DIRECTORS' AND OFFICERS' LIABILITY

D&O ADVANCEMENT DEVELOPMENTS

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

OCTOBER 9, 2008

The Delaware Court of Chancery this summer issued several decisions of interest interpreting standard language contained in expense advancement and indemnification provisions of corporate bylaws or certificates of incorporation. This month I examine decisions holding that (1) a provision for mandatory advancement of attorney's fees and expenses pending the "final disposition" of an action encompasses appellate proceedings; (2) a company cannot condition advancement to corporate officials on their agreeing to confess judgment in the underlying suit and assign to the company any rights they have against a D&O insurer providing coverage pursuant to a reservation of rights; (3) outside counsel can qualify as an agent of the corporation entitled to advancement under bylaws and DGCL §145; and (4) mandatory retroactive advancement bylaws can be valid.

Final Disposition

Sun-Times Media Group Inc. v. Black[1] illustrates how broad, mandatory advancement provisions can result in continuation of a corporation's obligation to pay defense expenses for a substantial period after an adjudication of serious employment-related wrongdoing by former executives. Defendants in *Sun-Times* were former officers of Sun-Times Media Group Inc. (f/k/a/ Hollinger International) who were convicted of and sentenced on criminal charges arising out of alleged self-dealing at the expense of the company. After sentencing, the defendants initiated an appeal from the final judgment entered by the trial court. While the criminal appeals were pending in the Seventh Circuit, Sun-Times filed a declaratory judgment action seeking (i) a declaration that it had no obligation under the certificate or bylaws to advance funds to the defendants for appellate costs and for fees and expenses incurred post-sentencing; and (ii) a "clawback" repayment or setoff for amounts previously advanced to the defendants in connection with the criminal counts of which they were convicted. While the Delaware suit was pending, the Seventh Circuit affirmed the defendants' convictions.

---

* **Joseph M. McLaughlin** *is a partner at Simpson Thacher & Bartlett.*

The crux of the case was the meaning in Sun-Times' bylaws and §145(e) of the DGCL of the commonly used words providing for advancement of expenses pending "the final disposition of such action, suit or proceeding." Section 145(e) provides that a Delaware corporation may advance to indemnitees reasonable attorney's fees and other expenses incurred in defending "any civil, criminal, administrative or investigative action, suit or proceeding" and that the advancement obligation terminates at the time of "the final disposition of such action, suit or proceeding." The Sun-Times' bylaws tracked the statutory language but made advancement mandatory. The Sun-Times argued that, unless contractually modified, a terminal advancement date of "final disposition" ends entitlement to advancement at the time of sentencing, and appeals-related work cannot properly be the subject of advancement.

Vice Chancellor Leo E. Strine, Jr. disagreed, holding that "final disposition" does not occur until the final, nonappealable conclusion to the underlying proceeding. Although defendants' criminal defense options had narrowed to filing a petition for certiorari from the Seventh Circuit affirmance of their convictions, the Court of Chancery ruled that "final disposition" has "only one apparent meaning" in the context of advancement: "an action, suit or proceeding refers to a discrete administrative or judicial matter involving a particular subject and encompasses all its stages, and that the final disposition of such an action, suit or proceeding occurs when its outcome is no longer subject to any further review as of right." This conclusion was reinforced, the court reasoned, by the linkage in DGCL §145 and the bylaws of the term "final disposition" to the concept of ultimate indemnification. Advancement may be provided only upon receipt of an undertaking from the recipient that amounts advanced shall be repaid if the recipient, in the statutory language, "shall ultimately be determined" not to be entitled to indemnification. The Sun-Times argued that the "ultimate determination" of whether an official is entitled to be indemnified should be made after entry of final judgment at the trial court level. But "[t]he most logical reading of the text," the court stated, is that advancement must continue until the underlying proceeding is finally concluded, "in the sense that its outcome is not subject to further disturbance," because the ultimate determination of entitlement to indemnification can not be made before that point.

Sun-Times also serves as a reminder to review the certificate of incorporation and bylaws to ensure consistency of treatment of indemnification and other matters, as any inconsistent bylaw provision is invalid under DGCL §109(b). In *Sun-Times*, the bylaws included fairly standard language used to exclude indemnification for permissive counterclaims or third-party claims offensively asserted by the indemnitee: "the Corporation shall not be obligated to indemnify any director or officer in connection with a proceeding (or part thereof) initiated by such person unless such proceeding (or part thereof) was authorized or consented to by the Board." The certificate contained similar language but omitted the phrase "(or part thereof)," causing the court to declare invalid the additional restriction in the bylaws.

Extra-Contractual Conditions

Can a company condition payment under an advancement obligation on the official agreeing to

confess judgment in the underlying suit and to cooperate in the company's pursuit of recovery from a D&O insurer? Vice Chancellor Strine answered the question with a resounding "no." In *Barrett v. Am. Country Holdings Inc.*,[2] Kingsway sued former directors in an underlying securities fraud action, in which D&O insurer Great American funded defense costs. When defense costs were about to exhaust the D&O policy, the former directors requested advancement of expenses under Kingsway's charter. Kingsway refused unless the former directors would agree to the following arrangement calculated to advance Kingsway's effort to hold Great American liable for Kingsway's damages in the fraud suit. The former directors would agree to confess judgment in the fraud action for a specific amount and assign to Kingsway any coverage claims the directors had against Great American, even though the D&O policy included the customary provision barring assignment of such claims without the insurer's consent. Kingsway sought the assignment to facilitate its pursuit of bad-faith refusal to settle claims against Great American. Kingsway also represented it would not seek to collect from the former directors' personal assets. "Put bluntly," the court summarized the proposal, "Kingsway wanted the former directors to give it a club to beat Great American with and to do so without Great American's consent."

In a strongly worded post-tral opinion, the court ordered Kingsway to pay advancement and "fees on fees" to the former directors. Kingsway's proposal was an affront to the policy rationale for advancement and indemnification to encourage officials to resist unjustified allegations, the court stated, because officials sued for "official wrongdoing and who [are] owed advancement [are] entitled to have those rights honored" so that they "can defend their good name and personal wealth." The court emphasized that, even if Kingsway did not intend to collect on the judgment, "[n]o judgment in a fraud or other reputation-implicating case is costfree." The court held that officials therefore have no obligation to settle underlying suits for anything short of a full release dismissal of claims.

Section 145(e)'s allowance of a corporation to advance the costs of litigation to officials is permissive, not mandatory; companies are free to limit the terms of advancement and even deny advancement entirely. Picking up on criticisms expressed in several Court of Chancery advancement decisions in recent years, the court cautioned that the failure of some companies to use the flexibility authorized by law to revise loosely worded bylaws in appropriate circumstances could lead to shareholder claims: "[A]n all too often ignored factor in these kind of cases is that the stockholders will also end up footing the bill for the company's own counsel. The accumulation of cases like this, where the stockholders get it coming and going because of the corporation's refusal to honor mandatory advancement contracts, is regrettable, and at some point, a case of sufficient dollar value will arise such that a board is sued for wasting the corporation's resources by putting up a clearly frivolous defense."

"One wishes," the court continued "that the tsunami of regret that swept over corporate America regarding mandatory advancement contracts would have been followed by the more careful tailoring of advancement provisions, with a diminishment (especially as to officers) of the mandatory term that seems to so bother directors faced with the responsibility of actually ensuring that the corporation honors its contractual duties once a (typically) former officer is

sued or prosecuted for fraud or other serious wrongdoing."

Outside Counsel

In an issue of first impression in Delaware, Vice Chancellor Donald F. Parsons, Jr. held that a former outside litigation counsel who acted on behalf of a company in dealings with third parties qualifies as an "agent" under DGCL §145 and the company's bylaws, and therefore is entitled to advancement of legal fees and expenses. In *Jackson Walker LLP v. Spira Footwear Inc.*,[3] the law firm Jackson Walker represented Spira in a Texas litigation concerning the validity of a shareholders' agreement among major shareholders of Spira. After a change of control at Spira, the new board fired Jackson Walker, refused to pay the firm's outstanding legal fees, and sued the firm in Texas for breach of fiduciary duty and sought, inter alia, to recover fees previously paid to the firm, and to avoid accrued and unpaid fees. Jackson Walker then sued Spira in Delaware to obtain advancement of its attorney's fees and expenses in defending the claims brought against it by Spira in Texas.

Spira's mandatory advancement provision directed payment of legal expenses "upon receipt of an undertaking by or on behalf of the Director, officer, employee or agent . . . ." In *Fasciana v. Elec. Data Sys. Corp.*,[4] the Court of Chancery held that an outside lawyer who performed corporate transactional work and who later was alleged in various proceedings to have engaged in misconduct in his capacity as legal advisor to the corporation was not entitled to advancement, because an "agent" under §145 does not include lawyers who provide legal advice to a corporate client unless they act on the client's behalf in dealing with third parties. In *Jackson Walker*, the alleged wrongs for which Spira sued Jackson Walker involved conduct in which the firm acted as litigation counsel on behalf of Spira in relations with third parties, and therefore qualified as an agent entitled to advancement. It did not matter that Jackson Walker provided some legal services not directly related to the Texas litigation because the firm's primary role was to represent Spira in the Texas action. The court acknowledged that "Delaware courts understandably proceed with caution in granting advancement and indemnification to agents in general, and to attorneys in particular," but "the General Assembly has provided Delaware corporations with the option of advancing and indemnifying litigation expenses for their agents" without identity limitation. Continuing the theme mentioned earlier in this article, the court noted that "Spira was, and is, free to craft a narrower bylaw, and then to provide narrower advancement and indemnification rights in its contracts with outside contractors." Until then, however, a law firm whose services entail dealings with third parties on behalf of the company is eligible for advancement and indemnification where bylaws or other mechanism extend such rights to agents.

Retroactive Advancement

In *Underbrink v. Warrior Energy Services Corp.*,[5] plaintiffs were former directors of Warrior who sought advancement for expenses incurred in a Texas suit to which they were added as defendants several months after their board service concluded upon completion of a secondary public offering. The company (which had recently been acquired) declined payment, arguing

that its pre-acquisition directors breached their fiduciary duties by, shortly before the secondary offering, adopting amended and restated bylaws providing for mandatory and retroactive reimbursement of litigation expenses at a time when these directors faced an imminent threat of litigation. Warrior argued the advancement bylaw was invalid for numerous reasons, including (i) that it was adopted by written consent, and not at a meeting as purportedly required under bylaws; (ii) that the retroactivity provision, which would make advancement mandatory with respect to acts that occurred prior to the adoption of the bylaws, was invalid for lack of consideration; (iii) that the directors failed to conduct any analysis regarding the value of the specific reimbursement obligation or whether such reimbursement would be in the best interests of the company; and (iv) plaintiffs' undertakings were inadequate because they contained a limitation that they would not repay amounts advanced until "all appellate remedies related to [a determination that they are not entitled to indemnification] have expired or been exhausted."

The court rejected each argument. The adoption of the advancement bylaw through written consent was valid, the court ruled, because DGCL §141(f) permits approval by unanimous written consent of any action required or permitted to be taken at a board meeting, unless restricted by the certificate or bylaws, and nothing in the Warrior certificate or bylaws could be read as restricting the power of the board to amend the bylaws by unanimous written consent. Rejecting the argument that the retroactive advancement provision lacked consideration because the plaintiffs approved no actions as directors contemporaneously with or after passage of the amended bylaws, the court countered that before they resigned the plaintiffs approved many of the necessary components for the secondary offering and shortly thereafter signed Warrior's S-1 registration statement.

Warrior's argument that adoption of the advancement provision was subject to entire fairness review because plaintiffs self-interestedly protected themselves from imminent litigation fared no better. The court followed *Orloff v. Shulman*,[6] in which the Court of Chancery held that where plaintiffs challenge the adoption of a mandatory advancement bylaw that requires the corporation to advance litigation expenses sometime in the future rather than a board decision to advance particular litigation expenses in the absence of a mandatory advancement provision, the board decision is subject only to business judgment review. The court determined that when the board adopted the bylaws, plaintiffs faced only an "imminent threat of litigation" for actions they took as Warrior directors, so that Warrior's mandatory advancement provision would be valid unless it was "unreasonable," which it was not. Finally, the form of undertaking provided by plaintiffs satisfied the bylaw requirement, derived from DGCL §145(e), that indemnitees provide "a written undertaking executed by or on behalf of the Indemnitee providing that the Indemnitee will repay the advance if it shall ultimately be determined that the Indemnitee is not entitled to be indemnified . . . ." The limitation in plaintiffs' undertakings that they would not repay amounts advanced until "all appellate remedies related to [a determination that they are not entitled to indemnification] have expired or been exhausted" did not run afoul of the bylaws because consistent with *Sun-Times*, supra, the position that "final disposition" of a proceeding does not occur until all appellate remedies had been exhausted or expired was at least colorable, and in any event Warrior had forfeited the objection by failing to object to the form of plaintiffs'

undertakings contemporaneously with its initial denial of the requests for advancement.

Endnotes:

1. 954 A.2d 380 (Del. Ch. 2008).

2. 951 A.2d 735 (Del. Ch. 2008).

3. 2008 WL 2487256 (Del. Ch. 2008).

4. 829 A.2d 160 (Del. Ch. 2003).

5. 2008 WL 2262316 (Del. Ch. 2008).

6. 2005 WL 5750635 (Del. Ch. 2005).