# Indemnification of Directors and Officers: Recent Developments in Delaware Law

## I. Indemnification and Advancement of Expenses

Under Section 145 of the Delaware General Corporation Law ("DGCL"), corporations have extensive power to indemnify directors, officers and others against threatened, pending and completed legal actions.[1] Under Section 145(e) of the DGCL, this power extends to providing advancement of legal fees; *provided* that the director or officer agrees to repay such advancement if ultimately determined not to be entitled to indemnification. Delaware corporations can opt to protect their directors further by including in their corporate charters a provision eliminating or limiting personal liability for monetary damages for breach of fiduciary duty as a director[2] and/or by entering into separate indemnification agreements with their directors and officers.

Recent legislation and decisions from the Delaware Chancery Court have cast new light on the law regarding indemnification of, and advancement of expenses to, directors and officers. Accordingly, Delaware corporations and their advisors should review their indemnification arrangements with directors and officers to ensure that the arrangements provide the protection intended.[3]

## II. Delaware Legislature Overrides Retroactive Elimination of Indemnification and Advancement of Expenses

On April 10, 2009, Delaware Governor Jack Markell signed into law House Bill 19 (effective August 1, 2009) containing important amendments to the DGCL. Among other things, the new law provides:

> A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to such provision after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or

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1 The only limitations in civil suits are (i) that the indemnified person must have acted in good faith and with a reasonable belief that he or she was serving the best interests of the company and (ii) that a company may not indemnify a person found liable to the company itself, unless a court rules otherwise. With respect to a criminal act or proceeding, the officer or director must not have had reasonable cause to believe that his or her act was unlawful. DGCL § 145.

2 DGCL § 102(b)(7) provides that corporations may include a provision in their corporate charters for this purpose. There are further exceptions to this right of exculpation, however, such as when the director's act or omission is determined to lack good faith or involve intentional misconduct or a knowing violation of the law. The Delaware Supreme Court recently held in *Gantler* v. *Stephens*, 965 A.2d 695, 709 (Del. 2009), that "officers and directors of Delaware corporations have identical fiduciary duties." The court took care to note that despite the commensurate obligations of directors and officers, DGCL Section 102(b)(7) does not expressly permit exculpation of officers from liability for breaches of their duty of care in the current statutory provision. *Gantler* v. *Stephens* also leaves unclear the extent to which officers' acts or omissions will be subject to the business judgment rule.

3 Companies also customarily provide directors' and officers' liability insurance to persons serving in those capacities. The important role such insurance plays in protecting such persons, and its inter-relationship to corporate indemnification arrangements, is beyond the scope of this memorandum.

omission explicitly authorizes such elimination or impairment after such action or omission has occurred.[4]

The legislation overrides the Delaware Chancery Court's holding in *Schoon* v. *Troy* in which Vice Chancellor Lamb held that a contractual right to advancement of expenses under corporate bylaws only vested upon a director being named as a defendant in the relevant action or proceeding.[5] In *Schoon* v. *Troy*, the defendant, a former director of Troy Corporation, had not been named as a defendant in the breach of fiduciary duty action until after he had resigned from the board of directors and after Troy Corporation had amended its bylaws to eliminate advancement of expenses to former directors.

## III. Recent Cases

### *Underbrink v. Warrior Energy Services Corp.*[6] *- "Imminent Threat of Litigation" Not Enough to Invalidate Amendment to Bylaws*

In *Underbrink* v. *Warrior*, the court considered the question of whether a board may validly adopt a compulsory advancement bylaw that applies retroactively.

St. James Capital Partners, L.P. and St. James Merchant Bankers, L.P. (collectively, "the St. James Partnerships") invested over $20 million in Warrior Energy Services Corporation ("Warrior") from June 1997 through February 2000. Two of the general partners of the St. James Partnership, Charles Underbrink and James Harrison, became directors of Warrior. As of December 2000, investors in the St. James Partnerships had lost over $15 million. In 2002, certain limited partners brought lawsuits against the St. James Partnerships and Messrs. Underbrink and Harrison. At that time, the allegations did not mention Warrior and did not relate to Messrs. Underbrink and Harrison in their capacity as directors of Warrior. As the lawsuits slowly progressed, Warrior conducted a secondary public offering in April 2006. In connection with the offering, Messrs. Underbrink and Harrison resigned as directors of Warrior so that the resulting vacancies could be filled by independent directors. In addition, Warrior's bylaws were amended to provide for mandatory indemnification and advancement of expenses to former and current directors.

In November 2006, Warrior was added as a defendant to the lawsuits brought by the limited partners of the St. James Partnership. Messrs. Underbrink and Harrison were also added as defendants in their capacity as former directors of Warrior. In December 2006, Warrior became a wholly owned subsidiary of Superior Energy Services, Inc. When Messrs. Underbrink and Harrison made a request for advancement, Warrior denied the request, claiming that the adoption of the amended bylaws was invalid because their adoption was a breach of the directors' fiduciary duties. Warrior argued that the validity of the adoption of the amended bylaw should be assessed under an "entire fairness" test asserting that Messrs. Underbrink and Harrison "knew that they were being targeted as directors of Warrior"[7] and so were acting in their own self-interest in voting to approve the bylaw amendment.

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[4] *An Act to Amend Title 8 of Delaware Code Relating to the General Corporation Law*, 77 Del. Laws. Chapter 14, 145th General Assembly, formerly House Bill No. 19. Section 3 of the Act amending subsection (f) of § 145, Title 8, Delaware Code.

[5] 948 A.2d 1157 (Del. Ch. 2008).

[6] 2008 WL 2262316 (Del. Ch. 2008).

[7] *Id.* at 12.

Vice Chancellor Parsons found that Messrs. Underbrink and Harrison faced at most "an imminent threat of litigation" at the time the bylaws were amended, and therefore their decision was entitled to the protection of the business judgment rule. In applying that standard, the court found the retroactive mandatory advancement bylaw amendment to be valid.

***Sun-Times Media Group Inc. v. Black*[8] - *Indemnification Rights Apply Throughout Appeals Process***

Like many Delaware corporations, Sun-Times' bylaws provided for advancement of expenses pending "the final disposition of such action, suit or proceeding." The bylaw language drew directly from DGCL § 145(e). Defendants were former officers of Sun-Times Media Group who, after a four-month jury trial, were convicted of self-dealing at the expense of the company. The question for the Delaware Chancery Court was whether Sun Times' advancement obligations continued during the defendants' appeal to the U.S. Court of Appeals for the Seventh Circuit and, potentially, during an appeal to the U.S. Supreme Court.

Vice Chancellor Strine concluded that "final disposition" is the final, non-appealable conclusion of a proceeding, when a "conclusive determination of the subject matter" has been made. The Court concluded by noting that DGCL Section 145(e) is permissive, not mandatory, and therefore a corporation is free to limit the terms of advancement, including circumscribing mandatory advancement to exclude advancement for costs incurred during the appellate stages of a proceeding.

***Barrett* v. *American Country Holdings, Inc.*[9] - *Corporations May Not Impose Conditions to Indemnification and Advancement of Expenses Not Contained in Operative Documents***

Kingsway Financial Services, Inc. ("Kingsway") sued former directors for securities fraud in which a D&O insurer 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 confess judgment in the fraud action for a specific amount and assign to Kingsway any coverage claims the directors had against the insurer. Kingsway made its request notwithstanding the fact that the D&O policy included a customary provision barring assignment of such claims without the insurer's consent.

Vice Chancellor Strine noted that "the very purpose of an advancement right is to enable a corporate official to protect herself against claims of official wrongdoing." Thus, continued the court, the corporation "has no right to breach its obligation to those it has sued on the pretense that the former directors will not agree to the entry of an adverse judgment in a securities case. The former directors have every right to defend the case and to seek a complete vindication, one which will minimize the reputational consequences they have already suffered as a result of the corporation's charges of intentional fraud." Finally, Vice Chancellor Strine emphasized that stockholders are adversely affected when the corporation refuses to honor mandatory advancement contracts. "[A]t 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."[10]

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8 954 A.2d 380 (Del. Ch. 2008).

9 951 A.2d 735 (Del. Ch. 2008).

10 *Id.* at 747.

***Levy v. HLI Operating Company, Inc.*[11] *- Co-indemnitors Need to Explicitly Agree Among Themselves Their Respective Indemnity Obligations or Equitable Contributions Will Be Imposed***

In 2001, the audit committee of HLI Operating Company ("Old Hayes"), 34 percent of which was owned by the private equity firm Joseph Littlejohn & Levy Fund II, L.P. ("JLL Fund"), publicly announced that the company's financial statements from 1999 to early 2001 would need to be restated. Shortly thereafter, lawsuits were filed by stockholders and bondholders against the company, its officers and its directors for various federal securities law violations. In December 2001, Old Hayes filed for protection under Chapter 11 of the Bankruptcy Code, and in May 2003, the bankruptcy court approved a reorganization plan. In May 2005, the parties to the federal securities actions and the insurance carriers for the corporation reached a settlement that provided for payment by the insurance carriers and certain former directors. After reaching this settlement, the former directors sought indemnification payments from Old Hayes under its bylaws, each of their separate indemnification agreements and the reorganization plan.

Vice Chancellor Lamb found that, because four of the former directors had already received indemnification payments from JLL Fund, these former directors suffered no actual loss. As a result, the appropriate cause of action was a claim for equitable contribution by JLL Fund against Old Hayes as co-indemnitor, since there was no contractual arrangement as to how the shared liability would be divided. The court went on to find Old Hayes liable for one-half of the indemnification paid to the four directors affiliated with JLL Fund.

This case highlights the need for private equity firms to ensure that the rights and priorities of indemnification obligations among the firm, its funds and the portfolio companies in which it invests are clearly defined in the various indemnity agreements, charter documents and bylaws of the various entities.

***Sodano v. AMEX LLC*[12] *- Hierarchical Indemnification and Advancement of Expenses Structures Will Be Honored***

After acquiring the American Stock Exchange LLC ("AMEX") in 1998, the National Association of Securities Dealers ("NASD") requested that Salvatore Sodano serve as the CEO and chairman of AMEX. The NASD granted Sodano advancement of expenses and indemnification rights related to his work at AMEX, but the agreement explicitly stated that these obligations were secondary to any indemnification or advancement of expenses that Sodano might collect from AMEX.

Vice Chancellor Strine held that in accordance with the operative documents, the NASD and AMEX were not co-indemnitors with coequal indemnification obligations. Rather, AMEX was required to indemnify and advance expenses to Sodano first and the NASD was obligated to indemnify and advance expenses second, and then only if AMEX was financially or legally unable to make such payments. This case confirms that Delaware courts will honor hierarchical structures and other detailed arrangements with regard to indemnification and advancement of expenses as long as they are spelled out clearly.

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11 924 A.2d 210 (Del. Ch. 2007).

12 2008 Del. Ch. LEXIS 92 (Del. Ch. 2008).

***Jackson Walker L.L.P* .v. *Spira Footwear, Inc.*[13] *- Litigation Counsel Meets the Definition of "Agent"***

The law firm Jackson Walker L.L.P. was hired by Spira Footwear, Inc. ("Spira") in connection with a dispute among Spira's stockholders. After a change in control of Spira, the new board of directors terminated Jackson Walker, refusing to pay the firm's outstanding legal fees. The new board claimed that Jackson Walker had breached its fiduciary duties and wrongfully advanced the interests of the former owners to the detriment of Spira. Jackson Walker then filed an action for advancement of expenses, claiming that Spira's bylaws provided it with such right by reason of the fact that it was an agent of Spira.

Vice Chancellor Parsons began by noting that "Delaware courts understandably proceed with caution in granting advancement and indemnification rights to agents in general, and to attorneys in particular." However, because Jackson Walker was given the authority to act on behalf of Spira in its capacity as litigation counsel, Jackson Walker met the definition of agent under Section 145 when acting in such capacity. "As outside litigation counsel, Jackson Walker was Spira's agent because it had the 'power to act on behalf of the principal with third persons.' Trial lawyers have the ability to bind their client in dealings with the court and other parties to the litigation. Thus, in litigation, attorneys regularly act as an arm of the corporation vis-à-vis the outside world."[14]

## IV. Conclusion

Companies should review their charter documents, bylaws, agreements with individual officers and directors to confirm that they meet the mutually agreed needs and goals of the company and its directors and officers. Parties should be aware that courts will scrutinize the language of such documents to ascertain the degree of indemnification, advancement of expenses and coverage afforded in such documents. In addition, a director or officer may be entitled to indemnification from a number of entities and in such cases, consideration should be given to the hierarchical structure established by the relevant documentation and whether it appropriately reflects the priorities which the parties intended.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Richard E. Farley at 212.701.3434 or rfarley@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

13 2008 WL 2487256 (Del. Ch. 2008).

14 *Id.* at 6 (quoting *Fasciana* v. *Electronic Data Systems Corp.,* 829 A.2d 160 (Del. Ch. 2003) )(internal quotations omitted).

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