreement to serve in an indemnification-available capacity pursuant to an employment agreement converts all of his or her duties into non-indemnifiable personal obligations. Put simply, regardless of the label of the claim, the requisite connection between official capacity and underlying suit is established if the official’s corporate powers were used or necessary for the commission of the alleged misconduct for which indemnification is sought.

Endnotes:

1. 8 Del. C. § 145(a).
2. 2002 WL 982419 (Del. Ch. 2002).
3. 888 A.2d 204 (Del. 2005).
4. 2000 WL 1847676 (Del. Ch. 2000), *aff’d* in part, 809 A.2d 555 (Del. 2002).
5. 2002 WL 1358761 (Del. Ch. 2002), *aff’d*, 820 A.2d 371 (Del. 2003).
6. 2004 WL 243163 (Del. Ch. 2004).
7. 2008 WL 2168397 (Del. Ch. 2008).
8. 985 A.2d 392 (Del. Ch. 2009).

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