

CONCLUSION

A "material" fact for 14a-9 purposes, whose omission from a proxy statement will render the issuer liable, is one in which there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. What is required is proof that under all the circumstances the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder.

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INDEMNIFICATION OF CORPORATE OFFICERS UNDER
SECTION 145 OF THE DELAWARE GENERAL
CORPORATION LAW

In 1967 the Delaware legislature enacted broad changes in the state's General Corporation Law. One of the most controversial revisions¹ was in the area of indemnification of corporate officers, directors, employees and agents.²

Following Delaware's lead, the 1969 revision of the Model Business Corporation Act of the American Bar Association³ included the same wording as the Delaware statute. Illinois is now the only state which has not enacted some version of statutory indemnification of corporate officers and directors.⁴ Every other state, the District of Columbia, and the Virgin Islands have enacted a form of enabling legislation which either requires or permits indemnification of corporate officers and directors.⁵

The Delaware statute requires the indemnification of officers, directors, employees or agents who have "been successful on the merits or otherwise in defense of any action, suit or proceeding"⁶ which arises out of their corporate duties. The mandatory indemnification section specifically includes all "expenses (including attorneys' fees) actually and reasonably

1. 56 Del. Laws, ch. 50, § 1.

2. 8 DEL. C. § 145.

3. ABA-ALI MODEL BUS. CORP. ACT § 5 (1969).

4. Idaho is the most recent state to permit indemnification of a corporate director or officer. 30 IDAHO CODE § 166 (1976). The recent Idaho Act has a mandatory indemnification clause, 30 IDAHO CODE § 166(c) similar to 8 DEL. C. § 145(c).

5. W. E. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, §§ 16.04 and 16.05 (2d Ed. Supp. 1974).

6. 8 DEL. C. § 145(c).

incurred"⁷ in connection with such actions.⁸ Section 145(g) permits a corporation to purchase and maintain insurance against such liability.

The official comment to the Model Business Corporation Act describes the purpose of adopting the indemnification section:

The subject of indemnification by a corporation of its directors, officers, and employees against the expenses incurred by them in defending claims and actions for personal liability based upon alleged breach of some official duty has been one of increasing importance since the turn of the century. Demands for financial protection against personal attack have grown with the proliferation of derivative suits, civil and criminal actions in anti-trust matters, and actions instituted under other federal or state laws. Some recent actions are not based upon statute but upon errors of business judgment.⁹

Despite the nationwide trend toward liberalizing indemnification statutes, much criticism has accompanied the development. The following excerpt from an article by Professor Joseph W. Bishop, Jr. regarding the Delaware statute is typical of the continuing debate on indemnification versus public policy:

The objective of the 1967 revision of the Delaware statute on indemnification is apparently not to place limits on the protection of guilty management, but to make explicit the power of management to indemnify itself in situations where, under the original artless enactment of an untutored legislature, courts and commentators had questioned the propriety of indemnification.¹⁰

A recent book by Ralph Nader¹¹ made a broad attack on the indemnification statute. Nader and his associates described the statute as follows:

As written, this provision permits the corporation to insulate its officers from all potential liabilities. Officers may be insured against any negligence, self-dealing, looting the corporation or embezzlement, all conflicts of interest, and deliberate statutory violations. They may be reimbursed for violations of federal safety, civil rights, environmental, tax or anti-trust laws. . . .

Why should an executive of a drug company be indemnified for the costs of a criminal fine if he is convicted of allowing a harmful drug

7. *Id.*

8. Thirty states presently have similar mandatory requirements: Alabama, Alaska, Arkansas, California, Connecticut, Florida, Georgia, Idaho, Kansas, Kentucky, Louisiana, Minnesota, Michigan, Mississippi, Missouri, Nebraska, Nevada, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Virginia, Washington and Wisconsin. KNEPPER, *supra* note 5, at § 16.04.

9. ABA-ALI MODEL BUS. CORP. ACT, § 5, Comment (1971).

10. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1081 (1968) (footnotes omitted).

11. R. NADER, M. GREEN, J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976).

to injure several thousand people when the same act as a private individual would send him to jail? An untenable double standard has been created.¹²

Despite the heated controversy it has generated, the Delaware indemnification statute has been considered in only three reported opinions.¹³

An examination of these cases sheds light on the public policy which underlies the Delaware indemnification statute. These judicial interpretations have eroded the conjecture on which some of the critics based their broad condemnations and also provide a background against which to view the corporate director's desire for personal indemnification rights.

A chronological approach to the three reported cases provides the simplest method for understanding the judicial construction given to some of the most controversial parts of the statute.

In the first Merritt-Chapman & Scott¹⁴ case (hereinafter referred to as *MCS*), indemnification was denied to two directors of the plaintiff corporation and an officer of a subsidiary. The three directors had been indicted in 1966 by a federal grand jury in New York for filing false reports with the New York Stock Exchange and the Securities and Exchange Commission in violation of section 10(b) of the Securities Exchange Act of 1934.¹⁵ The three directors sought payment of attorneys' fees and expenses incurred in defending *part* of one count of fraud in violation of section 10(b) of the Act¹⁶ which the federal court had dismissed. The court refused indemnification under the Delaware statute since the defendant directors had been found guilty of five related counts of perjury, subornation of perjury, filing false statements with the SEC, obstruction of justice, and fraud upon the corporate shareholders.¹⁷ The court stated:

Indemnification statutes were enacted in Delaware, and elsewhere, to induce capable and responsible businessmen to accept positions in corporate management. . . . 8 Del. C. §145 . . . give[s] *vindicated* directors and others involved in corporate affairs a judicially enforceable right to indemnification.

It would be anomalous, indeed, and diametrically opposed to the spirit and purpose of the statute and sound public policy to extend the benefits of indemnification to these defendants. . . .¹⁸

Three defendant directors filed an appeal in the Supreme Court of Delaware. However, before any further action was taken in the *MCS*

12. *Id.* at 108.

13. *Merritt-Chapman & Scott Corp. v. Wolfson*, 264 A.2d 358 (Del. Super. Ct. 1970), *Galdi v. Berg*, 359 F. Supp. 698 (D. Del. 1973), *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. Super. Ct. 1974).

14. 264 A.2d 358.

15. *Id.* at 359. *See also* 321 A.2d at 140.

16. 15 U.S.C. § 78j(b) (1970).

17. *United States v. Wolfson*, 282 F. Supp. 772 (S.D.N.Y. 1967).

18. 264 A.2d at 360 (emphasis added).

case, the federal district court considered the Delaware indemnification statute in an unrelated case in May, 1973.¹⁹

The court granted indemnification for attorneys' fees of \$5,692.91 relying on section 145(c) and the 1970 *MCS* holding. This amount covered the expenses and fees of two attorneys who had obtained dismissal *with prejudice* of six counts of securities violations and negligence in derivative actions against three directors of the Scotten-Dillon Company.²⁰

At the hearing regarding indemnification, a co-defendant, acting as a stockholder, opposed the fees. He contended that the charges would amount to a combined hourly rate of \$90 for the two attorneys and, therefore, were not "reasonable" as required by section 145(c).²¹

The court discussed the requirements of section 145(c) which "direct[s] that directors who have been successful in defense of claims shall be indemnified against expenses and attorneys' fees actually and reasonably incurred in connection therewith."²² It stated:

If time expended were the only factor to be considered in determining a reasonable fee, there might be some merit to the objections. But this is not the case, there are several factors to be considered: (a) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service competently, (b) the likelihood that a particular retainer will preclude other employment by the attorney, (c) the fee customarily charged in the community for similar services, (d) the amount involved in the litigation and the results obtained, (e) the time limitations imposed by the litigation, (f) the nature and length of professional relationship with the client, (g) the experience, reputation and ability of the lawyer performing the services, and (h) a consideration whether the fee is fixed or contingent. Considering all of these factors in the light of the factual showing made, including the services rendered and the successful results achieved on the large majority of the counts, the Court is unable to conclude that the combined charge of \$5,692.61, the actual amount billed for attorneys' fees and expenses to Gray, Dillon and Davis, is in excess of a reasonable fee.²³

A fourth defendant, Power, also moved for an indemnification award of \$3,265.08 for expenses related to a count against him which had been dismissed *without prejudice*. He claimed an absolute right to indemnification under the mandatory language of section 145(c) as an officer of a corporation "who had been successful on the merits or otherwise" in the defense of an action. The court disagreed and held that the "or otherwise" language could not be applied so as to indemnify an officer for legal fees and expenses regarding the dismissal of a charge without prejudice.²⁴

19. *Galdi v. Berg*, 359 F. Supp. 698 (D. Del. 1973).

20. *Id.* at 700.

21. *Id.*

22. *Id.*

23. *Id.* (footnotes omitted).

24. *Id.* at 701.

In refusing Power's claim for indemnification, the court stated:

The dismissal without prejudice of Count V, the only count in which Power was involved, did not *vindicate* Power either on the merits *or by a technical defense*, such as the statute of limitations. . . . Certainly, a dismissal without prejudice solely because the same charge is being litigated in other presently pending actions does not fall within the underlying purpose of §145.²⁵

Thus, by May of 1973, the Delaware indemnification statute had been given a much narrower judicial construction than its critics had predicted. At this point, it would appear that in order to have a right to indemnification, a corporate director or officer would have to have been vindicated or successful on a preliminary technical defense. The reasonableness requirement of the indemnification award had been given definite judicial guidelines and it had been made clear that no indemnification would be ordered by a court until the action involved had been terminated in some way.

In the interim, the MCS directors who had been denied indemnification in 1970 were still involved in litigation of the charges against them in the federal court. In November, 1970, the Second Circuit Court of Appeals reversed all the convictions and remanded the case to the district court.²⁶ The appeal from the 1970 Superior Court decision was stayed pending the outcome of a second trial. At this trial, Count IV was dismissed at the conclusion of the government's case for lack of proof. No verdict was reached by the hung jury on the remaining charges.

At this point, the directors had spent six years under indictment. A third trial began on September 19, 1972 in which two MCS directors (Wolfson and Gerbert) were charged with the remaining three criminal counts. The jury found Gerbert guilty of one count but could not agree as to the other two charges. The government's case against Wolfson again resulted in a hung jury and mistrial. The government prepared for a fourth trial.

In November, 1973, faced with the prospect of a fourth trial on the remaining charges, Wolfson entered a plea of *nollo contendere* to a charge of filing a false report for 1964 and the remaining charges were dismissed.

Gerbert, who had been convicted of perjury, agreed not to appeal and the government dropped the remaining charges against him rather than attempt a fourth trial.

Defendant Kosow was not re-tried after the Second Circuit's reversal of his conviction in November, 1970, but the indictment against him was not dismissed until March, 1973.

(In November, 1972, the charges against a fourth director, Staub, were *nolle prossed*. Although Staub had not requested indemnification in the 1970 MCS trial, he did file in the later 1973 case to be discussed.)

25. *Id.* at 702 (emphasis added).

26. *United States v. Wolfson*, 437 F.2d 862 (2d Cir. 1970).

In March, 1973, the appeal from the 1970 Superior Court decision was dismissed without prejudice so that the Superior Court could make a final decision based upon the new record.

The Merritt-Chapman & Scott Corporation sought a declaratory judgment against the four defendant-directors (including Staub whose suit for an indemnification award was joined) seeking a determination that the defendant-directors had no right to indemnification for expenses and counsel fees in the criminal action. The directors moved for summary judgment.

The Superior Court reviewed the above sequence of events in relation to the Delaware indemnification statute.²⁷ MCS argued that the statute required indemnification "only where there has been vindication by a finding or concession of innocence."²⁸

The court rejected this argument:

Success is vindication. In a criminal action, any result other than conviction must be considered success. Going behind the result, as MCS attempts is neither authorized by subsection (c) nor consistent with the presumption of innocence.

The statute does not require complete success. It provides for indemnification to the extent of success "in defense of any claim, issue or matter" in an action. Claimants are therefore entitled to partial indemnification if *successful on a count of an indictment, which is an independent criminal charge*, even if unsuccessful on another, related count."²⁹

No indemnification award was granted for expenses involving the *nollo contendere* plea of Wolfson nor with regard to the guilty plea of Gerbert. The court ruled that neither section 145 nor the corporate bylaws permitted indemnification when officers or directors have been "adjudged to have been derelict in their duty as director or officer."³⁰

Indemnification was granted with regard to the other claims of Wolfson and Gerbert and the claims of Staub and Kosow. The award, which involved four defendants and more than six years of litigation, totaled over two million dollars in fees and expenses. Interest was also granted on expenses actually paid.

The second MCS indemnification case ended approximately ten years after the SEC investigation had begun. It is the last reported case in Delaware which deals with section 145. Since indemnification cannot be granted until final dismissal or acquittal has been granted, it is possible that there are future cases awaiting fruition.

27. Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Super. Ct. 1974).

28. *Id.* at 141.

29. *Id.* (emphasis added).

30. *Id.* at 143.

It is certain that lengthy, expensive proceedings such as those involving the MCS directors have led to a growth in corporate purchase of Director and Officer Insurance coverage.³¹ This trend has also been viewed as an abuse which could lead to a director's being insured against his own wrongdoing. However, the typical director and officer policy leaves little justification for such fears since the exclusion clause includes the following: (1) libel and slander; (2) any such personal profit or advantage to which the director or officer is not legally entitled; (3) salary, compensation or bonuses voted to the insured by directors of the company without the previous approval of the stockholders of the insured corporation if prior approval was legally required; (4) claims under the Securities Exchange Act of 1934 for profits made from the purchase or profits made from the purchase or sale of securities of the company, or similar claim under statutory or common law; (5) dishonesty or fraud; (6) loss insured under any other valid policy; (7) bodily injury or property damage stemming from contamination or pollution — unless sudden and accidental; (8) loss based on or attributable to bodily injury or sickness, death of any person, or to damage to or destruction of tangible property; (9) loss due to nuclear reaction, nuclear radiation or radioactive contamination.³²

In addition, the uncertainty regarding liability risk has kept the price of such insurance high. Policies are priced on an individual basis and are generally available only to publicly owned corporations with assets in excess of \$10,000,000.³³

The present case law in Delaware, coupled with the restricted insurance coverage available in this area, has limited the benefit of indemnification statutes to directors who are in a position to be abused by expanding personal liability. Accordingly, there seems little likelihood that directors who abuse their fiduciary duties will be aided by even the most permissive indemnification statute.

The time has come for the critics to view the matter of indemnification of corporate directors, officers and employees more objectively. Vigilance in guarding the public policy interests should, of course, be maintained. However, the needs of the corporate director for personal indemnification must be weighed in the balancing of such interests.

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31. KNEPPER, *supra* note 5, at § 16.04.

32. National Underwriting Co., F.C. & S. Bulls. (Feb. 1972).

33. *Id.* April, 1967.