# NOTE

## INDEMNIFICATION IN DELAWARE: BALANCING POLICY GOALS AND LIABILITIES


### ABSTRACT

*In the wake of corporate financial scandals, questions about indemnifying and holding officers and directors personally liable come into focus. Delaware law provides a permissive and mandatory approach for protecting and indemnifying officers and directors. Case law presents a balance between policy goals of indemnification and liability for bad faith acts of individuals. Determining the boundary line for this balance necessarily invokes culpability standards for fiduciaries where delineation of due care, loyalty, and good faith are pivotal aspects of when personal liability may lie against an officer or director. Whether concepts of "gross negligence" can provide the basis for "bad faith" will affect individual liability. Analysis of recent corporate scandals may shed light on whether Delaware law appropriately addresses such matters.*


### I. INTRODUCTION

Not long ago the U.S. economy was soaring. In the beginning of 2000 the Dow Jones Industrial Average (DJIA) approached 12,000 and the technology laced Nasdaq Composite (Nasdaq) approached 5,000.[1] By the end of March 2003, the DJIA was around 8,200 and the Nasdaq was around 1,400, representing drops in value of about thirty-two percent and seventy-two percent, respectively, over the span of three years.[2] What transpired over this period to lead to such losses? There is little doubt that economists, journalists and philosophers will analyze, write about and contemplate this matter for some time. While some people disrobe in response to corporate collapses such as Enron,[3] lawyers are busy devising

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[1]Yahoo! Finance at http://finance.yahoo.com/?u (last visited Jan. 27, 2004) (on file with the Delaware Journal of Corporate Law).

[2]*Id.*

[3]*See* Kristen Hays, *Women of Enron Bare All,* THE AGE (June 27, 2002), *at* http://www.theage.com.au/articles/2002/06/27/1023864626248.html; Alan Bernstein, *Playboy's Women of Enron Tell Tale of Boom to Bust,* HOUSTON CHRONICLE (June 27, 2002) *at* http://www.chron.com/cs/CDA/printstory/front/1472531 (June 27, 2002). Ten past and present women employees of Enron posed nude in Playboy's August 2002 issue, saying they posed for the fun of it and to earn some money. *Id.* Interestingly, none of the women said they lost a large amount of money from stock portfolios or retirement accounts.

strategies to hold individual officers and directors personally liable.

"Some institutional investors are . . . offering a premium above the agreed upon contingency fee for every dollar of recovery that comes out of the personal assets of corporate executives who are named as individual defendants."[4] The objective is to avoid shareholders "suing themselves," which essentially is what occurs when indemnification kicks in and the corporation pays out of its own pocket or out of insurance, premiums of which are paid by the corporation.[5] These costs are then passed on to the corporation's customers, if at all.[6]

Thanks to corporate financial scandals such as Worldcom, Tyco, Adelphia, and Enron, director and officer (D&O) insurance rates have skyrocketed.[7] "Pricing and coverage varies by client and the risk underwritten."[8] The cost of $10 million in D&O insurance ranges between $50,000 and $200,000 for small, private companies.[9] The cost sharply increases to as much as $3 million for a publicly traded company "with a large market cap facing serious business challenges or financial problems."[10] On the other hand, a Fortune® 2000 company without such problems can pay $750,000 to $1.2 million for D&O insurance.[11] This is double the figures of two or three years ago.[12]

When corporate scandals rock financial markets and large companies head into bankruptcy, indemnification and liability come into focus. In an ideal world, the wrongdoers would receive just punishment and the innocent would not suffer. Shareholders, employees and markets, however, all suffered when Enron shares dipped below one dollar ($1) per share.[13] In view of the tremendous losses incurred, is it reasonable to indemnify directors and officers? Will directors and officers be able to avoid personal liability in the wake of such colossal collapses? Indemnification and

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[4]Bruce Rubenstein, *Plaintiffs' Bar Finds New Target for Securities Suits; Institutional Investors Place a Bounty on Directors and Officers*, CORPORATE LEGAL TIMES, GOVERNANCE 14 (Jan. 2003).

[5]*Id.*

[6]Some companies go bankrupt when the fraud involved is large. *Id.*

[7]Amalia Deligiannis, *D&O Insurance Hikes Complicate Board Matters*, Corporate Legal Times, Counsel's Corner (Feb. 2003), at 10.

[8]*Id.*

[9]*Id.*

[10]*Id.*

[11]Deligiannis, *supra* note 7, at 10.

[12]*Id.*

[13]*Chronology of Fallen Energy Giant Enron*, THE ASSOC. PRESS & LOCAL WIRE (Jan. 13, 2004), *at* http://www.lexis.com/research/retrieve?_m=ee4dacfb89a6b5ac....

liability under Delaware law and its application to current corporate collapses are the subjects of this note.

Several themes and questions appear throughout this note and deserve to be mentioned. One theme resonating throughout the case law is the balance between policy goals of indemnification on the one hand and liability for bad faith acts of individuals on the other hand. Determining the boundary line for this balance necessarily invokes culpability standards for fiduciaries. For example, when does the poor performance of an officer, director, or employee cross over into a breach of fiduciary duties? A corollary matter is the determination of who should bear the risk of loss for errors made by poor performing directors, officers, or employees —shareholders, consumers, the individuals themselves? Are the policy goals enunciated by case law the only policy considerations? Should they be the only policy considerations? While answers to such questions are not readily available, it is hoped that analysis of recent corporate scandals can shed light on whether Delaware law appropriately addresses such matters.

Part II of this note includes a summary of Enron Corporation's collapse. Somewhat surprisingly, the tools employed to bring a sophisticated billion dollar company to its knees are rather simplistic. Part III lays out the legal background of liability and indemnification law in Delaware for directors, officers, employees, and corporate agents. Part IV then analyzes several scenarios in view of the legal background, addressing the particular themes and questions presented above. The note then concludes after posing some issues to watch.

## II. CORPORATE EMPIRES COLLAPSE

The list of corporate financial scandals and collapses is large and is still growing. Household names fall as directors, officers, employees, and agents head toward the shredder with a cabinet full of documents.[14] Businesses like Worldcom, Tyco, Adelphia, Enron, Arthur Anderson, and now HealthSouth, have seen their fortunes slide as news of financial misdeeds are uncovered. Here is Enron's story.[15]

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[14]This is in reference to Enron's former accounting firm, Arthur Andersen LLP, which was convicted of obstruction of justice in 2002, in part for shredding documents that were the subject of a government investigation. Arthur Andersen LLP no longer exists. Tomoeh Murakami, *Cole National Revises 7-Year Net Income Downward*, PLAIN DEALER, BUSINESS (May 20, 2003), at C3.

[15]*See* Elisabeth Bauman, *Not Business as Usual*, ONLINENEWSHOUR EXTRA (Jan. 30, 2002) (providing a concise history of the Enron collapse), *at* http://www.pbs.org/newshour/extra/features/jan-june02/enron.html.

Enron is a worldwide power company that traded electricity, plastics, Internet connections and more.[16] It reported earning $100 million in 2000 and had an aggregate share value worth billions of dollars.[17] On December 2, 2001, Enron filed for Chapter 11 bankruptcy.[18]

Enron grew rapidly through the 1990s.[19] In order to keep growing at a fast rate, Enron began to borrow money to invest in new projects.[20] Enron created partnerships to enter into transactions to offset losses.[21] Such "transactions resulted in Enron reporting earnings . . . that were almost $1 billion higher than should have been reported."[22]

In August 2001, Enron Vice President Sherron Watkins allegedly sent an anonymous letter to the chief executive officer (CEO) of Enron, Kenneth Lay, stating, "I am incredibly nervous that [Enron] will implode in a wave of accounting scandals."[23] While Lay sent emails to his employees reporting optimistic expectations for Enron stock prices, he was selling his own.[24]

On October 16, 2001, Enron reported a $638 million third-quarter loss.[25] After several public disclosures of revised financial statements accounting for large losses, Enron's stock dipped below $1 per share on November 28, 2001.[26] "Since Enron made deals based on the assumption that the stock would go up, it suddenly had to repay lots of money."[27] Running short on cash, Enron declared bankruptcy.[28]

The aftermath of Enron's storied collapse continues. Many lawsuits and criminal charges have been filed and are pending and others are still being investigated and filed. Here is a sampling of recent events. On March 12, 2003, in Houston, Texas, "[f]ederal prosecutors charged two

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[16] *Id.*

[17] *Id.*

[18] *Chronology of Fallen Energy Giant Enron*, *supra* note 13.

[19] Tom Fowler, *The Price and the Fall of Enron*, HOUSTON CHRONICLE (Oct. 20, 2002), *at* http://www.chron.com/cs/CDA./printstory.hts/special/enron/1624822.

[20] Bauman, *supra* note 15.

[21] William C. Powers, Jr., et al., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (Feb. 1, 2002), at summary of findings, *at* http://news.findlaw.com/hdocs/docs/enron/sicreport/index.html; Bauman, *supra* note 15.

[22] Powers, *supra* note 21.

[23] Letter from Sherron Watkins, Vice Pesident, Enron, to Kenneth Lay, Chief Executive Officer, Enron (Aug. 2001), *at* http://news.findlaw.com/hdocs/docs/enron/empltr2lay82001.pdf; Bauman, *supra* note 15.

[24] Bauman, *supra* note 15.

[25] *Chronology of Fallen Energy Giant Enron*, *supra* note 13.

[26] *Id.*

[27] Bauman, *supra* note 15.

[28] *Id.*

Enron Corp. executives [Kevin Howard and Michael Krautz ] with fraud yesterday for allegedly participating in a scam that generated $111 million in phantom earnings from an Internet movie-on-demand service that later fell apart."[29] Meanwhile, the Commodity Futures Trading Commission accused Enron and former vice president Hunter Shively of operating the Enron Online subsidiary as "an illegal futures exchange," and cited several instances of attempts to manipulate the natural-gas market.[30] The events involved occurred in July 2001.[31]

On "September 10, 2003—former Enron treasurer Ben Gilson, Jr. pleads guilty to conspiracy, [and] becomes [the] first former Enron executive put behind bars."[32] On "January 14, 2004—Andrew Fastow [Enron's former chief financial officer] pleads guilty to conspiring to commit wire and securities fraud. Separately, Lea Fastow [Andrew's wife] pleads guilty to filing a false tax return."[33] On January 22, 2004, Enron's accountant, Richard Causey, "pleaded not guilty to conspiracy and fraud charges."[34]

A federal judge in Houston, Texas, ruled on March 12, 2003, that some former Enron Corporation directors may have been negligent in their leadership, but that they did not participate in fraud or engage in insider trading.[35] The U.S. District Court approved requests from eight former directors to dismiss allegations in a shareholder lawsuit that they engaged in insider trading or securities fraud when approving financial proposals presented in board meetings.[36] Some of those proposals later were shown to have contributed to the company's swift failure in December 2001.[37]

On March 17, 2003, the Securities and Exchange Commission (SEC) accused Merrill Lynch and four former senior Merrill Lynch executives of helping Enron inflate profit and mislead investors with two financial deals in 1999.[38] "The SEC also approved a settlement in which Merrill Lynch

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[29]Kristen Hays, *Two Enron Executives Face Fraud Charges*, PHILA. INQUIRER, Mar. 13, 2003, at C3.

[30]*Id.*

[31]*Id.*

[32]*Fallout from Enron's Collapse*, PHILA. INQUIRER, Jan. 15, 2004, at C2.

[33]*Id.*

[34]Kristen Hays, *Accountant Could be Key Witness Against Enron's Former Executives*, PHILA. INQUIRER, Jan. 24, 2004, at C3.

[35]*See* Newby v. Lay (*In re* Enron Corp. Secs.), 258 F. Supp. 2d 576, 627-28 (S.D. Tex. 2003); *Former Enron Directors Dismissed From Suit*, PHILA. INQUIRER, Mar. 14, 2003, at C3.

[36]*Former Enron Directors Dismissed From Suit*, *supra* note 35, at C3.

[37]*Id.*

[38]Marcy Gordon, *SEC Accuses Four Ex-Merrill Officials of Abetting Enron*, PHILA. INQUIRER, Mar. 18, 2003, at E10.

will pay $80 million to resolve the case."[39] The settlement is to compensate investors who fell victim to the fraud.[40] Individual former executives of Merrill Lynch are still charged and plan to "vigorously defend" against the suit.[41] The transactions involved are also the subject of a criminal complaint filed in the fall of 2002 by the Justice Department against Enron's former CFO, Andrew Fastow.[42] Moreover, several financial institutions, including Merrill Lynch, Citigroup, and J.P. Morgan Chase are embroiled in a lawsuit with Enron shareholders, who seek billions of dollars in damages.[43]

As mentioned, this is merely a sampling of the criminal and civil actions against Enron and its directors, officers, employees, and agents. The approach by plaintiff attorneys is clearly designed to cast a wide net to catch every possible party that ever had dealings with Enron and may have some degree of culpability. It is no wonder the investing community has lost faith in companies as Enron is just one of many companies dealing with financial irregularities. On top of all this is the realization that off-book accounting transactions are not new.[44] Whether such transactions amount to fraud, however, is determined on a case-by-case basis.

While plaintiff attorneys pursue actions against anyone and everyone involved, an equal number of defense attorneys claim their client's innocence. Yet, someone has to be responsible. Where liability rests will depend heavily on federal laws, with state liability and indemnification laws as a backdrop. To some, the very notion that an officer or director may be indemnified while overseeing this phenomenal collapse, is offensive. To others, it is this very protection that enables people to take the risks of working in corporate America.

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[39] *Id.*

[40] *Id.*

[41] *Id.* The SEC alleges that the former Merrill executives aided and abetted Enron's earnings manipulation. *Id.*

[42] Gordon, *supra* note 38, at E10.

[43] *Id.*

[44] *See* Adam Lashinsky, *The Enron Story is Nothing New, Silicon Valley Firms Have Been Playing the Off-Balance Sheet Game for Years*, CNNMONEY, COMMENTARY (Feb. 4, 2002), *at* http://money.cnn.com/2002/02/04/investing/lashinsky.

## III. DELAWARE LIABILITY AND INDEMNIFICATION

### A. *Liability Exemptions Under Section 102(b)(7)*

In the aftermath of *Smith v. Van Gorkom*,[45] the Delaware legislature adopted Section 102(b)(7),[46] which permits corporations to adopt a charter provision to eliminate or limit the personal liability of directors for breach of their fiduciary duty to the corporation or its stockholders under certain circumstances (i.e. for duty of care violations).[47] Such a permissive right was and is viewed as a means for corporations to encourage people to serve as directors in a company.[48] Section 102(b)(7) is permissive for limiting liability only for "duty of care" violations by directors, by virtue of the limitations imposed by the statute.[49] Officers are not covered by the statute. An individual who is both an officer and a director may be liable for implementing an action as an officer, but not liable for approving that same action as a director.[50] Amending an existing certificate of incorporation to add language implementing Section 102(b)(7) cannot eliminate or limit any liability of directors for acts or omissions occurring prior to the effective date of the amendment.[51] Moreover, this limitation of liability is not an

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[45]In *Van Gorkom*, the supreme court imposed liability upon the directors for the board's approval of a "lock up" sale of their corporation to an unrelated third party without fully informing themselves of the circumstances surrounding the transaction which they had approved. The *Van Gorkom* opinion raised fears that independent directors would not undertake the risks of service, given the arbitrary standard of judicial review applied in hindsight. At the same time, structural weaknesses in the market for directors and officers liability insurance appeared. *See generally* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[46]DEL. CODE ANN. tit. 8, § 102(b)(7) (2002).

[47]PAT K. CHEW, DIRECTORS' AND OFFICERS' LIABILITY § 2:5.5[A], at 2-16 (Practicing Law Institute Oct. 2002).

[48]DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 6.02[7], at 6-17 (2002) (citing official legislative synopsis).

[49]DEL. CODE ANN. tit. 8, § 102(b)(7) (2002) allows for

> [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision *shall not eliminate or limit the liability of a director*: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [(i.e., liability of directors for unlawful payment of dividend or unlawful stock purchase or redemption)]; or (iv) for any transaction from which the director derived an improper personal benefit.

*Id.* (emphasis added).

[50]CHEW, *supra* note 47, § 2:5, at 2-16.

[51]DEL. CODE ANN. tit. 8, § 102(b)(7) (2002) states: "No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective."

impediment to obtaining injunctive relief, rescission or any other remedy not involving money damages.

In the ensuing time since adoption of the statute, many corporations have obtained shareholder approval to amend their charters and new corporations have included broad implementing language.[52] Although corporations have broadly endorsed limitations on liability for duty of care violations, judicial decisions have created uncertainty regarding the scope of misconduct for which liability limitations remain unavailable, particularly in cases delineating the type of conduct between a breach of the duty of care, loyalty, or good faith.

As for intentional misconduct, case law is clear that foreknowledge of the wrongfulness, as opposed to showing the conduct merely to be consciously undertaken, is required to accord individual liability. In *Arnold v. Society for Savings Bancorp, Inc.*,[53] a case involving a proxy solicitation to approve a merger, the scope of management's duty of disclosure was at issue, for information was subsequently determined to be false and misleading. In *Arnold*, because no bad faith had been shown, the directors were insulated from personal liability by a provision in the certificate of incorporation, adopted pursuant to Section 102(b)(7).[54] After remand and a second appeal, the Delaware Supreme Court declined to adopt as a matter of state law the concept of corporate liability, as opposed to director liability, for disclosure violations under Section 14 of the Securities Exchange Act of 1934.[55]

Clear cases of intentional misconduct aside, delineation of due care, loyalty, and good faith are pivotal aspects of when personal liability may lie against a director. Even so, some observers suggest that the delineation is an artificial construct applied after the evidence is heard and culpability is determined.[56] Notwithstanding such views, Delaware courts continue to struggle with delineating conduct into labels. The court of chancery has equated breaches of the duty of loyalty, or acts in bad faith, with concepts of self-dealing, holding that a breach of loyalty requires a showing that the directors claiming Section 102(b)(7) protections possessed interests potentially adverse to the corporation or its shareholders.[57] Moreover,

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[52]DREXLER ET AL., *supra* note 48, § 6.02[7] & n.58, at 6-19.

[53]650 A.2d 1270, 1286-88 (Del. 1994).

[54]*Arnold*, 650 A.2d at 1286.

[55]Arnold v. Society for Savings Bancorp, Inc., 678 A.2d 533 (Del. 1996).

[56]*See* DREXLER ET AL., *supra* note 48, § 15.06.

[57]*Id.* § 6.02[7], at 6-20 (citing John Hancock Growth Mgmt. Inc. v. Aris Corp., No. 9920, 1990 Del. Ch. LEXIS 130 (Del. Ch. Aug. 24, 1990), *reprinted in* 16 DEL. J. CORP. L. 1515 (1991)).

Chancellor Chandler has gone so far as to state that the "duty to act in 'good faith' is merely a subset of a director's duty of loyalty."[58] What happened to the triad of duties?[59] Equally important, is there a bright line distinction between the duties of due care and loyalty, or can egregious breaches of due care rise to the level of a breach of loyalty?

Chancellor Allen, in *In re Caremark International Derivative Litigation*,[60] reflected, largely in *dicta*, upon the standards of care applicable to performance of directorial duties, focusing with particularity upon the duty to monitor corporate affairs. Many of his observations have been restated in subsequent cases and academic articles. With respect to the board's responsibility to make decisions he argued that courts should look only to the methodology employed in reaching a decision. He stated that:

> *where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment,* he or she should be deemed to satisfy fully the duty of attention. If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors.[61]

Two U.S. Circuit Courts of Appeal had an opportunity to consider the delineation of fiduciary duties at the pleading stages of shareholder derivative actions.[62] Both courts allowed the cases to proceed over motions to dismiss and remanded for further proceedings. Under different sets of facts, both sets of plaintiffs alleged that the directors failed to act and exercise supervisory oversight. In *McCall v. Scott*,[63] the defendant directors were sued derivatively for a prolonged, systematic and company-wide pattern of submitting fraudulent Medicare claims, which was the

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[58]Orman v. Cullman, 794 A.2d 5, 14 n.3 (Del. Ch. 2002) (citing Emerald Partners v. Berlin, No. 9700, 2001 Del. Ch. LEXIS 20, at *86 n.63 (Del. Ch. Feb. 7, 2001)).

[59]In *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998), the director's fiduciary duty to both the corporation and its shareholders was characterized as a triad of duties: due care, good faith, and loyalty.

[60]698 A.2d 959, 968-70 (Del. Ch. 1996).

[61]*Id.* at 968.

[62]McCall v. Scott, 239 F.3d 808 (6th Cir.), *amended at* 250 F.3d 997 (6th Cir. 2001); *In re* Abbott Labs. Derivative S'holders Litig., 293 F.3d 378 (7th Cir.), *withdrawn at* 299 F.3d 898 (7th Cir. 2002), *reissued at* 325 F.3d 795 (7th Cir. 2003).

[63]239 F.3d 808, 814 (6th Cir. 2001).

subject of well-publicized, extensive investigation efforts.[64] The Sixth Circuit Court of Appeals concluded that plaintiffs "have alleged a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith."[65] The court stated: "Under Delaware law, the duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer."[66] The court distinguished its opinion from *Emerald Partners v. Berlin*[67] (discussed below), by noting that "here, plaintiffs have set forth particularized factual statements which, if proven, would establish a breach of the duty of good faith. This is all plaintiffs are required to do at this pre-trial stage in the litigation."[68] The court therefore held that prosecution of the action was not precluded by the Section 102(b)(7) charter provision.[69]

In *In re Abbott Laboratories Derivative Shareholders Litig.*[70] the Seventh Circuit Court of Appeals reached the same result as in *McCall*, but relied on "the magnitude and duration of the alleged wrongdoing," as opposed to the level of specific allegations, to support a lack of good faith and therefore individual director liability.[71] Whether the court applied "the 'bad faith' exception to lapses of oversight which arguably did not even rise to the level of gross negligence"[72] standard is debatable. The U.S. District Court for the Eastern District of Michigan, Southern Division, had a chance to consider similar issues for actions and inactions of Ford Motor Company's directors.[73] The court granted defendant directors' motion to dismiss and relied, in part, on the "gross negligence" standard necessary to prove a lack of good faith.[74] In so doing, the court distinguished its case from *McCall* and *In re Abbott Laboratories Derivative Shareholders Litig.* on a factual basis.

In a motion to dismiss, the Delaware Court of Chancery touched upon the topic of whether the core fiduciary duties of care and loyalty amount to a board's "duty to monitor" the personal affairs of an officer or director in matters indirectly affecting the company.[75] In dimissing the case

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[64] *Id.*

[65] *McCall*, 250 F.3d at 1000.

[66] *Id.* (citing Nagy v. Bistricer, 770 A.2d 43, 43 n.2 (Del. Ch. 2000)).

[67] No. 9700, 2001 Del. Ch. LEXIS 20 (Del. Ch. Feb. 7, 2001).

[68] *McCall*, 250 F.2d at 1001 n.2.

[69] DREXLER ET AL., *supra* note 48, § 6.02[7], at 6-21.

[70] 325 F.3d 795 (7th Cir. 2003).

[71] *Id.* at 809.

[72] DREXLER ET AL., *supra* note 48, § 6.02[7], at 67-21.

[73] Salsitz v. Nasser, 208 F.R.D. 589, 590 (E.D. Mich. 2002).

[74] *Id.* at 592.

[75] Beam v. Stewart, 833 A.2d 961, 970-72 (Del. Ch. 2003).

for failure to state a claim, the court of chancery distinguished *In re Abbott Laboratories Derivative Shareholders Litig.* as being "where directors were alleged to have been negligent in monitoring the activities of the corporation, activities that led to corporate liability" as opposed to monitoring the personal affairs of an officer or director.[76]

*McCall*, *In re Abbott Laboratories Derivative Shareholders Litig.*, and *Salsitz* all involved application of state law "due care" liability limitation clauses by federal courts at the pre-trial stage motion to dismiss. The fact that different federal courts may apply different standards for determining whether "due care" liability limitation protections will exist (even though purporting to apply state law), is significant. In the context of a bankruptcy action, where indemnification by the corporation may prove worthless, a finding of a lack of good faith may expose directors, particularly officers that are also directors, to significant personal liability.

Equally important are the manner in which a Section 102(b)(7) defense is invoked and the stage of pleadings at which a determination is made. Plaintiffs seek to get past the pleading stage and into discovery, where other details may be forthcoming. Defendants seek to end the matter at the pleading stage. Neither party is interested in bearing the burden of proof. The Delaware Supreme Court ruled that "the shield from liability provided by a certificate of incorporation provision adopted pursuant to 8 *Del. C.* § 102(b)(7) is in the nature of an affirmative defense."[77] Therefore defendants seeking the protection of this provision have the burden of establishing each of its elements.[78]

The supreme court expanded on this concept in another ruling involving the same parties. The court stated:

> a Section 102(b)(7) provision . . . can operate to defeat the plaintiff's ability to recover monetary damages. Accordingly, if the shareholder complaint only alleges a duty of care violation, . . . a trial pursuant to the entire fairness standard of review would serve no useful purpose. Thus, . . . the director defendants do not have to prove entire fairness to the trier of

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[76] *Id.*

[77] Emerald Partners v. Berlin, 726 A.2d 1215, 1223 (Del. 1999) (referencing Boeing Co. v. Shrontz, No. 11,273, 1992 Del. Ch. LEXIS 84 (Del. Ch. Apr. 20, 1992), *reprinted in* 18 DEL. J. CORP. L. 226 (1993); Rothenberg v. Santa Fe Pacific Corp., No. 11,749, 1992 Del. Ch. LEXIS 106 (Del. Ch. May 18, 1992), *reprinted in* 18 DEL. J. CORP. L. 743 (1993)).

[78] *Id.* at 1223-24.

> fact, because of the exculpation afforded . . . by the Section 102(b)(7) provision.[79]

The court continued with:

> The rationale of *Malpiede* constitutes judicial cognizance of a practical reality: unless there is a violation of the duty of loyalty or the duty of good faith, a trial on the issue of entire fairness is unnecessary because a Section 102(b)(7) provision will exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care. The effect of our holding in *Malpiede* is that, in actions against the directors of Delaware corporations with a Section 102(b)(7) charter provision, a shareholder's complaint must allege well-pled facts that, if true, implicate breaches of loyalty or good faith. Otherwise, in those cases that begin with the presumption of the business judgment rule, *ab initio,* our holding in *Malpiede* establishes that the proper invocation of a Section 102(b)(7) provision can obviate a trial pursuant to the entire fairness standard, even if the presumption of the business judgment rule is successfully rebuffed by a duty of care violation, since liability for duty of loyalty violations or violations of good faith are not at issue.[80]

The above language sounds like summary disposition is available for allegations of duty of care violations. The court, however, also stated that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided."[81] The court of chancery is left to wrestle with the issue of whether only duty of care violations are alleged in the complaint and whether a motion to dismiss can be sustained.[82] If the dismissal motion is denied, substantial expenditures of funds in litigation will result, even

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[79]Emerald Partners v. Berlin, 787 A.2d 85, 92 (Del. 2001).

[80]*Id.* (citing Malpiede v. Townson, 780 A.2d 1075, 1094-95 (Del. 2001)). An interesting side note to *Malpiede v. Townson* is that the plaintiff argued that failing to put a poison pill in place was a breach of fiduciary duty. This brings the topic of a poison pill full circle, having started out against arguments that insertion of a poison pill was itself a breach of fiduciary duties.

[81]*Id.* at 94.

[82]*See* Orman v. Cullman, 794 A.2d 5 (Del. Ch. Feb. 26, 2002).

where later analysis may determine that defendant directors are protected by exculpatory Section 102(b)(7) provisions in the corporation's charter.

### B. *Indemnification Under Section 145*

#### 1. Background

In 1986 the Delaware legislature provided a means for corporations to limit the substantive exposure of their directors to liability[83] and strengthened a corporation's ability to indemnify its officers and directors for litigation expenses and, in some instances, judgments.[84] "Section 145 remains the primary means of protecting directors against personal exposure to liability because of their service to the corporation."[85]

Section 145 is both permissive and mandatory in its application to corporations. The statute empowers corporations to indemnify their present or former officers, directors, employees, and agents, as well as persons serving in such capacities in other entities at the request of the corporation.[86] Under certain circumstances, the statute mandates indemnification.[87]

Subsections (a) and (b) define the extent of indemnification and the scope of its availability.[88] Subsection (b) is applicable to indemnification claims arising out of actions brought by the corporation itself, by its receivers, trustees, or custodians, or by stockholders derivatively on its behalf.[89] Subsection (a) is applicable to indemnification claims arising out of other actions, suits, and proceedings, whether civil, criminal, administrative, or investigative.[90] "The ability of directors to claim indemnity may be significantly affected by the form of the action."[91]

The permissive nature of Section 145 means that corporations do not have to include any type of indemnification to anyone, except as described in subsection (c). Yet, "virtually every public corporation has implemented [some form of indemnification] in order to provide assurances to its officers

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[83] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2002) and related discussion herein.

[84] *See* DEL. CODE ANN. tit. 8, § 145 (2002) and related discussion herein.

[85] DREXLER ET AL., *supra* note 48, § 16.01, at 16-2.

[86] *Id.* at 16-3.

[87] DEL. CODE ANN. tit. 8, § 145(c) (2002) mandates indemnification for present or former directors or officers who are successful on the merits or otherwise in defense of the matter giving rise to indemnification.

[88] DREXLER ET AL., *supra* note 48, § 16.01, at 16-2.

[89] *Id.* at 16-3.

[90] *Id.*

[91] *Id.*

and directors that they will have the absolute right to claim indemnification from the corporation when entitled to it."[92]

Indemnification clauses are typically inserted into corporate bylaws, corporate charters, individual employment contracts, and insurance agreements. Indemnification clauses vary in scope and coverage, sometimes providing different coverage for officers and directors than for employees and agents.[93] A combination of protections may be utilized. The benefits of a mandatory indemnification provision include (1) avoiding self-interest that may result in an after-the-fact, *ad hoc* approach, and (2) avoiding the problem of having an unfriendly board make decisions, either due to a change of control or due to personal differences.[94]

### 2. Interpretations, Policy Goals, and Eligible People

Indemnification is contractual in nature and therefore involves many aspects of contract law,[95] particularly interpretation of contract language.[96] Subsection (h)[97] defines "corporation" such that it is "theoretically possible

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[92]DREXLER ET AL., *supra* note 48, § 16.01, at 16-3.

[93]For example, the Restated Bylaws of Worldcom, Inc., a Georgia Corporation, state in Article X:

> The corporation shall indemnify and advance expenses to its directors to the fullest extent permitted under, and in accordance with, the corporation's Articles of Incorporation and the applicable provisions of Part 5 of Article 8 of the Georgia Business Corporation Code. . . . The corporation shall indemnify and advance expenses to its officers who are not directors to the same extent as to directors under Section 2 of this Article X. . . . The corporation may, to the extent and on such conditions as may be authorized by the Board of Directors, indemnify and advance expenses to its employees and agents who are not directors to the fullest extent permitted under, and in accordance with, Section 14-2-857 of the Georgia Business Corporation Code.

Restated Bylaws of Worldcom, Inc., *available at* http://contracts.corporate.findlaw.com/agreements/worldcom/bylaws.html (March 2003).

[94]DREXLER ET AL., *supra* note 48, § 16.01, at 16-3.

[95]*See* Stifel Fin. Corp. v. Cochran, 809 A.2d 555, 559 (Del. 2002) (stating that "because indemnification is a right conferred by contract, under statutory auspice, actions seeking indemnification are subject to the three year limitations period").

[96]Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 342-43 (Del. 1983) (stating that "analysis starts with the principle that the rules which are used to interpret statutes, contracts, and other written instruments are applicable when construing corporate charters and bylaws").

[97]DEL. CODE ANN. tit. 8, § 145(h) (2002) states that the term

> "corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors, officers, and employees or agents, so that any person who is or was a director, officer, employee or agent of such constituent corporation, or is or was serving at the request of such

that former officials of an absorbed corporation will have greater or lesser indemnification rights than present officials of the survivor, at least with respect to claims arising from their prior service."[98] The term "party" in the phrase "party to a . . . proceeding" was determined by the Delaware Supreme Court to refer "to either the plaintiff *or* the defendant in a lawsuit, and the entire phrase is broad enough to include an individual who acts as an intervenor or *amicus curiae* in any particular case."[99] The court, in rebutting the notion that indemnification was intended only for defensive purposes, stated:

> The invariant policy of Delaware legislation on indemnification is to "promote the desirable end that corporate officials will resist what they consider" unjustified suits and claims, "secure in the knowledge that their reasonable expenses will be borne by the corporation they have served if they are vindicated." Beyond that, its larger purpose is "to encourage capable men to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve."[100]

In *Shearin v. E.F. Hutton Group*,[101] Chancellor Allen construed *Hibbert* to "recognize that permissible indemnification claims will include those deriving from lawsuits brought by directors, officers, agents, etc., *only insofar as the suit was brought as part of the employee's duties to the corporation and its shareholders*."[102] Plaintiff's complaint was summarized by the court as follows:

> The gist of the complaint is that Hutton Trust was used inappropriately . . . by its parent E.F. Hutton Group, Inc. and its affiliate, E.F. Hutton, Inc., and that plaintiff sought to disclose this fact to the Hutton Trust board of directors. It is

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constituent corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, shall stand in the same position under this section with respect to the resulting or surviving corporation as such person would have with respect to such constituent corporation if its separate existence had continued.

[98]DREXLER ET AL., *supra* note 48, § 16.02[1], at 16-4.

[99]*Hibbert*, 457 A.2d at 343 (footnotes omitted).

[100]*Id.* at 343-44 (citing THE DELAWARE GENERAL CORPORATION LAW 98 (1972)).

[101]652 A.2d 578 (Del. Ch. 1994).

[102]*Id.* at 594.

> alleged that this stance made her very unpopular with senior management of Hutton Trust and legal officers of its affiliate. They tried, it is claimed, to force her to be silent, and when she would not be quiet these individuals defamed her by making false statements among themselves and to the Hutton Trust board, and by submitting an allegedly false document to regulators under her signature. As a result she was fired by Hutton Trust. She claims damages for defamation; for breach of her employment contract; and for interference with her contract of employment.[103]

Plaintiff's request for leave to amend her complaint to assert indemnification claims was denied because "[t]he suits brought by Ms. Shearin . . . cannot be considered a manifestation of her responsibilities to Hutton Trust."[104] The court appears to suggest that had plaintiff's complaint been brought while still an employee and in the interest of the corporation, indemnification may have been available.[105]

In *VonFeldt v. Stifel Financial Corp.*,[106] the court again interjected the same policy arguments in the context of construing contractual language in a corporation's bylaws.[107] The court held that the election of a director to the board of a wholly owned subsidiary by the parent constituted a "request" that the director serve the subsidiary.[108] Thus, the director was entitled to indemnification for costs incurred in defending a third party action, pursuant to bylaws requiring indemnification to the full extent permitted by Delaware law.[109] Policy reasons were again relied upon in allowing indemnification of "fees on fees."[110] The court held that "indemnification for expenses incurred in successfully prosecuting an indemnification suit are permissible under § 145(a), and therefore 'authorized by law.'"[111]

Subsection (j), added in 1986, requires that, "unless otherwise provided when authorized or ratified, indemnification undertakings survive the cessation of service to the corporation by the indemnitee and, in the

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[103] *Id.* at 581.
[104] *Id.* at 594.
[105] *Shearin*, 652 A.2d at 594 n.21.
[106] 714 A.2d 79 (Del. 1998).
[107] *Id.*
[108] *Id.* at 85.
[109] *Id.*
[110] VonFeldt v. Stifel Fin. Corp., 714 A.2d 79 (Del. 1998).
[111] *Stifel Fin. Corp.*, 809 A.2d at 561.

event of death, inure to his successors."[112] In a federal action brought against a former director for his personal sale of stock for the corporation he served, the phrase, "by reason of the fact that he is or was a director," in Section 145(a) was construed broadly.[113] The court refused to separate the director's actions from the company's overall structured sale of control transaction, stating that "neither the specific statutory provision under which a director is sued nor the mere form of the underlying complaint is dispositive of his right to indemnification."[114] In restating Delaware policy goals, the court expressly rejected the argument that indemnification was available under the statute only where a director has been charged with a breach of duty to, or an alleged wrong committed on behalf of, his corporation.[115]

### 3. Eligible Expenses

As mentioned, the ability of directors to claim indemnity may be significantly affected by the nature of the action. For example, Section 145(b) provides that the corporation may indemnify only for "expenses (including attorneys' fees) actually and reasonably incurred . . . in connection with the defense or settlement . . . if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[116] Section 145(b), however, prohibits indemnification "made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation," unless the court determines that such person is fairly and reasonably entitled to indemnification.[117] "The corporation may not indemnify under Section 145(b) for any amounts paid to it by way of satisfaction of a judgment or in settlement."[118]

Under Section 145(a) for other actions, the statute provides that the corporation may indemnify for:

> expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such action, suit or

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[112]DREXLER ET AL., *supra* note 48, § 16.02[1], at 16-5.

[113]Heffernan v. Pacific Dunlop GNB Corp., 965 F.2d 369, 371 (7th Cir. 1992).

[114]*Id.* at 374.

[115]*Id.* at 372.

[116]DEL. CODE ANN. tit. 8, § 145(b) (2002).

[117]*Id.*

[118]DREXLER ET AL., *supra* note 48, § 16.02[2], at 16-5.

> proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful.[119]

As noted, expenses incurred in successfully prosecuting an indemnification suit, including "fees on fees," are permissible under Section 145(a).[120] The scope and extent of what expenses are considered "reasonable" are not clear. The Superior Court of Delaware allowed indemnification of large fees charged by a prominent defense lawyer where the severity of the charges warranted the use of such an attorney.[121]

Corporations have the ability to control their exposure by including a provision in its charter or bylaws, or in a contract to indemnify, requiring use of designated counsel and conditioning advances of expenses upon such acceptance.[122] The court of chancery has held such requirements to be lawful as a general matter.[123] Any limits placed on designating counsel, however, are subject to an implied covenant of good faith and fair dealing, such that the individual director's defense is not compromised.[124]

### 4. Requirements: All Presumptions Aside

Both subsections (a) and (b) condition indemnification on a showing that "the person acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."[125] The phrase "not opposed to" covers situations "where a corporate official is sued for an extra-corporate transaction, such as a personal purchase or sale of the company's stock, or the personal purchase of other assets," which is not directly within the corporate interest for the particular transaction.[126]

An interesting, yet not litigated, aspect of indemnification under Section 145(a) involves the issue of presumptions. This aspect is particularly relevant to recent corporate failures and prosecutions of

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[119]DEL. CODE ANN. tit. 8, § 145(a) (2002).

[120]*Stifel Fin. Corp.*, 809 A.2d at 561.

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

[122]DREXLER ET AL., *supra* note 48, § 16.02[2], at 16-6.

[123]Chamison v. Healthtrust, Inc., 735 A.2d 912 ( Del. Ch. 1999), *aff'd*, Healthtrust, Inc. v. Chamison, 748 A.2d 407 (Del. 2000).

[124]*Id.* at 922.

[125]DEL. CODE ANN. tit. 8, § 145 (2002).

[126]DREXLER ET AL., *supra* note 48, § 16.02[3][a], at 16-7.

individuals. Section 145(a) provides:

> The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which such person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that such person's conduct was unlawful.[127]

In criminal actions under Section 145(a), the person seeking indemnity must have had no "reasonable cause to believe that such . . . conduct was unlawful."[128] Since criminal matters require a *mens rea* of something above negligence (usually knowledge or intent) and require proof beyond a reasonable doubt, it is difficult to imagine a scenario that provides for criminal liability yet qualifies for indemnification.

The terms "good faith" and "reasonable belief" have not been judicially explored under Section 145(a). Good faith, however, has been addressed in cases involving Section 102(b)(7). As discussed, the court of chancery has equated breaches of the duty of loyalty or acts in bad faith with concepts of self-dealing.[129] In the context of disclosures, the duty of disclosure has been described as a combination of the duties of care, loyalty, and good faith.[130] The basis, however, for director liability for a good faith disclosure error made with due care is an "unsettled" issue.[131]

Although Section 145(a) mandates that no presumption applies, it may be difficult to reach a contrary conclusion where a judgment is based upon a finding that the directors had been "grossly negligent" in informing themselves about a transaction.[132] The court may conclude that bad faith or a reckless disregard of the corporate interest is required to deny indemnification under such circumstances. The right facts, however, may

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[127]DEL. CODE ANN. tit. 8, § 145(a) (2002).

[128]*Id.*

[129]DREXLER ET AL., *supra* note 48, § 6.02[7], at 6-20 (citing John Hancock Growth Mgmt. Inc. v. Aris Corp., No. 9920, 1990 Del. Ch. LEXIS 130 (Del. Ch. Aug. 24, 1990), *reprinted in* 16 DEL. J. CORP. L. 1515 (1991)).

[130]*Malone*, 722 A.2d at 11.

[131]*See* Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1140 (1996).

[132]DREXLER ET AL., *supra* note 48, § 6.02.

persuade the court to reach a different conclusion, as has happened with federal courts construing Delaware law.[133]

Securities law violations are governed by different rules since "federal law is preemptive and precludes, on federal public policy grounds indemnification under state law for judgments incurred for such violations."[134] Determination of what is an actual federal violation, however, must be made with specific judicial findings in order to deny indemnification.[135]

### 5. Mandatory Indemnification

Section 145(c) provides mandatory indemnification for former directors or officers[136] who are successful on the merits or otherwise in a defensive action under subsections (a) and (b).[137] The "or otherwise" language permits the use of technical defenses, such as a statute of limitations, without losing the right to indemnification. In seeking indemnification for the successful defense of a criminal action under Section 145(c), a person is not required to show that he committed no actual wrong[138] or even that he acted in "good faith."[139] Therefore, it is

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[133]*Salsitz*, 208 F.R.D. at 592.

[134]DREXLER ET AL., *supra* note 48, § 16.02[3][a], at 16-8 (referencing Globus v. Law Research Servs., Inc., 418 F.2d 1276, 1287-89 (2d Cir. 1969); Laventhol, Krekstein, Horwath & Horwath v. Horwitch, 637 F.2d 672, 676 (9th Cir. 1980), *cert. denied sub nom.* Frank v. U.S. Trust Co. of N.Y., 452 U.S. 963 (1981); Heizer Corp. v. Ross, 601 F.2d 330, 334 (7th Cir. 1979)).

[135]*Id.* § 16.02[3][a], at 16-8 (referencing Commodity Futures Trading Comm'n v. Richards, No. 96C334, 1996 U.S. Dist. LEXIS 5359 (N.D. Ill. Apr. 23, 1996)).

[136]Until amendment in 1997, the right to mandatory indemnification extended to non-officer employees and agents. Now, indemnification of such persons is discretionary and may be dealt with on a non-board level. *Id.* § 16.02[3][c] n.15.

[137]See Section 145(c) which states that:

> [t]o the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

DEL. CODE ANN. tit. 8, § 145(c) (2002).

[138]DREXLER ET AL., *supra* note 48, § 16.02[3][c], at 6-10 (citing Green v. Westcap Corp. of Del., 492 A.2d 260 (Del. Super. Ct. 1985)). "The court found that a prospective indemnitee could recover for expenses incurred in the successful defense of a criminal action, even though a civil action based on the same activities brought by the corporation against him remained pending." *Id.* at 16.02[3][c] n.17.

[139]*Id.* § 6.02[3][c], at 16-10 (citing Cochran v. Stifel Fin. Corp., No. 17,350, 2000 Del. Ch. LEXIS 179, at *35-*36 (Del. Ch. Dec. 13, 2000), *reprinted in* 27 DEL. J. CORP. L. 639, 655 (2002)).

plausible that an officer or director may be indemnified for a successful defense in a criminal action and subsequently be held liable for a breach of loyalty or bad faith in a civil action. This will result in the payment of legal fees in the criminal action for a disloyal officer or director.

Dismissed counts or any result other than a conviction in criminal actions are considered a success for mandatory indemnification purposes.[140] Claimants are also 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.[141]

### 6. Advances

Indemnification is an after-the-fact compensation scheme for adjudicated liabilities. As described, receiving indemnification sometimes involves more litigation. Advancement, however, is prospective in its approach, providing funds before liability is determined. Under Section 145(e), expenses incurred in defending an action may be paid by the corporation in advance of the final disposition of such action. The defendant, however, is required to furnish an undertaking to repay such amount if indemnification is ultimately determined not to apply.[142] "In practice, most corporations advance litigation expenses to corporate officials whenever such officials are potentially entitled to indemnification. In many instances, D&O insurance covers such outlays."[143]

Blanket authorizations in corporate bylaws, articles, and contracts are standard fare. Mandatory advancement clauses have been broadly interpreted to apply, even in situations where the advancement request was borne out of a lawsuit brought by the company providing the advance.[144] Specific contract language is needed to entitle a person to mandatory

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[140]Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 141 (Del. Super. Ct. 1974).

[141]*Id.*

[142]Section 145(e) states that

> [e]xpenses (including attorneys' fees) incurred by an officer or director in defending any civil, criminal, administrative or investigative suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this section. Such expenses (including attorneys' fees) incurred by former directors and officers or other employees and agents may be so paid upon such terms and conditions, if any, as the corporation deems appropriate.

DEL. CODE ANN. tit. 8, § 145(e) (2002).

[143]DREXLER ET AL., *supra* note 48, § 16.04, at 16-16.

[144]*See* Citadel Holding Corp. v. Roven, 603 A.2d 818 (Del. Super. Ct. 1992).

advancement. A provision mandating indemnification "to the full extent permitted by Delaware law" will not "deprive the board of its function under Section 145(e) to evaluate the corporation's interest with respect to advancement of expenses.[145] Where a bylaw mandates the advance of expenses, it creates a vested right, which cannot be unilaterally terminated, to advances once a triggering event for advances occurs.[146] Without a bylaw or contract mandating the advance of expenses, a board determination to advance their personal litigation expenses is treated as a self-dealing transaction, governed by entire fairness. "A rubber-stamp resolution authorizing advances will not pass muster."[147]

With respect to employees or agents of a corporation, subsection (e) does not require an undertaking to repay advances, if provided. Where a corporation, however, has entitled employees or agents to advances without providing an undertaking, there is an implied reasonableness term to return such advances where the underlying conduct is not the proper subject of indemnification.[148] Additionally, the doctrine of unclean hands is unavailable for advancement determinations, because to apply this doctrine "would turn every advancement case into a trial on the merits."[149] One court, however, has upheld the doctrine of unclean hands to deny advances in litigation involving trusts under the Business Trust Act, title 12, Section 3801 of the Delaware Code Annotated.[150]

### 7. Miscellaneous Particulars

Subsection (f) provides that the provisions of Section 145 are not exclusive of rights conferred to individuals by contract, such as bylaws, articles of incorporation, employment contracts and insurance contracts.[151]

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[145]Advance Mining Sys., Inc. v. Fricke , 623 A.2d 82, 84-85 (Del. Ch. 1992).

[146]Salaman v. National Media Corp., No. 92C-01-161, 1992 Del. Super. LEXIS 564, at *17-*18 (Del. Super. Ct. Oct. 8, 1992).

[147]DREXLER ET AL., *supra* note 48, § 16.04, at 16-16 (citing Havens v. Attar, No. 15,134, 1997 Del. Ch. LEXIS 12 (Del. Ch. Jan. 30, 1997); Havens v. Attar, No. 15,134, 1997 Del. Ch. LEXIS 147 (Del. Ch. Nov. 5, 1997)).

[148]Reddy v. Electronic Data Sys. Corp., No. 19,467, 2002 Del. Ch. LEXIS 69, at *14 (Del. Ch. Jun. 18, 2002).

[149]*Id.* at *28.

[150]*See* Nakahara v. NS 1991 Am. Trust, No. 15905, 1998 Del. Ch. LEXIS 50 (Del. Ch. Mar. 20, 1998).

[151]Section 145(f) states that

> [t]he indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official

Such contract rights, however, cannot be broader that the statute permits, as discussed above. In 1994, subsection (k) was added, conferring exclusive jurisdiction upon the court of chancery to hear and determine all actions for indemnification and advance of expenses.[152]

Subsection (g) allows a corporation to purchase and maintain insurance for persons it is empowered to indemnify.[153] This includes obtaining insurance beyond which the corporation could directly indemnify. Some corporations organize captive insurance subsidiaries to provide coverage or provide letters of credit to insurers, supporting undertakings by the corporations purchasing coverage to reimburse the insurer for claims paid.[154] "Ultimately, questions raised concerning the validity of such actions may rest upon whether what is involved is really 'insurance.'"[155]

## IV. EXAMINING THE RUINS

Recall the facts of Enron's collapse. In a nutshell, Enron officials used off-book transactions, borrowed funds and complicated math to make Enron appear more profitable than it was, causing the stock price to rise. Knowledgeable insiders sold their stock when the price was high and made millions of dollars. When word spread that Enron was not as successful as claimed, the value of the company fell. Many investors were left holding

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capacity and as to action in another capacity while holding such office.

DEL. CODE ANN. tit. 8, § 145(f) (2002).

[152]Section 145(k) states that

> [t]he Court of Chancery is hereby vested with exclusive jurisdiction to hear and determine all actions for advancement of expenses or indemnification brought under this section or under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise. The Court of Chancery may summarily determine a corporation's obligation to advance expenses (including attorneys' fees).

DEL. CODE ANN. tit. 8, § 145(k) (2002).

[153]Section 145(g) states that

> [a] corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.

DEL. CODE ANN. tit. 8, § 145(g) (2002).

[154]DREXLER ET AL., *supra* note 48, § 16.08.

[155]*Id.* at 16-21.

worthless stock and lost their life savings. Perhaps realizing that Enron was just the tip of the iceberg, many investors lost confidence in the stock market.

The discussion below examines several scenarios. For each scenario, it is presumed that all officers and directors are indemnified to the fullest extent permissible under Delaware law. Moreover, all vice presidents are presumed to be officers of the corporation. Employees and agents are protected as the facts indicate.

### A. *Magnitude of the Fraud*

In this scenario, the fraud involved was small. One subsidiary with revenue of about $5 million and debt of about $200,000 erroneously did not report its debt to the corporate parent, Enron, pursuant to a decision made by the head of the subsidiary, a vice president of Enron. Everything else is dutifully reported, with revenue in the billions of dollars. A year later Enron restates its earnings for the period of this error, accounting for the $200,000 debt that was previously omitted, while simultaneously firing the vice president. Thereafter, a group of shareholders sue the vice president and board members derivatively for breaching their respective fiduciary duties. Damage amounts aside, how would indemnification and liability be applied?

Excluding security law violations, liability and the right to be indemnified will depend on state law. To that extent, the facts will center around whether a breach of due care, loyalty or good faith was involved in determining whether liability by the individuals to the corporation will lie and whether indemnification is available. With respect to the vice president that authorized the withholding of debt information, the analysis is straightforward. Intentional misconduct will not shield the officer from personal liability and he will not be indemnified, provided the vice president had foreknowledge of the wrongfulness.[156] A breach of the duty of due care will be a fact dependent issue, but indemnification under Section 145 will be available for damages awarded.[157] As for a breach of the duty of loyalty or bad faith acts, the court of chancery has equated this with concepts of self-dealing, requiring a showing of interests potentially adverse to the corporation or its shareholders.[158] If the vice president's

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[156]*See infra* Section III.A.

[157]*See infra* Section III.B.

[158]DREXLER ET AL., *supra* note 48, § 6.02[7], at 6-20 (citing John Hancock Growth Mgmt. Inc. v. Aris Corp., No. 9920, 1990 Del. Ch. LEXIS 130 (Del. Ch. Aug. 24, 1990), *reprinted in* 16 DEL. J. CORP. L. 1515 (1991)).

bonus, or pay, or promotion, were tied to the performance of the subsidiary, this may warrant the required showing. This analysis, however, is highly fact dependent. Some federal courts have relied on a "gross negligence" version of bad faith in analyzing such matters.[159] In this context, the magnitude of the fraud is extremely important.

The further up the chain of command one gets from the vice president, the harder it is to imagine a fact pattern that will rest liability on individual officers and directors, except for intentional misconduct. Here, the magnitude of the fraud will play an increasingly vital role in supporting a factual argument that a breach of loyalty or good faith has occurred. Moreover, for directors there will have to be facts alleging to show that the individuals benefited in some manner apart from the organization itself—a self-dealing aspect. The larger the fraud, the more likely it is that other people had a role in it.

While the magnitude of the fraud may play a role, especially if some form of "gross negligence" is used in establishing bad faith, it is harder to understand how certain individuals would benefit from the activities above and beyond the corporation as a whole. How is self-dealing involved when everyone purportedly benefits from the actions taken?

As the analysis shifts up the chain of command to the board level and the facts involve extremely large errors, omissions or fraudulent events, tremendous stress is applied to the notion that good faith and loyalty are one in the same. On the one hand, wide-spread corruption within an organization implicates all directors as playing the role of a silent observer, while at the same time it is nearly impossible to pinpoint any specialized self-dealing aspect. After all, absent intentional misconduct, were not the benefits sought after for the benefit of the whole corporation in the form of higher earnings?

The policy implications are significant. If the silent observers avoid personal liability via Section 102(b)(7) and are indemnified under Section 145 for actions taken against them, this may reinforce such behavior. This would be the effect if only self-dealing and breach of loyalty standards were applied and not "gross negligence" forms of bad faith to standards. This would also, however, provide substantial protection to directors, free of having to police their fellow board members. Currently, federal law is headed in the other direction, with proactive approaches to governance, such as Sarbanes-Oxley legislation and similar rule making.[160]

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[159] *See* McCall v. Scott, 239 F.3d 808 (6th Cir.), *amended at* 250 F.3d 997 (6th Cir. 2001); *see also* Salsitz v. Nasser, 208 F.R.D. 589, 592 (E.D. Mich. 2002).

[160] *See* Sarbanes-Oxley Act of 2002, 107 Pub. Law No. 204 (July 30, 2002).

### B. *Number of Incidents*

In this scenario, the fraud involved was small but continuous. This fact pattern is similar to the Medicare fraud in *McCall v. Scott*,[161] where the defendant directors were sued derivatively for a prolonged, systematic and company-wide pattern of submitting fraudulent Medicare claims. Even where small mistakes, concealments, or other misdeeds occur, is there a threshold limit in which to apportion liability and hold directors and officers personally liable? The analysis is similar to the one presented for the magnitude of the fraud analysis. Under such a scenario, the line between a breach of loyalty and a breach of good faith is blurred. The notion that an officer or director can be loyal to a corporation while being in control during a prolonged, systematic and company-wide pattern of fraudulent activity is problematic.

Even if one presumes that a breach of the duty of care occurs where the board oversees a company whose employees violate the law,[162] this still does not apportion liability, prevent the company from "suing itself" or provide a proactive approach toward preventing future violations. This is because silent directors and officers avoid personal liability for duty of care violations via Section 102(b)(7) or are indemnified under Section 145 for actions taken against them, thereby providing little incentive to take proactive approaches to avoid the problems in the first place.

In fact, federal law is attempting to address this aspect by requiring officers and executives to certify certain financial results.[163] In the struggle

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[161] 239 F.3d at 814.

[162] *See, e.g.*, *In re* Caremark Int'l Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

[163] The U.S. Securities and Exchange Commission states, in part:

> [T]he Commission believes it necessary to require written statements, under oath, from senior officers of certain publicly traded companies, identified in the list attached hereto (the "Companies"), with revenues during their last fiscal year of greater than $1.2 billion, that file reports with the Commission pursuant to the Securities Exchange Act of 1934, regarding the accuracy of their Companies' financial statements and their consultation with the Companies' audit committees .... Accordingly, pursuant to Section 21(a) of the Securities Exchange Act, it is: ORDERED, that the principal executive officer and principal financial officer of each of the Companies shall either (a) file a statement in writing, under oath, in the form of Exhibit A hereto, or (b) file a statement in writing, under oath, describing the facts and circumstances that would make such a statement incorrect. In either case, such statement shall further declare in writing, under oath, whether or not the contents of the statement have been reviewed with the Company's audit committee, or in the absence of an audit committee, the independent members of the Company's board of directors. Such sworn statement shall be delivered for publication in written form to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549 by the close of business on the first date that a Form 10-

between state's rights and federal preemption, federal legislation in this area is a significant turn of events, threatening to federalize corporate governance.

### C. *Policy Objectives and Compliance Programs*

The policy goals of state and federal legislation vary with respect to corporate governance and board decisions. Delaware's indemnification policy is designed to help directors avoid unjustified suits and to encourage people to serve as directors. Federal legislation is designed to protect the integrity of the American capital system, by being proactive and preventing the events that lead to questions of liability and indemnification from occurring in the first place. If a state, of its own accord, mandates certain reporting requirements, corporations might avoid such measures by choosing to incorporate in another state. Nevertheless, there is still room in state law for incentives for directors to take proactive roles in being involved in day-to-day operations of the corporation.

If a move toward a form of "gross negligence" bad faith liability occurs, either judicially or legislatively, then the role of compliance programs may become more prominent.[164] In showing that a well designed systematic approach toward implementing and auditing compliance with legal standards is in place, directors can support arguments that in fact, gross negligence or bad faith did not occur.[165] If enacted legislatively, compliance programs can be utilized as a tool to protect officers and directors who implement and follow such programs by shifting the burden of proof to plaintiffs to show that compliance programs were not being properly utilized, before any discussion of liability can begin.[166] Another approach is to condition Section 102(b)(7) protections on implementation of proactive programs by the board to avoid violations of law.[167] Admittedly, this may place the court as an after-the-fact supervisor of the sufficiency of corporate compliance programs.

Delaware law represents different policy goals from federal law and is a responsive approach to corporate governance matters, attempting to

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K or Form 10-Q of such Company is required to be filed with the Commission on or after August 14, 2002.

File No. 4-460, U.S. Securities and Exchange Commission, *at* http://www.sec.gov/rules/other/4-460.htm (June 27, 2002).

[164] *See* John F. Fatino, *Corporate Compliance Programs: An Approach to Avoid or Minimize Criminal and Civil Liability*, 51 DRAKE L. REV. 81 (2002).

[165] *Id.*

[166] *Id.*

[167] *Id.*

apportion liability after-the-fact. The hope is that such risks will encourage officers and directors to take proactive steps to avoid such liability. For many companies, this hope is realized. In the wake of Worldcom, Tyco, Adelphia, Enron, Arthur Anderson, HealthSouth, etc., this hope falls short. When failures of this magnitude (billions of dollars) occur, suing officers and directors is of little relief. Federal and state law have different objectives, which are expressed in the forms of legislation enacted.

### D. *Enron*

The facts behind Enron's collapse implicate many people and involve many laws. Officers and directors brought up on charges will seek to invoke any advancement rights available to them either by virtue of employment agreements, bylaw provisions, or the certificate of incorporation. While each person may be required to provide an "undertaking" to repay such advances if indemnification is ultimately unavailable, given the scope of the dollar amounts involved, such undertakings may be useless because individuals may file for bankruptcy if found liable. Moreover, it may be many years and many appeals later before some cases are resolved, with no assurance that Enron will still be in business or that the individuals will have any funds left.

Officers have a lot at stake because the protections afforded by Section 102(b)(7) are only available to directors. An officer, if found liable for a duty of care violation, may be indemnified under Section 145, however, indemnification may not be sufficient to cover any of the losses involved, especially since Enron is in bankruptcy and insurance companies are fighting to avoid liability. Officers and directors alike will argue that no breaches of loyalty occurred and that "gross negligence" is not an appropriate standard for determining whether bad faith is involved. Plaintiffs will argue to the contrary.

Employees and agents of Enron that are sued will search for ways to avoid liability, to seek indemnification or to obtain advances for litigation costs. Enron's bylaws are silent regarding these matters,[168] so the availability of such protections will depend on the Certificate of Incorporation or any employment/agency contracts.

Under the facts in Enron, it is plausible that an officer or director may be indemnified for a successful defense in a criminal action and subsequently be adjudged liable for a breach of loyalty or bad faith in a

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[168] *See* Bylaws of Enron Corp., Adopted Feb. 13, 1996, Findlaw, Corporate Counsel Center, *at* http://contracts.corporate.findlaw.com/agreements/enron/bylaws.1996.02.13.html (last visited Sept. 2, 2003).

civil action. The result would be that the corporation will pay the legal fees of the criminal action for a disloyal officer or director.

How Delaware courts would deal with the likes of Enron remains enigmatic because defendants are busy cutting deals and many actions involve federal securities law violations. The magnitude of the collapse presents facts prime for directors and officers to be held personally liable. Conversely, it also presents facts prime for directors and officers to obtain protection against personal liability. How the interplay between a breach of the duty of care, or a breach of the duties of loyalty and good faith, would be resolved under such facts is still open for future consideration. Delaware law is aptly suited to deal with apportioning liability after-the-fact and for addressing whether personal liability will lie or indemnification will be available.

Many corporate boards have received the message that losing the faith of its investors can have drastic consequences. Perhaps this alone, along with the potential for personal liability, is enough to spur proactive approaches toward ensuring that the likes of Enron never occur again. Then again, individuals do not commit fraudulent acts with the expectation of getting caught.

## V. ISSUES TO WATCH

Federal legislators will continue to seek proactive approaches to dealing with corporate governance. Such approaches will focus on the process of decision making and oversight performed by boards of directors, as does Sarbanes-Oxley. State governance law will likely continue to address apportionment of liability and the availability of indemnification after such events have taken place, seeking to shy away from detailed involvement in board decisions, except in cases of self-interest.

At some point it is expected that the Delaware Supreme Court will address whether concepts of "gross negligence" can be utilized as the basis for "bad faith" and therefore individual officer and director liability. The outcome may strengthen or weaken the protections afforded by Section 102(b)(7) and the indemnification provisions of Section 145.

Courts and legislators will continue to wrestle with the proper apportionment of risks in corporate affairs. Some will argue that shareholders bear the risk willingly and should take a more active approach in monitoring directors. Others may argue that officers and directors wield such authority as to shield shareholders from knowing what is truly transpiring within a corporation. Issues of liability, indemnification and risk sharing spill over into corporate democracy matters.

## VI. CONCLUSION

When corporate scandals rock financial markets and large companies head into bankruptcy, liability and indemnification come to the forefront. Determining the boundary line for balancing between policy goals of indemnification and liability for bad faith acts of individuals invokes culpability standards for fiduciaries. In Delaware, Section 102(b)(7) permits corporations to adopt a charter provision to eliminate or limit the personal liability of directors for duty of care violations.[169] Such a permissive right is viewed as a means for corporations to encourage people to serve as directors in a company.

Indemnification is contractual in nature and therefore involves many aspects of contract law, particularly interpretation of contract language. Section 145 empowers corporations to indemnify their present or former officers, directors, employees, and agents, as well as persons serving in such capacities in other entities at the request of the corporation.[170] Section 145 is both permissive and mandatory in its application to corporations; however, virtually every public corporation has implemented some form of indemnification in order to provide assurances to its officers and directors that they will have the absolute right to claim indemnification from the corporation when entitled to it.

The ability of directors to claim indemnity may be significantly affected by the nature of the action. Section 145(b) is for actions brought on behalf of the corporation. It provides indemnification only for "expenses . . . actually and reasonably incurred . . . in connection with the defense or settlement . . . if the person acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."[171] It prohibits indemnification "made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation."[172]

Section 145(a) covers all other actions and provides indemnification for:

> expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such action, suit or proceeding if such person acted in good faith and in a manner

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[169]DEL. CODE ANN. tit. 8, § 102(b)(7) (2002).

[170]DEL. CODE ANN. tit. 8, § 145(b) (2002).

[171]*Id.*

[172]*Id.*

> he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe such person's conduct was unlawful.[173]

The scope and extent of what expenses are considered "reasonable" are not clear.

Section 145(c) provides mandatory indemnification for former directors or officers who are successful on the merits or otherwise in a defensive action under subsections (a) and (b). Under Section 145(e), defense related expenses may be paid by the corporation in advance of the final disposition of such action. The defendant, however, is required to furnish an undertaking to repay such amount if indemnification is ultimately determined not to apply.

Delineation of due care, loyalty and good faith are pivotal aspects of when personal liability may lie against an officer or director, although some observers suggest that the delineation is an artificial construct applied after the evidence is heard and culpability is determined.[174] Nevertheless, Delaware courts continue to struggle with delineating conduct into labels, equating breaches of the duty of loyalty or acts in bad faith with concepts of self-dealing.[175]

Federal courts may apply different standards for determining whether "due care" liability limitation protections will exist under Delaware law. Such courts sometimes use a "gross negligence" standard in finding a breach of good faith, thereby holding directors and officers liable. In determining whether bad faith has occurred, both the magnitude of the fraud and the number of incidents involved may become important. In the context of a bankruptcy action, where indemnification by the corporation may prove worthless, a finding of a lack of good faith may expose directors or officers to significant personal liability. Whether concepts of "gross negligence" can provide the basis for "bad faith" will affect individual officer and director liability. The outcome may strengthen or weaken the protections afforded by Section 102(b)(7) and the indemnification provisions of Section 145.

State and federal policies regarding corporate governance differ, and the approaches taken by each, highlight this difference. The goals of Delaware's indemnification policy are to avoid unsubstantial claims and

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[173] *Id.* § 145(a).

[174] DREXLER ET AL., *supra* note 48, § 15.06.

[175] *Id.* § 6.02[7], at 6-20.

encourage people to serve as directors.[176] Federal legislation is designed to protect the integrity of the American capital system, by being proactive and preventing the events that lead to questions of liability and indemnification from ever occurring in the first place. While federal legislation will continue to seek proactive approaches by focusing on the process of decision making and oversight performed by boards of directors, state governance law will likely continue to apply an after-the-fact approach to liability and indemnification, except in cases of self-itnerest. The expansion of federal law may be at the expense of state governance law.

*Karl E. Stauss*[*]

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[176]*See id.* § 6.02.

[*]Special thanks to Widener Professor and Delaware State Legislator Robert J. Valihura, Jr.