DIRECTORS' AND OFFICERS' LIABILITY

DELAWARE DECISIONS CLARIFY KNOTTY INDEMNIFICATION ISSUES

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The contractual commitment by many companies to provide fullest-extent-of-the-law indemnification for legal expenses of directors and officers has long been an important inducement to corporate service. Events that disrupt the alignment of interest between indemnitee and the company, however, often confound the indemnitee's expectation that the company will bear individual litigation expenses. Several recent decisions lend clarity to a number of the subtler questions that arise in this area.

The Delaware Court of Chancery held that former directors who received full indemnification from one of two co-indemnitors lacked standing to bring a contribution claim against the non-paying co-indemnitor; a co-indemnitor that pays more than its fair share must initiate a contribution suit in its own name against a co-indemnitor. The court also declared void an agreement that purported to allow the directors to retain amounts that the company advanced them to fund their unsuccessful indemnification suit. The Bankruptcy Court for the District of Delaware refused to disallow the unliquidated claim of a former officer of a debtor for advancement and indemnification of defense costs, holding that the claim was not contingent and the debtor was not co-liable to the underlying securities law claimant for such costs. Interpreting Delaware law, the New Jersey Supreme Court held (over a dissent) that if a corporation's certificate of incorporation and bylaws conflict on the scope of indemnification, the certificate controls. On the related D&O insurance front, the Delaware Supreme Court reversed a trial court dismissal and held that a parent company's agreement to indemnify the directors of a subsidiary does not preclude D&O insurance coverage under a policy provision carving out of the "loss" definition liabilities indemnified by "the company" that obtained the policy, thus permitting the parent to sue the insurers both as the directors' assignee and in equitable subrogation.

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Delaware's Statutory Scheme

Interim advancement of litigation expenses and corporate indemnification serve two purposes: securing able corporate officials and encouraging them to resist meritless claims. Together with D&O insurance and DGCL §102(b)(7) - which authorizes corporations to limit the liability of directors for damages for non-intentional, non-bad faith breaches of their fiduciary duties - 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 which, as the Delaware courts have repeatedly emphasized, are distinct but related concepts. The statute distinguishes between indemnification for third-party actions and derivative actions. For third-party actions, section 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 attorney's fees as well as judgments or amounts paid in settlement. 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 entitlement to indemnification usually cannot be determined until after the merits of the underlying controversy are decided because the good faith standard requires a factual inquiry into the events that precipitated the lawsuit. In the derivative context, the corporation may indemnify directors and officers only for "expenses (including attorney's fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action."[1] The DGCL does not authorize reimbursement of settlements paid or judgments in derivative actions.[2] Delaware recognizes 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. However, section 145(g) authorizes corporations to purchase insurance covering such non-indemnifiable amounts.

Delaware permits corporations to advance funds to their directors and officers to cover the legal expenses of a pending lawsuit where the expenses would be indemnifiable at the suit's conclusion. Under section 145(e) of the DGCL, corporations may agree to advance funds before final disposition of underlying litigation upon receipt of an undertaking by or on behalf of the indemnitee to repay amounts advanced if it is ultimately determined that the individual is not entitled to be indemnified. A corporate official's entitlement to advancement 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, and advancement ordinarily is not conditioned on a finding that the party seeking advancement has met any standard of conduct. Although Delaware law does not require corporations to advance legal expenses, many corporations include mandatory advancement provisions in the corporate bylaws.

Co-Indemnification/Fees

In *Levy v. HLI Operating Co.*,[3] six former HLI directors sued HLI pursuant to broad indemnification agreements with the company entered into before its bankruptcy, to obtain reimbursement of monies they contributed to the settlement of securities litigation. Invoking a restriction on director indemnification rights contained in its bankruptcy reorganization plan, HLI rejected the indemnification request, but agreed pursuant to the indemnification agreements to advance the directors' attorney's fees and costs associated with the indemnification suit. Significantly, the agreements purported to allow the directors to retain amounts advanced regardless of the outcome of the indemnification suit.

In discovery, HLI learned that four of the plaintiffs had another source of indemnification - a substantial stockholder of HLI - which had contributed most of the settlement amount on behalf of the directors. HLI promptly sought summary judgment, asserting that the directors had no contractual right to indemnification from HLI because the directors were only entitled to indemnification for "amounts paid in settlement" from their own pockets. In addition, HLI argued that because the directors never had a claim for indemnification, they must reimburse the company for the attorneys' fees and expenses advanced to them during the indemnification suit. The court agreed.

Consulting insurance law principles, the court noted that a co-indemnitor who fully satisfies a joint indemnification obligation shared with a co-indemnitor covering the same indemnitee has a cause of action for equitable contribution against the co-indemnitor. Addressing whether the indemnitee can bring the contribution cause of action, the court observed that "contribution exists only among the insurers," and "has no place between insurer and insured."[4] Accordingly, once a co-indemnitor fully reimburses its indemnitee for indemnifiable liabilities, the indemnitee lacks standing to assert an indemnification claim against the other indemnitor in the indemnitee's own right. Consequently, the court held that the four *Levy* plaintiffs who had been indemnified could not pursue contribution claims against HLI, but the co-indemnitor could assert a cause of action for equitable contribution against HLI.

Turning to HLI's request to recover amounts already advanced to the directors to prosecute the indemnification claim, the court held that the provision in the directors' indemnification agreements that permitted them to retain fees advanced to them to prosecute an ultimately unsuccessful indemnification claim was void as contrary to Delaware law and public policy. The Delaware Supreme Court held in *Stifel Fin. Corp. v. Cochran* that DGCL §145(a) permits "indemnification for expenses incurred in successfully prosecuting an indemnification suit,"[5] also known as "fees on fees." The Court of Chancery has interpreted entitlement to fees on fees under *Cochran* as hinging on success in the underlying indemnification action.[6] *Levy* carried this logic a step further, holding that an indemnification provision mandating "fees on fees" must be conditioned on the indemnitee's success in the underlying indemnification action, or declared void. This result is consistent with DGCL §145(e) which, according to *Levy*, "is best read as limiting a corporation's power to indemnify fees on fees to those situations where success is achieved on the underlying claim."[7] The holding also furthers sound public policy by

discouraging frivolous indemnification claims. Consequently, HLI was entitled to recover the pro rata portion of fees and expenses it advanced on behalf of the directors who unsuccessfully pursued indemnification claims.

Bankruptcy Code

In Re: RNI Wind Down Corp.[8] involved an agreement by RNI, a hardware developer, to advance defense costs to a former officer named in an SEC enforcement action and subject to a DOJ grand jury investigation, pursuant to fullest-extent-of-the-law indemnification and advancement provisions in the company's certificate of incorporation. After RNI filed for bankruptcy, however, its plan administrator moved to disallow the officer's indemnification and advancement claim under section 502(e)(1)(B) of the Bankruptcy Code, which mandates disallowance of any claim for reimbursement or contribution filed by an entity that is co-liable with the debtor, to the extent that "such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance . . . ."

The Bankruptcy Court for the District of Delaware held that the claim for attorney's fees associated with the defense of an SEC or DOJ proceeding was not subject to disallowance. To disallow a claim under section 502(e)(1)(B), a claimant must show (1) that the claim is contingent; (2) that the claim is for reimbursement of a debt; and (3) the debtor and the claimant are co-liable for the debt. Noting that section 145(e) of the DGCL, which governs advancement, permits a Delaware corporation to pay "[e]xpenses (including attorney's fees) incurred by an officer or director," the court agreed with the plan administrator that advancement, like indemnification, is a form of reimbursement.

It disagreed, however, that the advancement claim was "contingent" because the ultimate amount of the claim and even whether the claimant will ultimately be entitled to indemnification are unknown. Noting that advancement, unlike indemnification, "is a right whereby a potential indemnitee has the ability to force the company to pay his litigation expenses as they are incurred regardless of whether he will ultimately be entitled to indemnification," the court concluded that the officer's "undisputed right to pre-indemnification advancement of certain litigation related expenses is anything but contingent. While it is subject to an undertaking to repay the advanced expenses in the event that it is determined that [the officer] is not entitled to indemnification, the advancement itself is not conditioned on a finding that the party seeking advancement has met any standard of conduct."[9] Moreover, the court reasoned, disallowance was not warranted simply because the debtors and the claimant might be co-liable to the government for the claimant's alleged securities law violation. The government had no claim against the debtors for the relevant liability - the former officer's defense costs. Notably, the court declined to follow co-liability case law that it believed "incorrectly collapsed the issues of [defense cost] reimbursement and liability," and which held that if there is co-liability in the underlying action, then any amounts sought through indemnification, including defense costs, should be disallowed.

Charter and Bylaws Conflict

In *Vergopia v. Shaker*,[10] an attorney served as both outside counsel and assistant secretary to Hometown, a car dealership. The attorney and Hometown were sued for trade libel and similar claims arising out of a press release issued by Hometown regarding the dismissal of two Hometown senior employees. When Hometown's D&O carriers refused to defend the attorney, he filed a cross-claim for indemnification against Hometown.

The New Jersey Supreme Court stated that the attorney's entitlement to indemnification turned on whether Hometown's certificate of incorporation or its bylaws controlled. In its certificate, the company agreed to indemnify its directors and officers to the fullest extent of Delaware law when they act in their official capacity "or in any other capacity while serving as a director, officer, employee or agent."[11] The company's bylaws, on the other hand, appeared to afford narrower protection by omitting the "in any other capacity" language.

The court ruled that when a company's corporate charter and bylaws are at variance, the charter governs indemnification rights. "To the extent that Hometown's bylaws seemingly diminish the scope of indemnification afforded to directors and officer by [the corporate charter] . . . the bylaws must yield."[12] In dissent, Justice Rivera-Soto argued that the charter and bylaws should be read together and that the bylaws should only yield when in direct conflict with the charter. As Rivera-Soto read them, Hometown's bylaws amplified, rather than conflicted with, the corporate charter, and together the documents conditioned indemnification on a demonstration that the attorney was sued "by reason of the fact that" he was Hometown's assistance secretary.

The majority rejected this reading and relied solely on Hometown's corporate charter in holding that the attorney was entitled to indemnification. According to the court, because the attorney was an officer of Hometown at the time he participated in the issuance of the press release and because he acted in furtherance of Hometown's interests, he was entitled to indemnification regardless of whether the challenged action was within the scope of his official duties as an officer. The court stated that to conclude otherwise would deny the attorney the broad protection promised by Hometown's corporate charter.

'AT&T Corp. v. Clarendon'

In *AT&T Corp. v. Clarendon American Insurance Co.*,[13] AT&T, the largest shareholder of Internet service provider At Home Corporation ("At Home"), appointed ten directors to At Home's board and purchased D&O insurance on their behalf. Following At Home's bankruptcy, the At Home directors were sued in multiple shareholder securities actions for which their insurers declined coverage. Because At Home was insolvent, AT&T agreed to step in and indemnify these directors. In exchange, the directors assigned to AT&T their breach of contract claims against the insurers. In AT&T's subsequent suit asserting the directors' coverage claims as assignee and subrogee, the insurers moved to dismiss, arguing that the directors had not suffered a "loss" within the meaning of the insurance policies because they had not actually paid for any legal expenses or judgments out of their own pockets. The insurers also challenged

AT&T's standing to sue on behalf of the directors.

Reversing a Superior Court dismissal, the Delaware Supreme Court concluded that under applicable California law the directors had suffered a "loss" which triggered insurance coverage, and that AT&T had standing to sue the insurers as the directors' assignee and equitable subrogee. The court found that the language of the various D&O insurance policies only precluded coverage for losses that were indemnified by At Home, but did not preclude coverage for losses that were indemnified by a third-party, such as AT&T. The court further ruled that "[u]nder California law, an insured becomes legally obligated to pay legal expenses as soon as the legal services are rendered,"[14] meaning that the directors had an insurable "loss" once the litigation began regardless of AT&T's agreement to indemnify the directors.

Even though the Supreme Court held that AT&T had standing to sue as assignee of the directors' breach of contract claims, it also considered whether AT&T had standing as the directors' equitable subrogee.[15] Under the law of California and elsewhere, a party paying the debt of another becomes the debtor's subrogee where (1) payment is made to protect the subrogee's interest; (2) the subrogee does not act as a volunteer; (3) the subrogee is not primarily liable for the debt; and (4) subrogation would not be unjust. The insurers disputed only the second element, arguing that AT&T had voluntarily indemnified the directors. The court rejected the argument, ruling that California law defines a volunteer as someone with no interests to protect by acting as indemnitor. Because AT&T had an interest in indemnifying At Home's directors in order to reassure directors of subsequently acquired subsidiaries that it would do the same for them, the court reasoned, it was not a volunteer and thus could sue as the directors' subrogee.

Endnotes:

1. Del. Code Ann. tit. 8, §145(b) (2007).

2. *TLC Beatrice Int'l Holdings, Inc. v. CIGNA Ins. Co.*, No. 97-Civ. 8589, 1999 WL 33454, at *4 (S.D.N.Y. Jan. 27, 1999).

3. 924 A.2d 210 (Del. Ch. 2007).

4. *Levy v. HLI Operating Co.*, 924 A.2d 210, 220 (Del. Ch. 2007) (internal quotation marks and citation omitted).

5. 809 A.2d 555, 561 (Del. 2002).

6. See, e.g., *Fasciana v. Elec. Data Sys. Corp.*, 829 A.2d 178, 184 (Del. Ch. 2003) (holding that partial success in an indemnification suit yields only partial indemnification of that suit's fees).

7. *Levy*, 924 A.2d at 226.

8. No. 06-10110, 2007 Bankr. LEXIS 2263 (July 9, 2007).

9. *In Re: RNI Wind Down Corp.*, No. 06-10110, 2007 Bankr. LEXIS 2263, at *28 (July 9, 2007).

10. 922 A.2d 1238 (N.J. 2007).

11. Id. 1243.

12. Id. at 1244 n.6.

13. No. 567,2006, 2007 Del. LEXIS 294 (July 2, 2007).

14. *AT&T v. Clarendon Am. Ins. Co.*, No. 567,2006, 2007 Del. LEXIS 294, at *18 (July 2, 2007).

15. Id. at *34 n. 31. The court stated that, as a technical matter, it did not need to consider the question of subrogation having determined that AT&T had standing to sue as an assignee. The court did so anyway "to avoid any potential controversy over AT&T's standing to sue in the proceedings on remand to the trial court." Id.