

DIRECTORS' AND OFFICERS' LIABILITY

MANDATORY VERSUS DISCRETIONARY ADVANCEMENT RIGHTS

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

FEBRUARY 14, 2008

Corporate indemnification and advancement of legal expenses are distinct rights, with advancement being a narrower and more provisional contractual benefit. By relieving corporate officials from the personal financial burden of paying ongoing expenses arising from lawsuits and investigations, advancement is widely recognized as an important corollary to indemnification as an inducement to secure able individuals to corporate service. The decision by a corporation to grant advancement of expenses incurred by an officer or director (and sometimes other employees and agents) in defending civil, criminal, administrative or investigative actions is essentially a decision to advance credit to corporate officials because amounts advanced to them must be repaid if it is subsequently determined that they are not entitled to be indemnified. But mandatory and unconditional advancement agreements can engender what one court called a "maddening" outcome: a corporate obligation to fund the legal expenses of an individual the board believes has acted against the interests of the corporation or even criminally.¹ As recent decisions illustrate, it is worth pausing to consider the implications of mandatory advancement rights, as opposed to advancement grants in which the board retains some discretion to exercise business judgment on whether and how to condition the advancement of credit to corporate officials.

Delaware's Statutory 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

* **Joseph M. McLaughlin** is a partner at Simpson Thacher & Bartlett. **Patrick M. Connorton**, a summer associate at the firm, assisted in the preparation of this article.

advancement. Indemnification is the right to be reimbursed for all out-of-pocket expenses and losses caused by an underlying claim. 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 attorney's 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. Consequently, entitlement to indemnification generally 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 underlying the suit or proceeding. The statute expressly provides that the termination of a case by judgment or settlement does not, by itself, create a presumption 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 attorney's fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action."² The statute does not authorize reimbursement of settlements paid or judgments in derivative actions.³ 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 §145.⁴

Indemnification is never self-executing; a decision maker 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 attorney's fees) that would be indemnifiable at the conclusion of the proceeding. It bears emphasis that no corporation is required to provide for advancement of expenses; the authority conferred by §145 is permissive.⁵ That is, a corporation is "free not to provide for advancement at all, or to provide it in limited situations. Therefore, any agreement on the part of a corporation to provide advancement rights should be construed according to its terms."⁶ Section 145(e) authorizes advancement of expenses incurred by an officer or director 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. Advancement to current directors and officers ordinarily is not conditioned on a finding that the party seeking advancement has met any standard of conduct. 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 §145(a) or (b). Accordingly, issues regarding the official's alleged conduct in the underlying litigation ordinarily have no bearing on a summary proceeding for advancement under §145(k).

Section 145 gives a corporation more discretion to determine whether and to what extent it will agree to provide advancement to its former directors and officers, as well as its other employees and agents. As to expenses incurred by former directors and officers or other employees and agents, §145(e) provides that "they may be so paid upon such terms and conditions, if any, as the corporation deems appropriate."

Of course, a corporation is free to make advancement mandatory through a clearly worded bylaw or contract making it mandatory. Mandatory advancement provisions are found in many corporate charters, bylaws and indemnification agreements. As courts have repeatedly and pointedly emphasized, if a corporation agrees to unconditional, unsecured advancement to its officers and directors (and sometimes even to employees and agents) the corporation will be held to that decision and will be deemed to have waived the opportunity to examine whether the extension of credit to a particular individual is in the corporation's best interests at the time of the request.⁷ Corporations that seek to avoid mandatory advancement provisions for reasons such as a present belief that the official acted unfaithfully to the corporation are likely to be rebuked with: "[T]his is yet another case in which defendants in an advancement case seek to escape the consequences of their own contractual freedom. Regretting the broad grant of mandatory advancement they forged on a clear day, they seek to have the judiciary ignore the plain language of their contracts and generate an after-the-fact judicial contract that reflects their current preference."⁸ Delaware courts have consistently rejected attempts by companies with broad, mandatory advancement provisions to avoid payments, even as to individuals whose misconduct is established by a plea of criminal guilt, and awarded "fees on fees" against some companies that have tried.⁹

Mandatory director and officer indemnification bylaw provisions typically employ some variation of the following: "the Corporation, to the full extent permitted by the laws of the State of Delaware as in effect at the time of the adoption of this Article or as such laws may be amended from time to time, shall indemnify any person made or threatened to be made a party to any threatened, pending, or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that he or she was a director or officer of the Corporation." Mandatory advancement frequently is provided by another bylaw provision, stating that mandatory advancement of expenses shall be provided in advance of final disposition of a proceeding, upon receipt of an undertaking to repay if it is ultimately determined the relevant official is not entitled to indemnification under the terms of the

governing indemnification provision.

Recent Decisions

Most corporations do not extend mandatory advancement rights to employees and agents, providing such rights only to directors and officers appointed by the board. In [*Sassano v. CIBC World Markets Corp.*](#),¹⁰ the Delaware Court of Chancery held after a trial that under the mandatory advancement bylaw provision at issue, a former employee who was neither a director nor a board-appointed officer nevertheless was entitled to advancement of costs incurred in defending multiple investigations and proceedings arising out of his alleged involvement in mutual fund market timing. The bylaws afforded advancement rights to directors and "officers with management supervisory functions," and who are sued by reason of their office or service. Rejecting the corporation's argument that advancement for officers was limited to executive officers appointed by the board, and did not extend to "nominal" officers, the court stated that contracts must be read as a whole and relied on another bylaw provision identifying two types of "officers" - executive officers and nominal officers. The court concluded that because the indemnification and advancement provisions did not separately address the rights of nominal officers, the most reasonable interpretation of the bylaws was that nominal officers also are entitled to advancement to the extent they exercised management supervisory functions. Reasoning that the former employee was a nominal officer at the relevant times based on his holding two officer titles, executive director and managing director, the court found that the former employee exercised "management supervisory functions" based on the plain meaning of that phrase, as applied to trial evidence that the employee made hiring and termination decisions, set his employees' salaries, and disciplined members of his 14-member group.

The court also continued the trend to reject corporate capacity-based arguments, which derive from the "by reason of" limitation contained in §145 of the DGCL and typical implementing bylaw provisions. Applying the Delaware Supreme Court's standard enunciated in *Homestore Inc. v. Tafeen*,¹¹ that "if there is a nexus or causal connection between any of the underlying proceedings . . . and one's official capacity, those proceedings are 'by reason of the fact' that one was a corporate officer, without regard to one's motivation for engaging in that conduct," the Court of Chancery declined to interpret the "by reason of" requirement as limiting indemnification only to circumstances in which officers were alleged to have engaged in wrongdoing in the course of performing management supervisory functions, instead holding that "the Bylaws simply require that [the employee] be sued by reason of being an officer with supervisory functions, not necessarily for acts he took in his management supervisory role." Examining the pleadings in the proceedings for which the employee sought advancement, the court concluded that the regulatory actions were brought against him by reason of his officer status, as they alleged that he created a large and successful market timing business in which he executed inappropriate mutual fund orders on behalf of his customers, certain market timing hedge funds.

In contrast, [*Thompson v. Williams Companies Inc.*](#)¹² illustrates the considerable latitude

afforded a corporation to protect its legitimate interests by setting reasonable terms and conditions on advancement to employees where the advancement bylaw does not provide for mandatory and unconditional advancement. Plaintiff, a non-officer, non-director, former employee had demanded advancement to cover costs incurred in defending against an indictment charging his participation in a conspiracy to manipulate the price of natural gas. The applicable advancement bylaw provided that expenses incurred by non-officer, non-director employees and agents in defending a civil or criminal action "shall be paid upon such terms and conditions, if any, as the Board of Directors deems appropriate." The board of directors agreed to advancement of Plaintiff's post-indictment expenses, provided he sign a fully-secured undertaking to repay any amounts advanced. The secured undertaking proposed by the board set three conditions on advancement: (i) that plaintiff represent to the board his personal belief that he met the "good faith, best interests of the company" standard for indemnification set forth in the indemnification bylaw; (ii) agreement that only legal expenses incurred post-indictment would be advanced; and (iii) that plaintiff provide "adequate security to secure fully [his] obligation . . . to repay" the corporation any amounts advanced should it be determined that he was not entitled to indemnification. Variations of this secured undertaking requirement have become more common in recent years, as courts have noted that a failure to address properly the credit risk associated with unsecured advancement, including ascertaining the requesting individual's ability to repay, could expose the board to a shareholder derivative lawsuit. The former employee rejected those terms, and sued for unconditional, unsecured advancement for all of his expenses incurred during the investigation and judicial proceedings arising from his alleged misconduct.

After a trial, the Court of Chancery held that the plain language of the advancement bylaw authorized the board of directors to impose conditions on the credit the company advanced to a former employee, making the key question whether the terms and conditions fixed by the board were "appropriate," within the meaning of the advancement bylaw. The court interpreted "appropriate" in this context as "enabling the board to condition a grant of advancement on terms and conditions that rational directors might believe necessary to protect [the company's] legitimate interests." Taking into account plaintiffs' admission that he lacked the wherewithal to provide the dollar-for-dollar security mandated by the undertaking, the court concluded that "the board rationally determined that extending credit to plaintiff was risky, so that the board's request for security was rationally tied to the amount of credit the company was advancing and the legitimate purpose of managing the company's exposure to that credit risk." The court acknowledged that a company could purport to impose conditions on advancement that would be so arbitrary as to evidence contractual bad faith, but they would need to be egregious, such as a "requirement that [plaintiff] walk a tight-rope between skyscrapers as a condition to receiving advancement, or a demand that [plaintiff] post security worth five times the amount advanced."

Similarly, the court determined that the board's requirement that plaintiff certify that his conduct was consistent with his ultimate entitlement to indemnification was a proper exercise of business judgment. The board understood that plaintiff had been named in an indictment alleging conduct which, if proved, could not be indemnified. Accordingly, the board properly

"wanted plaintiff to certify that he believes himself to have acted lawfully and faithfully." While that certification "may seem useless to those of a cynical bent," the court deemed it appropriate for the board "to desire an attestation of good faith from a former employee facing serious criminal charges before extending him hundreds of thousands of dollars in interest-free credit."

Conclusion

Mandatory, unconditional advancement rights can be an important inducement to attract qualified individuals to corporate service, by providing a firm commitment that corporate officials may defend themselves vigorously, secure in the knowledge that they will not have to pay legal expenses (at least initially) out of their own pocket. Such advancement rights will be enforced as written, regardless of the board's current assessment of a particular present or former official's conduct. A proper understanding that a board's decision to grant advancement is essentially a decision to advance credit - one that could be subject to shareholder challenge - therefore counsels that the board and its advisors give serious consideration to reserve the ability to place reasonable conditions on the credit it will advance to at least certain categories of officials, particularly former employees.

Endnotes:

1. [*Reddy v. Elec. Data Sys. Corp.*, 2002 WL 1358761, at *5 \(Del. Ch. June 18, 2002\), aff'd mem., 820 A.2d 371 \(Del. 2003\).](#)
2. [8 Del. C. §145\(b\).](#)
3. [*TLC Beatrice Intern. Holdings Inc. v. CIGNA Ins. Co.*, 1999 WL 33454 \(S.D.N.Y. 1999\).](#)
4. [8 Del. C. §145\(c\).](#)
5. [*Gentile v. Singlepoint Fin. Inc.*, 788 A.2d 111, 113 \(Del. 2001\) \(per curiam\).](#)
6. [Id.](#)
7. See, e.g., [*Homestore Inc. v. Tafeen*, 888 A.2d 204, 212 \(Del. 2005\).](#)
8. [*DeLucca v. KKAT Mgmt., LLC*, 2006 WL 224058, at *2, \(Del. Ch. Jan. 23, 2006\).](#)
9. See [*Bergonzi v. Rite Aid Corp.*, 2003 WL 22407303, at *1 \(Del. Ch. Oct. 20, 2003\).](#)
10. [2008 WL 152582 \(Del. Ch. Jan. 17, 2008\).](#)
11. [888 A.2d 204, 215 \(Del. 2005\).](#)

12. [2007 WL 2215953 \(Del. Ch. July 31, 2007\).](#)