DIRECTORS' AND OFFICERS' LIABILITY

INDEMNIFICATION UPDATE

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Delaware courts have recently issued decisions with important ramifications for the rights of directors and officers to indemnification and interim advancement by the corporation of litigation-related expenses. It will surprise some corporate officials to learn that unless additional protections suggested in this article are secured, the company can, as the Court of Chancery held, eliminate their advancement rights without their consent through bylaw amendment, even if their entire board service occurred under pre-amendment bylaws providing for advancement and the amendment eliminating their rights was approved after they left the board. The Chancellor and a Vice Chancellor of the Delaware court also issued decisions taking different approaches to the recurring issue of availability of advancement for counterclaims asserted by corporate officials in litigation against the company, with the Vice Chancellor suggesting that the Delaware Supreme Court needs to revisit this issue. In addition, a Third Circuit decision broadly interpreting a professional services exclusion identified in a D&O coverage binder underscores the importance of directors and officers of entities that provide investment management and advisory services ensuring their company has secured adequate errors and omission coverage to fill a potential coverage gap in their D&O policy.

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. Section 145 of the DGCL sets forth Delaware's statutory basis for indemnification and advancement. "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

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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.

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, section 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 by law 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.[1]

Vesting of Advancement Rights

There is no question that a right to advancement provided in bylaws or elsewhere can become a vested contract right which cannot be unilaterally terminated by the corporation.[2] But when does vesting occur? In *Schoon v. Troy Corp.*,[3] the Delaware Court of Chancery enforced a bylaw amendment approved by the board eliminating the availability of advancement of litigation-related expenses for former directors even though a former director sought advancement for conduct that occurred under a pre-amendment bylaw granting advancement to former directors. *Schoon* arose out of a dispute between the Troy Corporation and a major shareholder, the Bohnen family, which held approximately one-third of Troy's total equity. William Bohnen served as a director of Troy from 1998 until his resignation in 2005. Several months after Bohnen's resignation, the board approved amendments to Troy's bylaws which, among other things, eliminated the provision for advancement to former directors. Three months after the amendment, Troy sued Bohnen for breaches of fiduciary duty arising out of his alleged role while a director in providing Troy's confidential information to third parties.

Contrary to the assumption of many corporate officials, advancement rights do no vest, the court concluded, when the person becomes a director, or even upon accrual of the cause of action for which advancement is sought. Rather, vesting occurs when the corporation's obligations are triggered, *i.e.*, when the director is named in a proceeding for which advancement is available, or some firm indication exists (such as an investigation) that the potential claimant is contemplating claims against the director.

The court analyzed the effect on vesting of fairly standard bylaw language that the rights conferred in the bylaws "shall continue as to a person who has ceased to be a director or officer and shall inure to the benefit of such person." Rather than voiding a bylaw amendment that eliminates advancement availability for former directors, this language "is better understood as providing that a director, whose right to advancement is triggered in office, does not lose that right by ceasing to serve as a director." Thus the provision was of no benefit to Bohnen, who resigned before a proceeding was initiated against him.

The court also declined to derive a vested right to advancement from the corporation's continued provision in its amended bylaws for indemnification of former directors. As courts have emphasized repeatedly, indemnification is related to but distinct from advancement, and the corporation's clear separation of the two and provision "for unequal treatment of current and former directors in receiving advancement" must be enforced.

While the enforcement of post-service bylaw amendments eliminating former director advancement right may disconcert some corporate officials, steps can be taken to lock in advancement rights which cannot be altered without the director's consent. First, the company and directors can agree in individually-negotiated written contracts on the scope and details of advancement and indemnification rights, and the rights provided in such contracts cannot be altered without the director's consent. Alternatively, the company may decide that vesting should be addressed in the bylaws, and could offer protection either by providing that advancement and indemnification rights vest when the individual joins the board, or stating that any amendment or modification of the bylaws affecting such rights will not alter the rights of directors with respect to conduct pre-dating the amendment or modification without the affected individuals' express consent.

Advancement for Counterclaims

Indemnification and advancement provisions typically limit the company's payment obligation to costs associated with the "defense" of a proceeding. Corporations have the contractual freedom to expressly exclude counterclaims from advancement, but in practice few do. In *Reinhard & Kreinberg v. Dow Chem. Co.*,[4] another advancement dispute, the Delaware Court of Chancery examined when counterclaims should be considered "defenses," thus entitling counterclaimant corporate officials to advancement and indemnification. *Reinhard & Kreinberg* also evidences continuing judicial exasperation with advancement disputes: Chancellor Chandler compared adjudicating such disputes to acting as "playground monitor, refereeing needless and inefficient skirmishes in the sandbox," a task which the court "does not relish and will not perform."[5] The Chancellor noted that indemnification proceedings generally are better vehicles for resolution of the parties' respective responsibilities for litigation expenses, and urged the parties to set aside their differences—at least temporarily—and reach a good-faith agreement regarding advancement.

Reinhard and Kreinberg, former Dow Chemical executives whom Dow had sued in the Eastern District of Michigan, raised counterclaims against Dow, and then sued in the Delaware

Court of Chancery to compel advancement of their litigation expenses. The parties eventually stipulated that Dow would advance expenses "incurred in connection with plaintiffs' defense against Dow's claims." Thereafter, Dow refused to advance expenses incurred in pursuing the counterclaims, arguing that counterclaims are not "defenses" subject to advancement. In *Citadel Holding Corp. v. Roven*,[6] the Delaware Supreme Court had defined "defense" in the advancement context to include "legal work on [directors'] affirmative defenses and compulsory counterclaims." Whether the *Reinhard & Kreinberg* counterclaims constituted part of the "defense" of Dow's lawsuit under the stipulation thus turned on whether the counterclaims were permissive or compulsory. Chancellor Chandler reasoned that because compulsory counterclaims will be barred unless asserted in the suit, they are part of a litigant's "defense" because the initiation of the suit forces the defendant either to raise them or lose them. Conversely, because a defendant may choose not to raise a permissive counterclaim without risk of forfeiting the claim, permissive counterclaims are not deemed part of the "defense" and advancement would not be available.

The court declined to decide the nature of the counterclaims. Plaintiffs argued that the Michigan court's order consolidating the claims and counterclaims for trial constituted a determination that the counterclaims were compulsory and that this determination was entitled to preclusive effect, but Chancellor Chandler held that the consolidation order was not a determination of whether the claims were permissive or compulsory. Noting that the advancement dispute involved an advancement agreement entered under Delaware law but governing legal expenses incurred in a diversity suit pending in Michigan, the court requested additional briefing on what law should govern the determination of the nature of the counterclaims.

Last month, in *Zaman v. Amedeo Holdings, Inc.*[7], Vice Chancellor Strine addressed the tricky interpretive question of the availability of advancement under *Roven* for counterclaims asserted by a corporate official in a jurisdiction, such as New York, in which all counterclaims are permissive. The court began by noting that that perhaps "*Roven* never should have embraced the idea that any type of counterclaim was subject to advancement under a contractual right for 'defending' an action." *Roven*'s compulsory counterclaim standard remains the law, however, and if applied literally counterclaims asserted in a jurisdiction without traditional compulsory counterclaim rules would never be subject to advancement. The Court of Chancery concluded that rather than assume the Delaware Supreme Court intended only counterclaims recognized as compulsory under the forum's law to qualify as "defensive" for purposes of triggering advancement rights, "the interpretation of the 'in defending' limitation most faithful to the Supreme Court's teaching in *Roven*, is that the costs of prosecuting a counterclaim should be subject to advancement if the counterclaim would qualify as a compulsory counterclaims under the traditional counterclaim test used by both Delaware and federal civil procedure *and* when that counterclaim so directly relates to a claim against a corporate official such that success on the counterclaim would operate to defeat the affirmative claims against the corporate official." That is, a counterclaim fits within the "in defending" language if it defends the corporate official by directly responding to and negating the affirmative claim. This standard does offer a way to apply the *Roven* test to counterclaims

asserted in jurisdictions that do not recognize traditional compulsory counterclaim rules, but Vice Chancellor Strine has identified an ambiguity in *Roven* that warrants Supreme Court guidance.

D&O Professional Services Exclusion

Directors and Officers ("D&O") liability insurance policies issued to companies whose employees render professional services to others for a fee (*e.g.*, accounting firms and investment advisors) usually contain a "professional services exclusion." The coverage gap created by this exclusion from D&O coverage ordinarily is filled by an Errors and Omissions ("E&O") insurance policy, which covers claims alleging that the insured was negligent in providing professional services. In *MDL Capital Management, Inc. v. Federal Insurance Company*,[8] the Third Circuit adopted an expansive reading of a professional services exclusion referenced in a D&O coverage binder, and affirmed a summary judgment ruling barring coverage for an SEC investigation and related private litigation against an investment advisory firm and certain of its directors and officers. However, the court reversed a denial of E&O coverage based on a to-be-agreed-on manuscript endorsement referenced in an E&O binder. Although the decision is designated non-precedential, its reasoning is instructive on the interpretation of a professional services exclusion and coverage binders.

The insurer issued separate binders to MDL Capital, an investment advisor, for D&O and E&O coverage. Insurance binders are written instruments issued to evidence coverage until the details of the policies have been worked out or the risk is declined. Unless the parties have already expressly agreed to different terms, binders afford the coverage described in a specified standard-form policy. Portions of the binders at issue in this case showed that the parties intended to deviate from the terms of the form D&O and E&O policies, but had not worked out important details. The D&O binder referenced a specific policy form of the insurer, which contained a professional services exclusion barring coverage for, *inter alia*, "Loss on account of any Claim based upon . . . failure to render professional services, including but not limited to the following services: i. broker; ii. dealer; iii. financial adviser; iv. investment adviser; v. investment banker; vi. investment manager."

The E&O binder contained an endorsement titled "Broad Private Fund Exclusion" and referenced three MDL-managed funds, but expressly provided that the "endorsement wording [is] to be developed." Before final policies were issued, an investor in a private fund sued MDL Capital and three of its directors alleging losses stemming from defendants' mismanagement of the fund. In addition, the SEC commenced an investigation into potential securities law violations by MDL Capital and affiliated individuals regarding private funds.

Affirming the district court grant of summary judgment, the Third Circuit held that the breadth of the professional services exclusion compelled the conclusion that the D&O binder covered neither the private litigation nor the SEC investigation. Reviewing the allegations in the lawsuit, the court concluded that the claims challenged actions of MDL Capital in two capacities: investment manager and investment advisor, both of which the court concluded fell

squarely within the professional services exclusion. The court acknowledged that the lawsuit also challenged conduct of MDL Capital directors in their director capacity, *i.e*, their alleged failure to oversee the activities of MDL Capital, but concluded that these alleged failures of oversight also stemmed from MDL Capital's alleged failings as investment manager and investment advisor, so that *all* claims against the directors, ranging from fraud, state securities Act, negligence, breach of fiduciary duty and breach of contract, were excluded from coverage. This ruling is noteworthy because its focus on the policyholder's alleged wrongdoing when interpreting an exclusion resulted in no coverage even for claims that are unrelated from the perspective of the directors to the provision of professional services.

Similarly, the court concluded that the D&O binder did not cover the SEC investigation, in which the Staff alleged that entities affiliated with MDL Capital may have "defrauded or deceived individuals in connection with the offer, purchase and sale of securities . . .engaged in fraudulent transactions, practices or courses of business . . . made unauthorized transactions in the course of its business and attempted to conceal losses from these transactions and . . . failed to keep accurate records and books." The professional services exclusion barred coverage for the investigation because "[t]hese allegations are based upon MDL Capital's providing of, or failure to provide, investment adviser or investment manager services."

The Third Circuit also rejected the directors' contention that the binder's Outside Directorship endorsement granted coverage for the claims. Significantly, the endorsement expressly provided that outside directorship coverage would be limited to services provided for enumerated outside entities, the identification of which the insurer and the policyholder never accomplished.

The court's analysis of the E&O binder led it to directors' continue the analysis of the consequences of an omission in the negotiated scope of coverage. Here, the binder contained an endorsement purporting to exclude certain MDL private funds from coverage; however, beyond the endorsement's title, it only stated "(endorsement wording to be developed)." Importantly, the binder also provided that relevant "titles and headings are for convenience only." The district court had sided with Federal Insurance, holding that the title itself sufficiently demonstrated mutual intent to exclude the relevant funds from coverage. The Third Circuit reversed, noting that courts should not "rewrite the parties' agreement in order to give effect to the parties' conflicting views of what the Exclusion was intended to accomplish," and holding that excepting the title (which, being "for convenience only," did not bind the parties to anything), the parties never agreed on what the exclusion would provide and thus it provided no basis to bar coverage. In addition to its teaching on the potential breadth of a professional services exclusion, the decision also illustrates the risk both to insurers and insureds of leaving potentially critical subjects open in an insurance binder.

[1] *See, e.g.*, *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 212 (Del. 2005).

[2] *Salaman v. National Media Corp.*, 1992 WL 808095 (Del. Super. 1992).

[3] *Schoon v. Troy Corp.*, 2008 WL 821666 (Del. Ch. Mar. 28, 2008).

[4] 2008 WL 868108 (Del. Ch. Mar. 28, 2008).

[5] *Id.* at *5.

[6] 603 A.2d 818 (Del. 1992).

[7] 2008 WL 2168397 (Del. Ch. May 23, 2008).

[8] 2008 WL 876406 (3d Cir. Apr. 2, 2008).