

DIRECTORS' AND OFFICERS' LIABILITY

INDEMNIFICATION UPDATE

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Delaware courts have recently issued several noteworthy decisions addressing the rights of directors and officers to indemnification and interim advancement by the corporation of attorneys' fees and litigation-related expenses. These include Delaware Supreme Court rulings on when a corporate official's claim for indemnification accrues, and the permissible scope of an advancement proceeding, Court of Chancery guidance on whether mandatory indemnification provisions of a separate company may entitle an employee of a corporate affiliate to indemnification or advancement, and decisions in the protracted advancement dispute between Homestore, Inc. and a former officer, which is now in the Delaware Supreme Court.

Delaware's Statutory Indemnification/Advancement Scheme

Interim advancement of litigation expenses and corporate indemnification serve two objectives: securing able corporate officials and encouraging them to resist claims perceived to be meritless. Together with D&O insurance and DGCL § 102(b)(7) (authorizing a provision in the certificate of incorporation eliminating or limiting the liability of directors for damages for non-intentional, non-bad faith breaches of duty), corporate indemnification is a cornerstone of the effort to reduce the risk of personal liability arising out of board conduct.

Section 145 of the DGCL sets forth Delaware's statutory basis for indemnification and advancement. As in New York, the Delaware statute distinguishes between indemnification for third-party actions and derivative actions. For non-derivative actions, § 145(a) permits (but does not require) a corporation to indemnify directors and officers made or threatened to be made a party to an action for attorneys' fees actually and necessarily incurred, as well as judgments or amounts paid in settlement in civil, criminal, administrative or investigative proceedings. The indemnitee must have acted in good faith and for a purpose that he or she reasonably believed to be in the corporation's best interests. The statute expressly provides that the termination of a case by judgment or settlement does not, by itself, create a presumption

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that the standard of conduct has not been satisfied.

The statutory authorization for indemnification in derivative actions is narrower. In the derivative context, the corporation may indemnify directors and officers only for “expenses (including attorneys’ fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action.”¹ The statute does not authorize reimbursement of settlements paid or judgments in derivative actions.² The distinction reflects that in a derivative action the director or officer has allegedly breached a duty to the corporation, while in a third-party suit, the director or officer presumably acted in the best interests of the corporation when he purportedly damaged a third party, making it reasonable to expect broad corporate reimbursement. Section 145(g), however, authorizes corporations to purchase insurance covering such non-indemnifiable amounts. The same standard of conduct applies for reimbursement in derivative lawsuits as in third-party actions. Indemnification (including legal fees) becomes mandatory when the director or officer “has been successful on the merits or otherwise in defense” of any proceeding described in §145.³

Indemnification is never self-executing; a decisionmaker always must determine whether the proposed indemnitee acted in an indemnifiable capacity and meets the applicable standard of conduct. Section 145(d) provides that the determinations may be made by (a) a majority vote of directors who are not parties to the pertinent proceeding, even if less than a quorum; (b) by a committee of such non-defendant directors designated by majority vote of such directors, even if less than a quorum, or (c) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, or (d) by the stockholders.

“Advancement” is payment by the corporation during the pendency of a proceeding of expenses (principally attorneys’ fees) that would be indemnifiable at the conclusion of the proceeding. Section 145(e) authorizes advancement before final disposition of underlying litigation upon receipt of an undertaking by or on behalf of the indemnitee to repay such amount if it is ultimately determined that indemnification is not appropriate. The undertaking to repay does not have to be secured. A corporate official’s entitlement under the corporation’s advancement provisions to potentially indemnifiable litigation expenses during the pendency of an underlying proceeding is a separate question from whether the corporation must ultimately indemnify the official for expenses or liability covered by Section 145(a) or (b). Accordingly, issues regarding the official’s alleged conduct in the underlying litigation ordinarily have no bearing on advancement. Although Delaware law does not require corporations to advance legal expenses, many corporations include mandatory advancement provisions in the corporate bylaws.

Accrual of Claim

In *Scharf v. Edgcomb Corp.*⁴, the Delaware Supreme Court reversed a Court of Chancery dismissal of an indemnification claim as untimely under the applicable three-year statute of limitations. Scharf is the former CEO of Edgcomb, and in 1990 received an SEC subpoena and

ultimately a Wells Notice concerning, among other things, alleged insider trading. In May 1991, however, the SEC Staff provided Scharf's counsel with a qualified written assurance that it did not intend to proceed against Scharf. Between June 1992 and July 1994, the SEC actively litigated an enforcement action against a confidante of Scharf's pursuing theories that directly implicated Scharf in alleged misconduct, and even subpoenaed Scharf. The SEC's enforcement action settled in July 1994, with no claims ultimately filed against Scharf. When Scharf sued Edgecomb in the Court of Chancery in 1996 for indemnification of the expenses he incurred in successfully resisting the SEC investigation, the company successfully asserted at trial that the claim accrued no later than 1992 when the SEC brought an enforcement action but did not name him, and therefore was barred by the three-year statute of limitations.

The Delaware Supreme Court reversed, holding that a cause of action for indemnification accrues when the officer or director entitled to indemnification "can be confident any claim against him has been resolved with certainty." Reviewing the record, which included testimony from Scharf's attorneys, for the "date certain" on which Scharf could be confident that the outcome of the underlying matter – the enforcement action against his confidante and the SEC's potential claims against Scharf--had been resolved, the Court concluded that that a reasonable person in Scharf's position could not be confident that the matter had been conclusively resolved until the confidante settled with the SEC in July 1994, making Scharf's indemnification claim filed in 1996 timely.

Scope of Advancement Proceeding

In *Kaung v. Cole Nat. Corp.*,⁵ the Delaware Supreme Court reversed as premature a Court of Chancery determination that a company could obtain recoupment in an advancement proceeding of amounts previously advanced to a former officer. The officer had commenced an advancement action pursuant to an indemnification agreement seeking to compel the company to advance litigation expenses incurred in class action litigation and an SEC investigation, including fees for his attorneys' consultations with a controversial non-lawyer consultant. Pre-trial, the company approved payment of the attorneys' outstanding fees and agreed to advance future fees, subject to reasonableness, and the officer withdrew his request for payment of the consultant's fees. After a trial, the Court of Chancery determined, and the Delaware Supreme Court agreed, that the time billed by attorneys for dealings with the consultant was not reasonably incurred, and that the attorneys were not entitled to advancement of their unpaid legal fees relating to dealings with the consultant.

The Supreme Court reversed, however, the Court of Chancery determination that the officer had to repay the company fees previously advanced voluntarily in connection with attorney dealings with the consultant. Noting that the rights of interim advancement (DGCL §145(e)) and indemnification (DGCL §§145(a) and (b)) have distinct statutory bases, the Court emphasized that an advancement proceeding is summary in nature and narrow in scope, even if repayment of advanced expenses may ultimately turn on a right to indemnification. Accordingly, an advancement proceeding is "not appropriate for litigating indemnification or

recoupment. The detailed analysis required of such claims is both premature and inconsistent with the purpose of a summary proceeding.”

Importance of the Corporate Form

In *Flynn v. CIBC World Markets Corp.*,⁶ the Court of Chancery addressed to what extent the indemnification provisions of a separate company may entitle an employee of a corporate affiliate to indemnification. The court dismissed a summary advancement proceeding seeking advancement of legal fees pursuant to a mandatory advancement provision in the bylaws of World Markets Corp. (“WMC”). The proceeding was brought by an employee of Canadian Imperial Holdings who alleged that his alleged involvement in activities conducted under the CIBC World Markets group trade name, and dealings with employees of WMC entitled him to indemnification under WMC’s bylaws, which mandated advancement of litigation expenses to its present or former (i) directors and (ii) officers with management supervisory functions. Because the employee was not a statutory director elected by stockholders, the decision turned on the officer designation. He argued that the WMC bylaws’ establishment of “Nominal Officers,” *i.e.*, employees of WMC who have officer titles but are not Executive Officers appointed by the board, placed his officer title in a separate company in the CIBC World Markets group, together with day-to-day supervisory responsibilities of employees of World Markets Corp., within the scope of WMC’s mandatory indemnification provisions.

The court disagreed, refusing to deem plaintiff an employee of a distinct legal entity by which he was not employed. The court acknowledged that “business reality and corporate structure do not always dovetail,” but insisted that in the absence of fraud “corporate structure provides the binding force of corporate liability regardless of business reality.” It is not unusual, the court noted, for the employee of a company to report to an employee of an affiliated company sharing a common parent company, and this reporting chain will not provide a basis to bring an individual within the scope of indemnification rights provided only to a defined group of which the individual is not a formal part.

Tafeen

The Delaware Supreme Court will hear in a few months the appeal from several rulings in the extensively litigated advancement proceeding in *Tafeen v. Homestore, Inc.*, in which a former officer whose alleged conduct has drawn a mountain of litigation, including a criminal indictment, deflected eleven affirmative defenses asserted by the company to obtain a judgment directing advancement of \$4 million in fees already incurred and payment of future fees. Homestore’s bylaws mandated (i) indemnification “to the fullest extent permitted by” Delaware law; and (ii) advancement of attorneys’ fees upon receipt of an undertaking to repay amounts advanced if it should be determined ultimately that indemnification is not appropriate. The case in significant part concerns under what circumstances defenses in equity or law may declare illusory an undertaking to repay amounts advanced, and warrant denial of advancement.

Homestore sought summary judgment on multiple grounds, including a novel unclean hands defense that would permit denial of advancement upon a showing that the official deliberately sheltered or wasted assets to frustrate future recovery of amounts advanced if it is later established he is not entitled to indemnification. In *Tafeen v. Homestore, Inc.*,⁷ the court held that, if established, recognition of the defense would not offend any policy underlying indemnification rights because, if proved, sheltering activity “would undermine the spirit of the statute.” The court emphasized that directors and officers are “now on notice that they will not be permitted to use the [indemnification] statute itself after taking improper actions at the expense of the corporation's stockholders.” Whether Tafeen actually sheltered assets with the intent to frustrate potential reimbursement of amounts advanced, however, presented a factual question for trial. Homestore also argued that the contractual requirement for advancement that the underlying suit arise “by reason of the fact” of officer 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, stating that the requirement only ensures that a nexus exists between the underlying proceeding and the officer’s corporate function or capacity.

After the court limited discovery to what Tafeen knew about Homestore’s investigation into allegedly improper accounting and his right to advancement around the time he purchased a home in Florida (which has protective homestead laws), it conducted a trial on the unclean hands defense. Homestore adduced evidence it contended demonstrated that Tafeen had deliberately sheltered assets and made wasteful expenditures to frustrate potential creditors, including significant pre-payments on mortgages Tafeen held on his Florida homes, remarkable personal expenditure's such as a \$50,000 fish tank for his home, and the transfer of a substantial portion of Tafeen's other assets into trusts.

In October 2004, the court ruled that although Tafeen’s extravagant lifestyle was “very troubling,” Homestore failed to demonstrate by a preponderance of the evidence that Tafeen intended to shelter assets, and therefore he was entitled to have his reasonable fees advanced for the underlying suits, and payment and advancement of his attorney's fees incurred in prosecuting the advancement action (known as fees on fees).⁸ The court noted that Tafeen purchased his Florida property before any investigation into Homestore's accounting practices commenced, and saw no “persuasive evidence that Tafeen was aware of the homestead exemption under Florida law at the time he purchased” the Florida property. Tafeen’s sale of a Florida home and purchase of a less expensive Florida home during the relevant period, the court reasoned, also seemed incompatible with a scheme to shelter assets. The court emphasized that “inability to repay is not a disqualification for advancement,” and continuing a theme developed in the summary judgment ruling, suggested that Homestore’s problem could have been avoided through bylaws that required a secured undertaking for the advancement of litigation expenses -- “this Court is hard pressed to understand why it would be difficult to attract people to [corporate] positions if they were required to post a bond to secure the advancement of fees and costs related to litigation arising from their service in that capacity.”

In March 2005, the court adopted a Special Master's determination of the reasonableness of outstanding fees of approximately \$4 million. Homestore then asked the court to stay the company's advancement obligation pending appeal. In a determination recently affirmed by the Delaware Supreme Court, the Court of Chancery denied the request, ruling that Homestore had failed to establish that the payments would create irreparable harm, and added that "to be of any value to the executive or director, advancement must be made promptly, otherwise its benefit is forever lost because the failure to advance fees affects the counsel the director may choose and litigation strategy that the executive or director will be able to afford."⁹ The merits appeal will like be heard in the fall.

¹ 8 Del. C. § 145(b).

² *TLC Beatrice Intern. Holdings, Inc. v. CIGNA Ins. Co.*, 1999 WL 33454 (S.D.N.Y. 1999).

³ 8 Del. C. § 145(c).

⁴ 864 A.2d 909 (Del. 2004).

⁵ 2005 WL 1635200 (Del. July 5, 2005).

⁶ 2005 WL 1538337 (Del. Ch. June 21, 2005).

⁷ 2004 WL 556733 (Del. Ch. Mar. 22, 2004).

⁸ *Tafeen v. Homestore, Inc.*, 2004 WL 3053129 (Del. Ch. Oct. 27, 2004).

⁹ *Id.*, 2005 WL 1314782 (Del. Ch. May 26, 2005), *aff'd*, 2005 WL 1383348 (Del. June 8, 2005).