Unreported Cases

INTRODUCTION

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DAVID A. STOCKMAN V. HEARTLAND INDUSTRIAL PARTNERS, L.P. AND HEARTLAND INDUSTRIAL GROUP, L.L.C.

No. 4227-VCS

Court of Chancery of the State of Delaware, New Castle

July 14, 2009

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Robert S. Saunders, Esquire, Ronald N. Brown, III, Esquire, Brian D. King, Esquire, of Skadden, Arps, Slate, Meagher & Flom LLP, Wilmington, Delaware; and Jonathan J. Lerner, Esquire, Lea H. Kuck, Esquire, Skadden, Arps, Slate, Meagher & Flom LLP, New York, New York, Attorneys for Defendants.

STRINE, *Vice Chancellor*

I. Introduction

Two former officers and directors of Collins & Aikman Corporation ("C&A") seek, through separate actions, advancement of legal fees and indemnification from C&A's majority investor, Heartland Industrial Partners, L.P. ("Heartland") for their expenses arising from a variety of civil and criminal proceedings brought against them in connection with their roles at C&A.

David A. Stockman and J. Michael Stepp brought these suits after Heartland refused their requests for advancement related to ongoing legal proceedings, and for indemnification related to a dismissed criminal action, arguing that both advancement and indemnification to them are mandatory under Heartland's "Partnership Agreement." Heartland, for its part, argues that Stockman and Stepp's advancement and indemnification rights under the Partnership Agreement are more limited. Specifically, Heartland

contends that advancement is not mandatory where, as here, its General Partner has refused to provide written approval. Likewise, Heartland argues that indemnification is not mandatory because Stockman and Stepp must first plead and then prove that the conduct giving rise to the underlying dismissed criminal action met three requirements set forth in the Partnership Agreement. Specifically, Heartland asserts that it is Stockman and Stepp's burden to plead and ultimately demonstrate that they i) did not breach their duties to the partnership; ii) did not knowingly violate applicable law; and iii) did not act with scienter.

In this opinion, I find in favor of Stockman and Stepp on both their advancement and indemnification claims, and accordingly grant their motions for partial summary judgment regarding the advancement claims and deny Heartland's motion to dismiss the indemnification claims.

I find in favor of Stockman and Stepp because the plain language of the Partnership Agreement does not unambiguously support Heartland's reading of that document. In the case of the advancement claims, I conclude that there is only one reasonable reading of the Partnership Agreement, which is that Heartland's General Partner did not have discretion to withhold its written approval and defeat Stockman and Stepp's contractual right to mandatory advancement. Moreover, to the extent there is any ambiguity in the Partnership Agreement regarding advancement, that ambiguity must be resolved against Heartland.[1] Likewise, the Partnership Agreement does not clearly require an indemnitee to plead and demonstrate good faith, lawfulness, and a lack of scienter where, as occurred in this case, the indemnitee was successful in the underlying proceeding. Rather, if such a de novo inquiry is required at all by the Partnership Agreement — a reading that is hardly compelled by the odd language of the Agreement — Heartland bears the burden of proof, and Stockman and Stepp's pleading of success in the dismissed criminal action in their complaints satisfies any burden they have at this stage. In future proceedings, the parties can, if they do not settle the case, more specifically address this issue, recognizing that, absent a clear contractual requirement to prove good faith, lawfulness, and a lack of scienter in this circumstance, principles of both contract

[1] *See SI Mgmt. L.P. v. Wininger*, 707 A.2d 37, 42-44 (Del. 1998) (holding that ambiguities in a limited partnership agreement should be construed against the general partner unless all participants engaged in individualized negotiations); *Harrah's Entm't, Inc. v. JCC Holding Co.*, 802 A.2d 294, 309-10 (Del. Ch. 2002) (same); *see also Penn Mut. Life Ins. Co. v. Oglesby*, 695 A.2d 1146, 1150 (Del. 1997) (noting that it is incumbent on an issuer of securities to make the terms of its operative documents clear to a reasonable investor).

interpretation and of our state's public policy regarding indemnification will dictate an outcome in favor of Stockman and Stepp.[2]

II. Factual Background

I draw these undisputed facts from the well-pled allegations in both Stockman's First Amended and Supplemental Verified Complaint and Stepp's Verified Complaint (the "Stockman Complaint" and "Stepp Complaint," respectively) — which, except as noted, are the same in all material respects — and the documents incorporated in or attached to them.[3]

A. The Parties

Plaintiff David A. Stockman is a co-founder of Heartland and the Managing Member of both its General Partner and Investment Manager.[4] Plaintiff J. Michael Stepp is a Senior Managing Director of Heartland. Both served as officers and directors of C&A, which was one of Heartland's portfolio companies, at the direction of Heartland.[5] Stockman joined the C&A Board of Directors in 2001, became its Chairman in 2002, became CEO in 2003, and remained as Chairman and CEO until 2005. Stepp was Vice President and CFO of C&A from 2002 until 2004, and also served as the Vice Chairman of the C&A Board.

C&A designed, engineered, and manufactured automobile interior components. Heartland is a private equity fund. In 2001, Heartland acquired a 60% stake in C&A, and continued to acquire C&A shares in the following years. In March 2005, C&A publicly disclosed and corrected "certain historical accounting errors" that had been revealed in an internal

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[2]*See Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002) (recognizing Delaware's strong public policy interest in promoting indemnification in order to, among other benefits, encourage capable people to serve as directors); *DeLucca v. KKAT Mgmt., L.L.C.*, 2006 WL 224058, at *7 (Del. Ch. Jan. 23, 2006) (holding that, where reasonable, indemnification contracts should be read in favor of indemnification in light of Delaware's pro-indemnification policies); *Delphi Easter Partners Ltd. P'ship v. Spectacular Partners, Inc.*, 1993 WL 328079, at *2 (Del. Ch. Aug. 6, 1993) (holding that courts should construe limited partnership agreements 'so as to achieve where possible the beneficial purposes that indemnification can afford').

[3]Ct. Ch. R. 10(c); *Vanderbilt Income & Growth Assoc's v. Arvida/JMB Managers, Inc.*, 691 A.2d 609, 613 (Del. 1996). This includes the Partnership Agreement, which was attached to the Stepp Complaint and incorporated by reference in the Stockman Complaint.

[4]Beginning in June 2005, Stockman entered an agreement delegating these duties to an executive committee pending the investigations against him, and so, assumably, did not take part in the General Partner's decision to deny the advancement and indemnification requests at issue here. *See* Stockman Compl. ¶ 6.

[5]Stockman Compl. ¶ 7; Stepp Compl. ¶ 8.

management review.[6] Two months later, C&A filed for bankruptcy protection and was liquidated in 2007.

B. The Proceedings

C&A's announcement of its accounting and financial problems was followed by a multitude of legal actions naming Stockman and Stepp, among other C&A officers and directors, as defendants. Currently, about half a dozen civil actions remain pending against Stockman and Stepp in Michigan, New York, and Delaware. The one criminal action brought against Stockman and Stepp (the "Criminal Proceeding"), however, was dismissed through a *nolle prosequi* order on January 9, 2009. The Criminal Proceeding was filed by the federal government in the District Court for the Southern District of New York and was dismissed by that court at the request of the Acting U.S. Attorney, who concluded, "[a]fter a renewed assessment of the evidence," that further prosecution of Stockman and Stepp "would not be in the interests of justice."[7] The *nolle prosequi* order constitutes a dismissal without prejudice. The U.S. Attorney may bring the same charges against Stockman and Stepp within the applicable statute of limitations, which varies in this case between five and ten years depending on the charge, but would be required to do so through a new indictment.[8]

C. Heartland's Partnership Agreement

Stockman and Stepp's claims are governed by Heartland's Partnership Agreement, which provides for indemnification of and advancement to, among others, officers and directors of its portfolio companies. There is no dispute that Stockman and Stepp are "Indemnitees" as that term is defined in the Partnership Agreement.

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[6]Stockman Compl. ¶ 8.

[7]Stepp Compl. Ex. B ¶ 3. A *nolle prosequi* order is '[a] legal notice that a lawsuit or prosecution has been abandoned.' BLACK'S LAW DICTIONARY 1074 (8th ed. 2004). 'It is a judicial determination in favor of [the] accused and against his conviction, but it is not an acquittal, nor is it equivalent to a pardon.' *Id.* (quoting 22A C.J.S. *Criminal Law* § 419, at 1 (1989)).

[8]The doctrine of *nolle prosequi*, involving dismissal at the request of the prosecutor, has been codified in Rule 48 of the Federal Rules of Criminal Procedure. 'A dismissal properly taken under Rule 48(a) is without prejudice, and, within the period of the statute of limitations, a second indictment or information may be brought on the same charge.' 3B CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE & PROCEDURE § 811 (3d ed.) (citations omitted); *see also Woods v. Clay*, 2005 WL 43239, at *15 n.6 (N.D. Ill. Jan. 10, 2005) ('[A] *nolle prosequi* order terminates the charge and requires the institution of a new and separate proceeding to prosecute the defendant.' (quotations omitted)).

The Partnership Agreement contains a broad indemnification provision (the "Indemnification Provision"):

> *To the fullest extent permitted by law, the Partnership agrees to indemnify and save harmless each of the Indemnitees* from and against any and all claims, liabilities, damages, losses, costs and expenses . . . of any nature whatsoever, known or unknown, liquidated or unliquidated, that are incurred by any Indemnitee and or to which such Indemnitee may be subject by reason of its activities on behalf of the Partnership or in furtherance of the interest of the Partnership or otherwise arising out of or in connection with the affairs of the Partnership, its Portfolio Companies or any Alternative Vehicle . . . *provided, that: (i) an Indemnitee shall be entitled to indemnification hereunder only to the extent that such Indemnitee's conduct (A) was in or was not opposed to the best interests of the Partnership, (B) in the case of a criminal action or proceeding, the Indemnitee had no reasonable cause to believe his conduct was unlawful, or (C) did not constitute fraud, bad faith, willful misconduct, gross negligence, a violation of applicable securities laws or any material breach of the Agreement or the Advisory Agreement . . . .*[9]

The Partnership Agreement also grants Heartland's Indemnitees generous advancement rights under certain conditions (the "Advancement Provision"):

> *Expenses reasonably incurred* by an Indemnitee in defense or settlement of any claim that may be subject to a right of indemnification hereunder *shall be advanced by the Partnership* prior to the final disposition thereof upon receipt of an undertaking by or on behalf of the Indemnitee to repay such amount to the extent that it shall be determined ultimately that such Indemnitee is not entitled to be indemnified hereunder. *No advances shall be made by the Partnership under this Section 4.4(b)(i) without the prior written approval of the General Partner* or (ii) in connection with an action

[9]Partnership Agreement § 4.4(a) (emphasis added).

> brought against an Indemnitee by a Majority in Interest of the Limited Partners.[10]

Thus, advancement of expenses to Heartland Indemnitees is mandatory under the Partnership Agreement, subject to the requirement of prior written approval from the General Partner, and except in situations where Heartland itself, through a majority of its owners, sues an Indemnitee, which is not the case here.

D. Heartland's Refusal To Provide Advancement Or Indemnification

After the various actions against them were initiated, Stockman and Stepp submitted advancement claims to C&A's insurance carriers for their ongoing legal expenses, which were apparently paid until C&A's insurance policies were exhausted. Stockman and Stepp next turned to Heartland's insurance carriers for advancement, but by the autumn of 2008, Heartland's insurance plans were also exhausted.

When Stockman and Stepp then turned to Heartland directly to provide the funds, Heartland refused to advance legal expenses to Stockman or Stepp unless they agreed to additional conditions not set forth in the Partnership Agreement. Stockman alleges that Heartland required him to accept a cap on the total amount of legal fees for which he could receive advancement.[11] Similarly, but less restrictively, in a letter attached to the Stepp Complaint, Heartland requested that Stepp provide monthly litigation budgets as a condition of receiving advancements.[12] Both Stockman and Stepp plead that Heartland also asked them to submit written certifications that they were entitled to advancement, including statements that they at all times acted in accordance with the requirements for indemnification listed in the Indemnification Provision, and to put up adequate security in case repayment is ultimately required.

Heartland took the position that the Partnership Agreement granted it the discretion to impose these additional conditions through the requirement in the Advancement Provision that the Heartland's General Partner give prior written approval before any funds are distributed. Stockman and Stepp dispute that Heartland has this discretion. Accordingly, Heartland has so far denied Stockman and Stepp's advancement requests.

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[10]Partnership Agreement § 4.4(b) (emphasis added).
[11]Stockman Compl. ¶ 19.
[12]Stepp Compl. Ex. F at 2.

Heartland has been similarly unwilling to open its purse strings to indemnify Stockman and Stepp with regard to the Criminal Proceeding, which was dismissed at the request of the Acting U.S. Attorney in January 2009. Heartland informed Stockman and Stepp that their indemnification requests, made after the Criminal Proceeding was dismissed, were premature. Heartland contended that if a court in one of the still-pending civil proceedings found that Stockman and Stepp's conduct involved a state of mind inconsistent with the requirements set forth in the Indemnification Provision, then Stockman and Stepp would not be entitled to indemnification with regard to the Criminal Proceeding. As a result, Heartland argued, it could not make a determination about Stockman and Stepp's eligibility for indemnification until all legal proceedings against them were resolved.

After Heartland rejected their advancement and indemnification requests, Stockman and Stepp both filed suit in this court seeking indemnification for the Criminal Proceeding and advancement of legal expenses for the pending proceedings, which in turn led to a flurry of motions and cross motions seeking claim-dispositive orders. Heartland has moved to dismiss both the Stockman and Stepp Complaints in their entirety for failure to state a claim. Stockman and Stepp responded by each filing motions for partial summary judgment regarding their advancement claims. The result is that the advancement claims in this action are subject both to motions for summary judgment from Stockman and Stepp and to Heartland's motions to dismiss. The indemnification claims, on the other hand, are subject only to Heartland's motions to dismiss.

III. Legal Analysis

A. Applicable Standards

Two standards of review are applicable to the pending motions. First, Stockman and Stepp's motions for summary judgment regarding the advancement claims are governed by Court of Chancery Rule 56, under which parties are entitled to summary judgment if they demonstrate "that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."[13] Second, Heartland's motions to dismiss both the advancement and indemnification claims are governed by the Rule 12(b)(6) standard providing for dismissal where a plaintiff to fails

[13]Ct. Ch. R. 56(c); *see also United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810, 829-30 (Del. Ch. 2007).

to "plead enough facts to plausibly suggest that the plaintiff will ultimately be entitled to the relief she seeks."[14]

These two standards largely converge where, like here, a dispute turns on issues of contract interpretation. In both cases, a moving party is generally only entitled to a claim-dispositive order on its motion — either for summary judgment or dismissal — where the contract is unambiguous.[15] A contract is unambiguous if its terms are "reasonably or fairly susceptible" to only one meaning.[16] So, as a general rule, a party is only entitled to a dispositive order short of trial where its interpretation of a contract is the only reasonable one.

But, where the contract in dispute is an entity's organizing document, like the Partnership Agreement, a dispositive order following motion practice may be appropriate even where the contract is ambiguous. When an agreement like the Partnership Agreement makes promises to parties who did not participate in negotiating the agreement, Delaware courts apply the general principle of *contra proferentum*, which holds that ambiguous terms should be construed against their drafter.[17] The *contra proferentum* approach protects the reasonable expectations of people who join a partnership or other entity after it was formed and must rely on the face of the operating agreement to understand their rights and obligations when making the decision to join.[18]

As a practical matter, it is critical that the governing instruments of entities be interpreted consistently and that they be applied in a predictable manner. To introduce the consideration of parol evidence when issues

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[14]*Desimone v. Barrows*, 924 A.2d 908, 929 (Del. Ch. 2007).

[15]*See VLIW Tech., LLC v. Hewlett-Packard Co.*, 840 A.2d 606, 615 (Del. 2003); *United Rentals*, 937 A.2d at 830.

[16]*Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992); *see also United Rentals*, 937 A.2d at 830.

[17] *See, e.g.*, *SI Mgmt. L.P. v. Wininger*, 707 A.2d 37, 43 (Del. 1998) ('[A]mbiguous terms in the Agreement should be construed against the General Partner as the entity solely responsible for the articulation of those terms.'); *Penn Mut. Life Ins. Co. v. Oglesby*, 695 A.2d 1146, 1149-50 (Del. 1997) ('[I]t is the obligation of the issuer of securities to make the terms of the operative document understandable to a reasonable investor whose rights are affected by the document.'). Delaware courts have applied this principal in a variety of procedural contexts. *See, e.g.*, *Werner v. Miller Tech. Mgmt., L.P.*, 831 A.2d 318, 333 (Del. Ch. 2003) (denying motion to dismiss); *In re Nantucket Island Assocs. Ltd. P'ship Unitholders Litig.*, 810 A.2d 351, 361 (Del. Ch. 2002) (granting plaintiffs' motion for summary judgment); *Harrah's Entm't, Inc. v. JCC Holding Co.*, 802 A.2d 294, 309-10 (Del. Ch. 2002) (applying principle by analogy in corporate charter context in post-trial opinion).

[18]*See Oglesby*, 695 A.2d at 1150; *Harrah's*, 802 A.2d at 309-10 ('[W]hen a court is asked to construe a limited partnership agreement drafted solely by the corporate general partner, it will resolve all ambiguities against the general partner as drafter and in favor of the reasonable expectations of the public investors.').

regarding subjects like indemnification come up would create unpredictable results, reduce the incentives for clear drafting, and undermine the ability of investors, officers, and other relevant constituencies to rely on the written text of governing instruments in deciding whether to invest in, work for, or supply debt capital to entities.[19]

Thus, where an entity's governing instruments are involved, the onus is on the drafter to be clear. As discussed by our Supreme Court, in the context of discussing both insurance contracts and operative entity documents:

> [T]he insurer or the issuer, as the case may be, is the entity in control of the process of articulating the terms. The other party, whether it be the ordinary insured or the investor, usually has very little say about those terms except to take them or leave them or to select from limited options offered by the insurer or issuer. Therefore, it is incumbent upon the dominant party to make terms clear. Convoluted or confusing terms are the problem of the insurer or issuer — not the insured or investor.[20]

The same concerns are equally applicable to the directors, officers, and employees of limited partnerships who, like limited partners, typically must base their decision to serve on the terms of the limited partnership agreement as written. That is, in the case of an entity with ongoing operations, key constituents, including directors, officers, and employees, look to the governing instrument's words, and not some obscure archive of parol evidence.[21] As a result, any ambiguities in Heartland's Partnership

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[19]*See Kaiser Aluminum Corp. v. Matheson*, 681 A.2d 392, 398-99 (Del. 1996).

[20]*Oglesby*, 695 A.2d at 1149-50.

[21]Notably, and in contrast to Stepp, Stockman does not argue that *contra proferentum* is applicable to his claims, likely because, as a co-founder of Heartland, Stockman was probably involved in drafting the Partnership Agreement. I nevertheless apply *contra proferentum* to both Stockman and Stepp's claims. Doing otherwise risks the bizarre outcome of concluding that the same language of the Partnership Agreement means different things as applied to two persons who are both Indemnitees within the meaning of the Indemnification and Advancement Provisions. Because the Partnership Agreement makes promises to officers and directors who did not participate in its drafting, the Partnership Agreement must be read in all cases in light of the expectations that its text would create for a reasonable officer or director. *See Kaiser*, 681 A.2d at 398-99 (holding that, when faced with ambiguous provisions in preferred stock certificates, 'the Court must construe the document to adhere to the reasonable expectations of the investors who purchased the security and thereby subjected themselves to the terms of the contract' in order to, in part, avoid the drawbacks of disuniform readings of contract provisions that apply to many people).

Agreement should be resolved in favor of the reasonable expectations of Heartland's Indemnitees regarding their indemnification and advancement rights.

With these standards in mind, I turn to the parties' specific contentions regarding the Partnership Agreement.

B. The Advancement Claims

At the center of the parties' dispute over advancement is the question of how to read the requirement that "[n]o advances shall be made by the Partnership . . . without the prior written approval of the General Partner."[22] Heartland argues that the plain meaning of the prior written approval requirement is that the General Partner has discretion to deny that approval, otherwise there would be no point in requiring prior approval.

In contrast, Stockman and Stepp argue that the language providing that "[e]xpenses reasonably incurred by an Indemnitee . . . *shall* be advanced by the Partnership"[23] makes advancement mandatory, and the written approval requirement serves the more ministerial, but still important, purpose of ensuring that the requirements set forth in the Advancement Provision — that the expenses be reasonably incurred and the indemnitee provide an undertaking to repay non-indemnifiable expenses — have been met before the money is turned over.

In my view, Stockman and Stepp's interpretation of the Partnership Agreement is the only reasonable one. A basic principle of contract interpretation is that the court reads an agreement as a whole to give effect to each term and to harmonize seemingly conflicting terms.[24] There is, admittedly, some tension in the Advancement Provision between the requirement that litigation expenses "*shall* be advanced" and the requirement that "[n]o advances *shall* be made by the Partnership . . .

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[22]Partnership Agreement § 4.4(b).

[23]Partnership Agreement § 4.4(b) (emphasis added).

[24]*See, e.g.*, *Council of the Dorset Condo. Apartments v. Gordon*, 801 A.2d 1, 7 (Del. 2002) ('A court must interpret contractual provisions in a way that gives effect to every term of the instrument, and that, if possible, reconciles all of the provisions of the instrument when read as a whole.'); *Julian v. E. States Constr. Serv.*, 2008 WL 2673300, at *7 (Del. Ch. July 8, 2008) ('[W]hen interpreting a contractual provision, a court attempts to reconcile all of the agreement's provisions when read as a whole, giving effect to each and every term.'); *Delta & Pine Land Co. v. Monsanto Co.*, 2006 WL 1510417, at *4 (Del. Ch. May 24, 2006) ('[C]ontracts must be interpreted in a manner that does not render any provision illusory or meaningless.') (quotations omitted); *In re Cencom Cable Income Partners, L.P. Litig.*, 2000 WL 640676, at *5 (Del. Ch. May 5, 2000) ('In order to discern the intent of the parties, the contract should be read in its entirety and interpreted to reconcile all of the provisions of the agreement.').

without the prior written approval of the General Partner."[25] But, Heartland's interpretation of the Partnership Agreement strains the plain meaning of the relevant language when it is read in its full context, as it must be. In contrast, Stockman and Stepp's interpretation of the Partnership Agreement is reasonable and supports a finding that Stockman and Stepp are entitled to judgment as a matter of law.

1. Heartland's Reading Of The Partnership Agreement Is Unreasonable

Heartland argues that the use of "shall be advanced" in the first part of Advancement Provision is meant to protect Heartland from potential duty of loyalty claims by limited partners for authorizing advancements to Heartland officers and directors, and, on the flip side, the requirement of written approval in the second part of the Advancement Provision is meant to protect Heartland from having to give advances where "advancement would be inappropriate."[26] Stated differently, Heartland argues that the Advancement Provision serves to shield Heartland's advancement decisions from any form of challenge by eliminating discretion at the front door to bar limited partner claims — expenses "shall be advanced" — but then reintroducing discretion through the back door to also bar Indemnitee claims — "no advances shall be made . . . without prior written approval."

But this argument does not convince me for a number of reasons. For starters, the plain meaning of "shall be advanced" is that advancement is mandatory. To give the General Partner unfettered discretion to deny an advancement request would, in essence, convert the Advancement Provision to a permissive rather than a mandatory term, in contravention of its plain language.

And, the Advancement Provision does not serve the liability-insulating purpose that Heartland claims it does because the Advancement Provision does not eliminate suits from limited partners. As written, any discretion granted to the General Partner through the written approval requirement must necessarily be exercised in accordance with the General Partner's fiduciary duties.[27] Taken as a whole, the Partnership Agreement embodies a clear and specific approach to allocating discretion to the

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[25]Partnership Agreement § 4.4(b) (emphasis added).

[26]Heartland Ans. Br. to Stepp Mot. for Partial Summ. J. at 7.

[27] Under the Partnership Agreement, the General Partner is liable to Heartland and its limited partners for conduct that was not in or opposed to the best interests of Heartland, that the General Partner had reason to believe was unlawful, or that was the result of fraud, bad faith, willful misconduct, gross negligence, a violation of applicable securities laws, or a breach of the Partnership Agreement. Partnership Agreement § 4.3(a).

General Partner: numerous provisions throughout the Agreement delegate decisions expressly to the "discretion," "sole discretion," or "sole and absolute discretion" of the General Partner.[28] And, the Partnership Agreement states that, when the General Partner's decision is subject to one of those standards, it "shall be entitled to consider any interests and factors as it desires, including its own interests," therefore limiting the ability of plaintiffs to sue the General Partner.[29] The import of these provisions is that the Partnership Agreement's drafters thought about when the General Partner should have discretion and explicitly stated in the Agreement when the General Partner has discretion. It would be very poor drafting indeed for Heartland to leave out a contractually important, liability-limiting term like "sole and absolute discretion," or at least "discretion," where Heartland intended to immunize the General Partner from a claim regarding advancement.

Indeed, in its provisions regarding the rights of limited partners to transfer their interests, the Partnership Agreement creates the same situation of required written approval that can be denied in the General Partner's discretion that Heartland claims the Advancement Provision creates, but does so by explicit reference to a standard of discretion: "A Limited Partner shall not sell, assign, pledge or otherwise transfer its Interest in whole or in part to any Person . . . *without the prior written consent of the General Partner, which consent may be given or withheld in the sole and absolute discretion of the General Partner* . . . ."[30] Heartland has offered no explanation for why two provisions that purport to achieve the same purpose would be drafted so differently in the same agreement. In other words, Heartland says that the Advancement Provision should be read as

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[28]*See, e.g.*, Partnership Agreement § 2.7 (General Partner may change fiscal year end date 'in its sole discretion'); § 2.9(d)(ii) ('General Partner may obtain such additional capital as determined by the General Partner in its sole discretion'); § 2.9(e)(ii) (same); § 3.2 (opinion of counsel 'may be waived by General Partner in its sole discretion'); § 3.3(a) ('General Partner may, in its sole discretion, admit additional Limited Partners'); § 3.3(g) ('General Partner in its sole discretion may adjust the percentage interests' in response to adding limited partners); § 3.4(b)(i) ('Distributions prior to the termination of the Partnership may only take the form of cash or Marketable Securities, in the General Partner's discretion . . . .'); § 3.4(b)(ii) ('General Partner may, in its sole discretion, offer each Partner a choice to receive an in kind distribution of Marketable Securities'); § 4.2(a) ('[General Partner] shall be authorized and empowered on behalf of and in the name of the Partnership to carry out any and all of the objects and purposes of the Partnership and to perform all acts and enter into and perform all contracts and other undertakings that it may in its sole discretion deem necessary or advisable or incidental thereto . . . .'); § 4.2(b) ('General Partner is authorized and empowered . . . [to] make in its sole discretion, an and all elections for federal, state, local and non-United States tax matters.'); § 4.10 ('General Partner in its discretion may terminate or change the composition of the membership of the Advisory Board at any time').

[29]Partnership Agreement § 11.2(b).

[30]Partnership Agreement § 8.2(a) (emphasis added).

stating that Heartland may not grant an advancement request without the prior written approval of the General Partner, which approval may be given or withheld in the sole discretion of the General Partner. But Heartland does not explain why this clear formulation was not used if this was the intent. It would have been easy to write the Advancement Provision to accomplish the end Heartland wanted using the Partnership Agreement's provision on transfers of interest as a model; all the Advancement Provision had to say is that the General Partner's approval of an advancement request "may be given or withheld in the sole and absolute discretion of the General Partner." Instead of that type of clearly non-binding formulation, the drafters of the Partnership Agreement used plainly mandatory language to describe an Indemnitee's right to receive advancement.

Thus, given the availability of drafting tools that clearly stated the discretion of the General Partner and the Partnership Agreement's consistent use of them, it is unreasonable to read the Advancement Provision, which lacks any phrase involving the word "discretion," as somehow obliquely conferring discretion to the General Partner.[31]

2. Stockman And Stepp Are Entitled To Judgment As A Matter Of Law

In contrast to Heartland's flawed interpretation, Stockman and Stepp's interpretation of the Advancement Provision — that the prior written approval requirement gives the General Partner a means of policing the express preconditions to an Indemnitee's receipt of advancement contained in the Advancement Provision — is reasonable and gives

[31]In this regard, Heartland's ambitious argument that § 4.2(a) of the Partnership Agreement grants the General Partner discretion to deny advancement claims is unpersuasive. Under § 4.2(a), the General Partner is authorized 'to perform all acts and enter into and perform all contracts and other undertakings *that it may in its sole discretion deem necessary or advisable* or incidental' to carrying out the business of the Partnership. Partnership Agreement § 4.2(a) (emphasis added). Heartland argues that this provision grants the General Partner discretion in *all* of its actions! But, if § 4.2(a) is a blanket conferral of discretion, then the numerous uses of 'sole discretion' or its variants throughout the Partnership Agreement are superfluous. As a result, this interpretation is at odds with the requirement that this court attempt to give meaning to every term in an agreement. *See NAMA Holdings, LLC v. World Market Ctr. Venture, LLC*, 948 A.2d 411, 419 (Del. Ch. 2007) ('Contractual interpretation operates under the assumption that the parties never include superfluous verbiage in their agreement, and that each word should be given meaning and effect by the court.'); *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 588 (Del. Ch. 2006) (stating that, as a general matter, courts 'attempt to interpret each word or phrase in a contract to have an independent meaning so as to avoid rendering contractual language mere surplusage'); *W. Willow-Bay Court, LLC v. Robino-Bay Court Plaza, LLC*, 2007 WL 3317551, at *11 (Del. Ch. Nov. 2, 2007) ('Delaware courts do prefer to interpret contracts to give effect to each term rather than to construe them in a way that renders some terms repetitive or mere surplusage.').

meaning to all of the terms in that Provision. Although advancement may be required, it would place Heartland in a precarious situation if it had to turn over its cash on receipt of any request for advancement, without some means of ensuring that the requirements clearly set forth in the Advancement Provision — that the expenses are reasonably incurred and the Indemnitee provide an undertaking to repay non-indemnifiable expenses — are met. Relatedly, judges on this court are familiar with situations where entities have taken the position that they need not advance funds because a particular proceeding or claim does not implicate the indemnitee's official capacity,[32] or that an entity's advancement obligation is triggered only after another entity's coverage is exhausted.[33] The approval role of the General Partner under the Advancement Provision allows it to examine requests for advancement to address issues like these. This review function is important, even if it leaves the General Partner with no blanket discretion to deny a proper advancement request.

In this regard, I am unpersuaded by Heartland's argument that any reading of the prior written approval requirement in a limited or non-discretionary way is precluded by the nature of the last part of the Advancement Provision, which categorically bars advancement where the underlying proceeding was brought by a majority of the limited partners. Heartland's assertion is that this second restriction on advancement is plainly meant to be substantive, and so a harmonious reading of the Advancement Provision requires that the first restriction on advancement, the prior written approval requirement, be read equally substantively. But, as just discussed, the prior written approval requirement need not be read as conferring broad discretion to have substance. The approval requirement bars advancement in all cases where the request does not meet the express conditions of the Advancement Provision as policed by the General Partner, making the prior written approval requirement as categorical a restriction, albeit a narrow one, as the bar on advancement in suits brought by the majority of limited partners.

In sum, reading the written approval requirement as one of limited discretion does not read any language out of the Partnership Agreement and provides the only reasonable way to harmonize all of the terms of the

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[32] *See, e.g.*, *Sassano v. CIBC World Mkts. Corp.*, 948 A.2d 453, 470 (Del. Ch. 2008); *Zaman v. Amedeo Holdings, Inc.*, 2008 WL 2168397, at *25 (Del. Ch. May 23, 2008); *Tafeen v. Homestore, Inc.*, 2004 WL 556733, at *4-5 (Del. Ch. Mar. 22, 2004), *aff'd*, 888 A.2d 204 (Del. 2005); *Reddy v. Elec. Data Sys. Corp.*, 2002 WL 1358761, at *5-6 (Del. Ch. June 18, 2002).

[33] *See, e.g.*, *DeLucca v. KKAT Mgmt., L.L.C.*, 2006 WL 224058, at *15 (Del. Ch. Jan. 23, 2006).

Advancement Provision, making the Advancement Provision unambiguous.[34]

Moreover, to the extent there is any ambiguity in the Advancement Provision, that ambiguity must be resolved against Heartland in favor of the reasonable expectations the terms of the Provision engender in those they affect. Delaware courts resolve ambiguities in governing instruments in order to provide uniform, predictable interpretations of the documents that officers, investors, and other constituencies who provide benefits to the entity rely on in making their decisions about whether to participate in the entity's activities.[35] This principle of interpretation protects the participants' reasonable expectations, which in turn benefits the entity by encouraging participants to provide their capital, be it human or financial, at a lower cost than they would if they faced greater uncertainty.[36] Here, the language of the Advancement Provision creates a reasonable expectation on the part of Indemnitees that the written approval of the General Partner will be forthcoming in any instance where an advancement request met the express criteria of the Advancement Provision. Accordingly, to the extent there is any ambiguity about the General Partner's obligation to provide written approval in these circumstances, that ambiguity must be construed in favor of Stockman and Stepp, who indisputedly met the Advancement Provision's express requirements.

For all of these reasons, I conclude that Stockman and Stepp are entitled to summary judgment in their favor on the advancement claims.[37]

C. The Indemnification Claims

Section § 17-108 of the DRULPA gives limited partnerships wider

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[34]In reaching the conclusion that the Advancement Provision confers limited discretion on the General Partner, I make no finding about whether Heartland's request that Stepp provide litigation budgets was a legitimate exercise of the General Partner's discretion. In my view, there is a colorable argument that a non-binding litigation budget requested merely as a guide for Heartland to budget its own expected costs may be a reasonable condition to the General Partner's written approval, but I do not dilate on this question as neither side's briefs focused on this minor issue.

[35]*See SI Mgmt.*, 707 A.2d at 43; *Oglesby*, 695 A.2d at 1149-50; *Kaiser*, 681 A.2d at 398-99.

[36]*See Kaiser*, 681 A.2d at 398 ('[T]he creation of enduring uncertainties as to the meaning of boilerplate provisions [in debenture indentures] would . . . vastly increase the risks and, therefore, the costs of borrowing with no offsetting benefits either in the capital market or in the administration of justice.' (quoting *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982))).

[37]Because I grant Stockman and Stepp summary judgment, I necessarily deny Heartland's motions to dismiss with respect to the advancement claims, which raise the same issues.

freedom of contract to craft their own indemnification scheme for a partnership's indemnitees than is available to corporations under § 145 of the DGCL, which creates mandatory indemnification rights for corporate indemnitees in some circumstances and also bars indemnification in others.[38] Here, the drafters of the Partnership Agreement used their contractual freedom to craft an approach to indemnification that employs language drawn from § 145, but in a selective way that creates some room for confusion. In a nutshell, the Indemnification Provision adopts § 145's standard for good faith and lawful conduct, but is silent about the effect of a disposition of the underlying proceeding in favor of the Indemnitee, which is a key consideration when determining whether a corporate official is entitled to indemnification under § 145.

This inelegant drafting has given rise to a dispute between the parties over whether Stockman and Stepp must plead, and ultimately prove, that they acted in accordance with the three requirements for indemnifiable conduct listed in the Indemnification Provision in order to be entitled to indemnification with regard to the Criminal Proceeding, even though that Proceeding was dismissed in their favor. Typically, analysis of the indemnification rights of participants in a limited partnership begins with the language of the relevant partnership agreement. But here, all of the parties have made express appeals to the language and policies of § 145 — which appears to have served as a model to the Partnership Agreement's drafters — in their arguments about how the Indemnification Provision should be interpreted. As such, it is useful to first take a brief look at that statutory scheme created by § 145 and how it would operate in this case before turning to Heartland's Partnership Agreement.

1. Indemnification Under § 145

Section 145 states, in relevant part:

> (a) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the

[38] *See* 6 *Del. C.* § 17-108 ('Subject to such standards and restrictions, if any, as are set forth in its partnership agreement, a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever.').

> corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation . . . *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.* . . .
>
> (b) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that the person is or was a director, officer, employee or agent of the corporation . . . *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.* . . .
>
> (c) *To 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.[39]

As discussed by our Supreme Court:

> 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

[39] 8 *Del. C.* § 145 (emphasis added).

> honesty and integrity as directors will be borne by the corporation they serve.[40]

Section 145 meets these policy goals in two ways. First, subsections (a) and (b) authorize corporations to indemnify their officers, directors, and other agents in proceedings brought against them "by reason of the fact" of the indemnitee's position as long as the indemnitee "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, in proceedings within the scope of §145(a), "with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful."[41] Thus, under §§ 145(a) and (b), corporations can shield their indemnitees from the risk that they will incur personal liability in the course of their good faith efforts to serve the corporation. But, the corporation's power to do so is limited where there is a risk that indemnification will encourage officers to break the law or breach their duty of loyalty to the corporation. As explained by members of the committee that drafted § 145:

> It was also apparent that revision was appropriate with respect to the limitations which must necessarily be placed on the power to indemnify in order to prevent the statute from undermining the substantive provisions of the criminal law and corporation law. If indemnification in criminal proceedings were to be included within the scope of the statute, the full deterrent effect of the anti-trust law, for example, could be maintained only where the party involved had no reasonable cause to believe his conduct was unlawful. . . . The need for a similar provision to protect the corporation law's requirement of loyalty to the corporation was equally apparent . . . .[42]

In other words, the purpose of the limits on indemnifiable conduct in §§ 145(a) and (b) is in part to ensure that corporate officials do not evade the consequences of their own misconduct in such a way that they are rewarded for or encouraged to violate applicable laws and to breach their fiduciary duties to the corporation.

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[40] *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002) (quotations omitted).

[41] 8 *Del. C.* §§ 145(a), (b).

[42] S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 78 (1967).

But, where there is no punishment to avoid — i.e., there has been no conviction, no fine, and no settlement payment — the corporation may not inquire into the good faith and lawfulness of its indemnitees. Rather, the second integral part of the § 145 scheme is that corporate indemnitees have an absolute right to mandatory indemnification where they are "successful on the merits or otherwise" in the underlying proceeding.[43] In other words, § 145(c) assures corporate indemnitees that their reasonable legal expenses will be paid any time they are "successful" in a proceeding. An indemnitee in a criminal proceeding is successful any time she avoids conviction: "[s]uccess is vindication . . . any result other than conviction must be considered success."[44] Accordingly, if § 145 were applicable to Stockman and Stepp's claims, they would be considered successful in the Criminal Proceeding because it was dismissed, and Stockman and Stepp would be entitled to mandatory advancement.[45]

Admittedly, some believe that there remains a question in our law as to whether a corporate indemnitee is successful when an action is dismissed without prejudice and could theoretically be revived, as is the case here.[46] But, two recent decisions of this court support awarding indemnification after a dismissal without prejudice on the basis that indemnification decisions should be made on a case-by-case basis, especially where the governing bylaw or organizational document provides broad, mandatory indemnification rights.[47] To do otherwise would be the

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[43]*See* 8 *Del. C.* § 145(c); *see also FGC Holdings Ltd. v. Teltronics, Inc.*, 2007 WL 241384, at *9 (Del. Ch. Jan. 22, 2007) ('[S]ubsection (c) grants an absolute right of indemnification to the movant, provided that he has been successful on the merits or otherwise.'); *Perconti v. Thornton Oil Corp.*, 2002 WL 982419, at *3 (Del. Ch. May 3, 2002) ('Under 8 *Del. C.* § 145(c), an officer or director who meets the requirements of the statutory provision has an absolute right to indemnification.').

[44]*Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 141 (Del. Super. 1974); *see also Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87, 96 (2d Cir. 1996) ('"[S]uccess' under § 145(c), does not mean moral exoneration. Escape from an adverse judgment or other detriment, for whatever reason, is determinative.'); *Zaman*, 2008 WL 2168397, at *22 ('The success on the 'merits or otherwise' standard is one that grants indemnification to corporate officials even when they have not been adjudged innocent in some ethical or moral sense.').

[45]*See Perconti*, 2002 WL 982419, at *3. In *Perconti*, the U.S. Attorney had dismissed charges against a corporate officer after a mistrial. This court then held that the officer was entitled to indemnification under § 145(c): 'Dismissal of the charges against Perconti by the government, for whatever reason, constituted 'success." *Id.*

[46]*See* 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS ('BALOTTI & FINKELSTEIN') § 4.12[B] at 4-63 n.391 (2009) (noting that the law is unclear in this area and that '[t]he Court of Chancery has not clearly stated what 'otherwise' means.').

[47]*See Zaman v. Amedeo Holdings, Inc.*, 2008 WL 2168397 (Del. Ch. May 23, 2008);

same as requiring indemnitees to wait for all proceedings against them arising from the same set of operative facts to be concluded before receiving indemnification for any of them, which this court has held to be improper in similar circumstances.

In *Levy v. Hayes Lemmerz International, Inc.*,[48] this court held that plaintiffs did not have to await the outcome of an SEC investigation into alleged accounting irregularities in order to receive indemnification for a settled class action suit arising from the same conduct.[49] The *Levy* court took particular note of the bylaw's promise to provide indemnification for an action "whether civil, criminal, administrative, or investigative,"[50] which is similar to the Indemnification Provision's promise to provide indemnification for "any and all claims . . . of any nature whatsoever," and concluded that this language evinced an intent to treat indemnification requests on a case-by-case basis because "a party may be indemnified for a civil action, and may also seek indemnification for a later criminal action, if it arises."[51]

Moreover, as the *Levy* court noted:

> To read this language to mean that in any case where multiple causes of action could be raised the indemnified party must wait for all relevant statutes of limitations to run, or for all other possible causes of action to be disposed of, is to eviscerate the important right of indemnification on which Delaware corporations rely to secure qualified people to serve on their boards.[52]

Similar concerns animated this court's holding in *Zaman v. Amedeo Holdings, Inc.*,[53] where the court concluded that indemnitees were entitled to indemnification on federal claims that were dismissed without prejudice

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Levy v. Hayes Lemmerz Int'l, Inc., 2006 WL 985361 (Del. Ch. Apr. 5, 2006).

[48]2006 WL 985361 (Del. Ch. Apr. 5, 2006).

[49]Heartland argues that this court's decision in *Levy* is distinguishable because it applied § 145, but the Indemnification Provision is not identical to § 145 because, as discussed, it does not contain the language found in § 145(c). This argument is unpersuasive. For starters, Heartland does not indicate how the existence or non-existence of a § 145(c) alters the *Levy* analysis. Even where § 145(c) would not be applicable because the indemnitee was not successful in the underlying action, I read *Levy* as indicating that a party need not wait until all actions against it are settled before seeking indemnification on the basis that it acted in good faith and without reason to believe its conduct was unlawful.

[50]*Levy*, 2006 WL 985361, at *10.

[51]*Id.*

[52]*Id.*

[53]2008 WL 2168397 (Del. Ch. May 23, 2008).

for lack of subject matter jurisdiction, and that the indemnitees did not have to wait until the dismissed claims were resolved in state court.[54]

I adhere to the *Levy* and *Zaman* approach here and conclude that, under § 145(c), the dismissal of the Criminal Proceeding would be considered a success. Otherwise, requiring Stockman and Stepp to wait for all of the relevant statutes of limitation to run, one of which is ten years in this case, would work the very evisceration of important indemnification rights that *Levy's* well-reasoned analysis counsels against.[55]

With this understanding of how the corporate statutory scheme would operate in this case, I turn to the governing terms of the Partnership Agreement.

2. Indemnification Under The Partnership Agreement

The Indemnification Provision begins with an expansive grant of mandatory indemnification rights: "*To the fullest extent permitted by law*, the Partnership agrees to indemnify and save harmless each of the Indemnitees from and against *any and all claims*, liabilities damages, losses, costs and expenses . . . *of any nature whatsoever*, known or unknown, liquidated or unliquidated . . . ."[56] The "to the full extent permitted by law" language is common in both corporate bylaws and in alternative entity operating agreements,[57] and is "an expression of the intent for the promise of indemnity to reach as far as public policy will allow."[58]

The Partnership Agreement's broad grant of indemnification, however, is subject to certain qualifications:

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[54]*Id.* at *22 ('Here, the Derbyshires were successful in having the Federal Action entirely dismissed. The fact that the dismissal of a lot of the counts was without prejudice does not mean that the Derbyshires were not successful.').

[55]For the same reasons, I reject Heartland's argument that Stockman and Stepp cannot receive indemnification for the Criminal Proceeding until all the pending civil proceedings involving the same underlying conduct are resolved. *See also Green v. Westcap Corp. of Del.*, 492 A.2d 260, 265 (Del. Super. 1985) ('Under § 145 indemnification must be considered as each criminal or civil proceeding arises or is concluded.').

[56]Partnership Agreement § 4.4(a) (emphasis added).

[57]*See, e.g.*, *Donohue v. Corning*, 949 A.2d 574, 576 (Del. Ch. 2008) (LLC agreement); *Brown v. LiveOps, Inc.*, 903 A.2d 324, 328 (Del. Ch. 2006) (corporate bylaw); *Underbrink v. Warrior Energy Servs. Corp.*, 2008 WL 2262316, at *7 (Del. Ch. May 30, 2008) (corporate bylaw); *FGC Holdings*, 2007 WL 241384, at *8 (corporate bylaw); *Morgan v. Grace*, 2003 WL 22461916, at *2 (Del. Ch. Oct. 29, 2003) (LLC agreement).

[58]*DeLucca*, 2006 WL 224058, at *10; *see also Brown*, 903 A.2d at 328; *Underbrink* 2008 WL 2262316, at *7.

> [A]n Indemnitee shall be entitled to indemnification hereunder only to the extent that such Indemnitee's conduct (A) was in or was not opposed to the best interests of the Partnership, (B) in the case of a criminal action or proceeding, the Indemnitee had no reasonable cause to believe his conduct was unlawful, *or* (C) did not constitute fraud, bad faith, willful misconduct, gross negligence, a violation of applicable securities laws or any material breach of the Agreement or the Advisory Agreement . . . .[59]

These requirements are similar to the language in §§ 145(a) and (b) requiring that an indemnitee act "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."[60] But, puzzlingly, and unlike § 145, the drafters of the Indemnification Provision joined the list of requirements with "or" rather than "and," an issue I address in more detail below.

Moreover, the Indemnification Provision is silent with respect to the rights of Indemnitees who are successful in proceedings brought against them, meaning the Indemnification Provision does not address the issue covered by § 145(c). The appropriate interpretation of this silence — i.e., whether the Partnership Agreement's silence should be read as implicitly adopting a success standard akin to § 145(c) or not — is important because, as discussed above, such a success standard would mandate indemnification in this case.

3. The Partnership Agreement Does Not Require Stockman And Stepp To Plead That Their Conduct Was Consistent With The Indemnification Provision's Requirements

Heartland argues that even though Stockman and Stepp were successful in the Criminal Proceeding, they still must plead and ultimately demonstrate that they acted in accordance with the requirements set forth in the Indemnification Provision because the omission of a success standard in that Provision should be read as an intentional choice by the drafters to require an affirmative showing of proper conduct in all cases. Moreover,

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[59]Partnership Agreement § 4.4(a)(i) (emphasis added).
[60]8 *Del. C.* § 145(a).

Heartland argues that an Indemnitee must comply with all three of the requirements listed in the Indemnification Provision because the "or" joining those three requirements should be read as an "and."

For their part, Stockman and Stepp argue that they were not required to plead anything about their conduct because the mandatory nature of the Indemnification Provision shifts the burden to Heartland to demonstrate that Stockman and Stepp's conduct was at odds with that Provision. This is a persuasive argument. Although a plaintiff generally bears the burden of pleading all elements of her claim, in the case of a mandatory indemnification provision, the burden rests on the party from whom indemnification is sought to prove that indemnification is not required.[61] By imposing a mandatory indemnification obligation on itself in the Partnership Agreement, Heartland undertook to pay all indemnification requests unless Heartland could demonstrate that indemnification was not required.[62] As a result, Stockman and Stepp are not required to make allegations about their conduct in order to state a claim for indemnification. And, even if such allegations were required, Stockman and Stepp have pled that the Criminal Proceeding against them was dismissed without an adverse finding. Given that plaintiff-friendly inferences must be made, and that it is reasonable to believe that the federal government would not dismiss an indictment lightly, the pled facts support the reasonable inference that the government could not prove that Stockman and Stepp engaged in any criminal wrongdoing, an inference that supports a claim for indemnification.

This determination that the Stockman and Stepp Complaints sufficiently allege indemnification claims that can move forward could end the analysis for present purposes because it provides a sufficient basis to deny the motions to dismiss. I dilate on this topic a bit longer, however, because denying the motions to dismiss simply passes a key legal question down the line — namely, does the Indemnification Provision of the Heartland Partnership Agreement require an Indemnitee to endure a plenary trial on the conduct underlying a favorably dismissed case as the price of indemnification? That is, must the Indemnitee endure the equivalent of the

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[61] *VonFeldt v. Stifel Fin. Corp.*, 1999 WL 413393, at *3 (Del. Ch. June 11, 1999) ('By using the phrase 'shall indemnify,' the bylaw not only mandates indemnification; it also effectively places the burden on [the corporation] to demonstrate that the indemnification mandated is not required.').

[62] *See id.* ('To overcome this self-imposed, mandatory obligation on [the corporation's] part, [the corporation] must demonstrate to this Court why it should not be required to indemnify [its director]. . . . This interpretation, however, does not discharge the good faith requirement; it only shifts the burden on this issue to the corporation.').

very proceeding she has already won to get her costs indemnified? The parties have to some, but not full, extent joined issue on these questions. For the sake of efficiency, and so that the parties can contemplate how to approach the remainder of this case, I now consider, in a necessarily preliminary way, how the court might approach these questions.

The reason these questions arise is because Heartland argues that the Indemnification Provision requires that an Indemnitee's conduct have complied with all three of the listed requirements, specifically: i) the conduct was in or not opposed to the best interests of Heartland; ii) the Indemnitee had no reasonable cause to believe the conduct was unlawful in the case of criminal actions; and iii) the conduct did not constitute fraud, bad faith, willful misconduct, gross negligence, a violation of applicable securities laws, or a material breach of the Partnership Agreement or an associated advisory agreement. Thus, Heartland contends that there must be a judicial proceeding to determine whether Stockman and Stepp met that standard. That is, even though Stockman and Stepp had the Criminal Proceeding against them dropped, Heartland asserts that it can force them to litigate over the substance of the conduct underlying the dismissed indictments before receiving indemnification. This requires not only an ultimate conclusion about scienter and motive, but, critically, an inquiry into exactly *what conduct* was at issue in the dismissed Criminal Proceeding.

To support its argument that the Indemnification Provision requires compliance with all three of the listed standards, not just one, Heartland contends that the "or" in the Indemnification Provision should be read as "and." In so doing, Heartland relies heavily on the language and policies of § 145:

> The language and context of the provision make clear that, although joined by the term "or," all three requirements must be met. As indicated in a case relied upon by Mr. Stepp, good faith and acting in the best interests of the partnership are indispensable requirements for indemnification. *Cf. Vonfeldt v. Stifel Fin. Corp.*, C.A. No. 15688, 1999 WL 413393, at *2 (Del. Ch. June 11, 1999) ("It should now be clear that, as far as § 145 is concerned, Delaware corporations lack the power to indemnify a party who did not act in good faith or in the best interests of the corporation."). This policy underlying indemnification from Delaware corporations, on which Mr.

> Stepp seeks to rely, serves to reinforce the conclusion that the Limited Partnership Agreement requires compliance with all three requirements.[63]

Reading the Indemnification Provision in the way Heartland contends helps avoid an arguably unreasonable result. Although the normal approach to interpretation is to treat "and" as conjunctive and "or" as disjunctive, the opposite approach has been applied where the normal approach would lead to an absurd result or one contrary to the drafter's overall intent.[64] Here, employing "or" in the disjunctive sense could lead to rather odd results.

And, although Heartland has not provided any briefing on how the "or" came to be included in the Indemnification Provision, I note that language identical to the Indemnification Provision's standard of conduct appears in the Partnership Agreement's provision limiting the liability of the General Partner to Heartland and its limited partners (the "Exculpatory Provision"). But, in the Exculpatory Provision the "or" makes more sense given the surrounding text:

> [No Indemnitee] shall be liable to the Partnership or to any limited Partner for (i) any act or omission taken or suffered by the Indemnitees in connection with this Agreement or the matters contemplated herein, unless such act or omission (A) was in or was not opposed to the best interests of the Partnership, (B) in the case of a criminal action or proceeding, the Indemnitee had no reasonable cause to believe his conduct was unlawful, *or* (C) did not constitute fraud, bad faith, willful misconduct, gross negligence, a violation of applicable securities laws or any material breach of the Agreement or the Advisory Agreement . . . .[65]

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[63]Heartland's Rep. Br. in Support of Mot. to Dismiss Stepp Compl. at 12 (footnotes omitted); *see also* Heartland's Rep. Br. in Support of Mot. to Dismiss Stockman Compl. at 16-17 (containing an identical passage except referring to Stockman rather than Stepp).

[64]*See In re Application of Emmet S. Hickman Co.*, 108 A.2d 667, 671 (Del. 1954) ('It is well settled that the disjunctive 'or' in a statute or ordinance may be read as 'and' if to do so will conform to the legislative intent. This rule of construction has resulted from the common and careless use of the words in legislation.'); *Concord Steel, Inc. v. Wilmington Steel Processing Co.*, 2008 WL 902406, at *7 n.57 (Del. Ch. Apr. 3, 2008) ('In the analogous statutory interpretation context, courts occasionally have construed 'and' to mean the disjunctive 'or' to avoid an incoherent reading of a statute.').

[65]Partnership Agreement § 4.3(a) (emphasis added).

It would be strange for the Partnership Agreement's drafters to have intended to have different standards of conduct for indemnification and liability insulation given the identical nature of the language used. The more plausible explanation for the "or" in the Indemnification Provision is that it was the result of careless "pasting" of text. The carelessness of the drafting is also suggested by the inclusion in the Exculpation Provision of the phrase from § 145 dealing with criminal cases. This is odd, as criminal cases do not involve civil liability, but rather responsibility to society. This inclusion was either a blunderbuss or a use of § 145's language as a very crude way of crafting an exculpatory provision somewhat in the mold of § 102(b)(7).[66]

For these reasons, it is possible that Heartland could prevail on the merits of its contention that the "or" in the Indemnification Provision should be read conjunctively, meaning that, where the standard of conduct in the Indemnification Provision is applicable, Indemnitees must demonstrate that they did not breach their duties to the partnership, did not knowingly violate applicable law, and did not act with scienter. It is important to recognize, however, that such a conclusion would necessarily rely on a number of the interpretive tools that this court uses to make sense of governing instruments that on their face appear to generate absurd results, including turning to background statutory schemes and public policies.[67]

This point is important because Heartland asks the court to ignore these same considerations when they work against Heartland with regard to interpreting the Indemnification Provision's silence on a success standard. On that issue, Heartland argues that the terms of the Indemnification Provision, and the lack of an explicit success standard, must be read as a careful choice made by the Partnership Agreement's drafters to force even successful Indemnitees to demonstrate their compliance with their legal and fiduciary duties, even though such a reading leads to an inefficient result at odds with Delaware's public policies for indemnification.

Heartland cannot, however, have it both ways. For starters, any contention that the terms of the Indemnification Provision's standard of conduct were thoughtfully selected and carefully reviewed is belied by the fact that those very terms contain a misplaced "or" that Heartland has

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[66] 8 *Del. C.* § 102(b)(7). In § 102(b)(7), the DGCL permits exculpation of duty of care violations involving breaches of positive law, but only if it was not a 'a knowing violation of law.' *Id.*

[67] *See Cantor Fitzgerald, L.P. v. Cantor*, 2000 WL 307370, at *21 (Del. Ch. Mar. 13, 2000) (discussing the rule that, if a partnership agreement is silent or ambiguous, the Court may 'begin to look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence' (quoting *Sonet v. Timber Co., L.P.*, 722 A.2d 319, 324 (Del. Ch. 1998))).

strenuously argued must be corrected by reference to § 145 and its underlying policies. That is, Heartland's argument is particularly problematic in light of the way Heartland has asked the court to draw on § 145 to resolve the "or" problem. Heartland has argued, in essence, that the standard of conduct in the Indemnification Provision should be read the same as the analogous language in §§ 145(a) and (b). But, the meaning of the analogous §§ 145(a) and (b) language is informed by the existence of § 145(c).

The language of §§ 145(a) and (b) applies comfortably only to cases where there has been a finding that the party seeking indemnification has violated some legal or equitable duty to someone, the party has made an admission of culpability, or the party has settled a case by making a payment.[68] In the first two of these situations, there is a strong basis to believe the indemnitee acted against the interests of the corporation or society, and therefore providing indemnification would dampen the incentives of corporate officials to comply with their legal and fiduciary duties, a result at odds with public policy. Moreover, in these situations, there will be a judicial record developed in a plenary proceeding regarding the underlying conduct which can serve as a basis for evaluating whether the indemnitee met the §§ 145(a) and (b) standard for good faith and law compliance.

In the case of settlements, there has been precious little application of the §§ 145(a) and (b) standard because indemnitees typically work with the corporation, its lawyers, and insurers in resolving cases. I am not aware of, and no party has cited, a proceeding in this court examining whether the conduct of a potential entity indemnitee who settled a case met the good faith test of §§ 145(a) and (b). After all, parties seek to settle cases in order to obtain peace and end further costs, not to kick the litigation can down the road.

Given this dearth of cases involving settlements, it is equally unsurprising that the §§ 145(a) and (b) standard is ill-suited for application to matters concluded by a dismissal in favor of an indemnitee. And, in a case like this one, where the underlying proceeding was dismissed in the defendants' favor with no finding of guilt, no admission of guilt, or even an

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[68]Where one of these circumstances is not present, the corporate indemnitee was, assumably, successful in the underlying proceeding, triggering the mandatory advancement right of § 145(c), which does not require that the indemnitee meet the §§ 145(a) and (b) standard. *See FGC Holdings*, 2007 WL 241384, at *9 (the indemnification right granted by § 145(c) is 'absolute'); *Green*, 492 A.2d at 265 (situations within the scope § 145(c) are not subject to the state of mind requirements of §§ 145(a) and (b)).

agreement to pay for peace, § 145 (c) shields corporate indemnitees from any inquiry into their conduct.[69]

Given these realities, the requirements of §§ 145 (a) and (b) seem best read as public policy limits designed to prevent corporations from indemnifying corporate officials in only the most incentive-distorting circumstances: when the officials have been convicted or otherwise incurred liability as a result of culpable conduct *and* that liability was the result of conduct that involved a certain level of scienter. Nothing cited by Heartland suggests that these requirements — which are baked into the Indemnification Provision — were designed to require an indemnitee who faced civil or criminal liability claims and had those claims dismissed to then put on, or even defend, a merits case about the purity of their state of mind regarding the conduct alleged in the dismissed claims. Indeed, turning an indemnification case into a hypothetical trial on the merits of a dismissed case is a bizarre notion to propose and would be counterproductive to Delaware's policy goal of assuring indemnitees "that their reasonable expenses will be borne by the corporation they have served if they are vindicated."[70]

From Heartland's financial perspective, the economic inefficiency of such a proceeding would be rather large. To be specific, one can assume that the costs Stockman and Stepp incurred to get the indictment against them dismissed were far less than would have been involved in defending against its charges at trial. If Heartland demands a plenary hearing on the conduct that Stockman and Stepp engaged in — in which Heartland must prove that Stockman and Stepp violated their legal or equitable duties with a state mind inconsistent with the Indemnification Provision's coverage — Heartland will have to expend huge resources presenting its case. Meanwhile, it may well have to advance funds to Stockman and Stepp to defend themselves in such a hearing, a defense that would likely far exceed what they seek in indemnification now. And, in any event, if Heartland loses, it will have to bear its own costs and indemnify Stockman and Stepp.

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[69] *See* 1 RODMAN WARD, JR. ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 145.4 (4th ed. 2004) (noting that the purpose of the 'or otherwise' language in § 145(c) is to avoid forcing indemnitees to incur the expense of litigating on the merits where a preliminary defense is sufficient to dispose of the underlying case); *see also Green*, 492 A.2d at 265 (reviewing the legislative history and determining that the drafters of § 145 specifically intended that situations within the scope § 145(c) would not be subject to the state of mind requirements of §§ 145(a) and (b)); 1 BALOTTI & FINKELSTEIN § 4.12[B], at 4-63 n.388 ('The good faith requirement does not apply to a director or officer who is 'successful' under Section 145(c).').

[70] *Cochran*, 809 A.2d at 561 (quotations omitted).

The awkward terms of the Indemnification Provision do not unambiguously require such an inefficient approach. Rather, these terms are perhaps better read as a crude way of requiring that an Indemnitee have acted with an innocent state of mind only in a situation where the Indemnitee seeks indemnification for a civil or criminal liability or fine, or somehow tries to stick Heartland with the costs of a settlement payment without its consent. In that circumstance, where there is a solid basis for concluding that the Indemnitee committed a breach of fiduciary or legal duty, or Heartland is being asked to foot the bill for a settlement, the Indemnitee may only recover if the Indemnitee is found to have acted with the requisite level of subjective innocence. But in a situation where the outcome of the underlying proceeding is favorable to the Indemnitee and provides no rational basis to infer that a breach of duty occurred, the Indemnitee is not required to litigate over the substance of her conduct and her state of mind.

Reading the Indemnification Provision in this way does not contravene, as Heartland argues, the policy of the DRULPA to "give maximum effect to the principle of freedom of contract."[71] The drafters of the Partnership Agreement could have exercised their freedom of contract to eschew the Delaware statutory approach to corporate indemnification and create an indemnification scheme that does not grant mandatory indemnification to successful Indemnitees. But, they did not do so clearly in this case. Instead, the Indemnification Provision provides mandatory indemnification "to the fullest extent permitted by law." Delaware law plainly allows an entity to indemnify an officer or director who avoids conviction in a criminal proceeding, regardless of whether there is an affirmative finding that she was not culpable. Thus, as an initial matter, the Indemnification Provision grants Stockman and Stepp a very broad right to mandatory indemnification. And, the limiting language of the Indemnification Provision does not clearly eliminate this right as to the dismissed Criminal Proceeding. Rather, the Indemnification Provision simply adopts statutory language from § 145 that ensures that no convicted indemnitee will receive indemnification unless she acted in good faith and had no reason to believe her conduct was unlawful.

In other words, the Indemnification Provision can be reasonably read as implicitly incorporating the notion that indemnification is available to a prevailing Indemnitee, and that the conditions relating to the Indemnitee's state of mind are meant to police the availability of indemnification only

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[71] 6 *Del. C.* § 17-1101(c).

where the Indemnitee has suffered an adverse judgment, admitted to a breach of duty, or settled a case for money. Admittedly, this conclusion rests on what explicit terms of the Indemnification Provision imply rather than state. And, Heartland is accurate in saying that the Partnership Agreement does not incorporate language from § 145(c), and restricts itself only to a garbled recitation of the words of §§ 145(a) and (b). But, the omission of an explicit success criteria from the Indemnification Provision does not, in my view, clearly require a successful Indemnitee in a criminal proceeding to face a de novo inquiry into whether "the Indemnitee had no reasonable cause to believe his conduct was unlawful."[72] That language, in itself, clearly implies there is a preexisting basis for believing that the Indemnitee committed an unlawful act, and triggers an inquiry into whether the Indemnitee had reason to know that her conduct was unlawful. Similarly, the language requiring that the Indemnitee act "in or not opposed to the best interests of the Partnership" and that the Indemnitee's conduct "did not constitute fraud, bad faith, willful misconduct, gross negligence, a violation of applicable securities laws or any material breach of the Agreement or the Advisory Agreement"[73] presupposes that Heartland is being asked to indemnify culpable conduct that raises the question of whether the Indemnitee acted with scienter. But, when the criminal charges against an Indemnitee are dismissed without any finding of liability, the contract argument for examining what the Indemnitee did and whether the Indemnitee acted with an innocent state of mind is arguably irrelevant as there is no underlying violation to examine.

And, to the extent there is reasonable doubt about whether the Indemnification Provision grants mandatory indemnification to successful Indemnitees, important principles of contract interpretation support a reading in favor of providing indemnification. First, such an interpretation is consistent with the general principles for approaching indemnification provisions in limited partnership agreements set forth by then-Chancellor Allen in *Delphi Easter Partners*[74]:

> In construing contractual language under DRULPA conferring rights of indemnification, courts should interpret language so as to achieve where possible the beneficial purposes that indemnification can afford. Those benefits include the

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[72]Partnership Agreement § 4.4(a)(i)(B).

[73]Partnership Agreement § 4.4(a)(i) (emphasis added).

[74]*Delphi Easter Partners Ltd. P'ship v. Spectacular Partners, Inc.*, 1993 WL 328079 (Del. Ch. Aug. 6, 1993).

> allocation of certain risks at the outset of a contractual relation in order to make the contractual structure feasible or more attractive to participants.[75]

Here, that means that any ambiguity regarding whether Heartland owes indemnification rights should be resolved against it, and in favor of the Indemnitees seeking indemnification. That result is consistent with analogous precedent in corporate cases.[76] Similarly, the doctrine of *contra proferentum* is applicable in this context and would dictate that the lack of clarity in the Indemnification Provision be read against Heartland and in favor of indemnification for Stockman and Stepp.

In sum, if it is reasonable to read the Indemnification Provision as granting Indemnitees like Stockman and Stepp a right to mandatory indemnification for actions that are concluded in their favor, the principles of contract interpretation governing limited partnership agreements would require that I read the Indemnification Provision in that way.

For all these reasons, it may be that there is little left to litigate regarding Stockman and Stepp's indemnification claims. But, because no party has sought summary judgment on the indemnification claims, my ruling is necessarily limited to making a determination about the motions to dismiss. The parties should reflect on how to proceed, and if Heartland persists in contending that an evidentiary hearing on the nature and lawfulness of Stockman and Stepp's conduct is required, it must as an initial matter file an answer that pleads facts supporting a rational inference that the conduct of Stockman and Stepp at issue in the Criminal Proceeding breached a legal duty and that Stockman and Stepp acted with a state of mind inconsistent with their right to indemnification.

For now, I simply deny Heartland's motions to dismiss the Stockman and Stepp Complaints.

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[75] *Id.* at *2; *see also DeLucca*, 2006 WL 224058, at *7 ('Delaware has a strong public policy in favor of assuring key corporate personnel that the corporation will bear the risks resulting from performance of their duties on the grounds that such a policy best encourages responsible persons to occupy positions of business trust, so Delaware courts have read indemnification contracts to provide coverage when that is reasonable.' (citing *Perconti,* 2002 WL 982419, at *3; *VonFeldt*, 714 A.2d at 84)).

[76] *See Cochran*, 809 A.2d at 561 ('This Court has emphasized that the indemnification statute should be broadly interpreted to further the goals it was enacted to achieve.'); *VonFeldt*, 714 A.2d at 84. ('We eschew narrow construction of the [indemnification] statute where an overliteral reading would disserve [Delaware's public policy regarding indemnification].').

IV. Conclusion

For the foregoing reasons, Stockman and Stepp's motions for summary judgment are granted, and Heartland shall advance Stockman and Stepp their unpaid legal expenses in accordance with the terms of the Advancement Provision as discussed in this opinion. Furthermore, Heartland's motions to dismiss are denied in their entirety. IT IS SO ORDERED.

DELOITTE LLP AND DELOITTE & TOUCHE LLP, EACH A DELAWARE LIMITED LIABILITY PARTNERSHIP V. THOMAS P. FLANAGAN

C.A. No. 4125-VCN

Court of Chancery of the State of Delaware, New Castle

December 29, 2009

Paul J. Lockwood, Esquire of Skadden, Arps, Slate, Meagher & Flom LLP, Wilmington, Delaware, and Jay B. Kasner, Esquire and Joseph N. Sacca, Esquire of Skadden, Arps, Slate, Meagher & Flom LLP, New York, New York, Attorneys for Plaintiffs.

Philip A. Rovner, Esquire of Potter Anderson & Corroon LLP, Wilmington, Delaware, and J. Kevin McCall, Esquire, Chris C. Gair, Esquire, and Nicole A. Allen, Esquire of Jenner & Block LLP, Chicago, Illinois, Attorneys for Defendant.

NOBLE, *Vice Chancellor*

I. INTRODUCTION

A partner in an international accounting firm is accused by the partnership of trading in the securities of certain of the firm's clients, in contravention of his partnership agreement and of the general fiduciary duties he owed to his partners, and is further accused of fraudulently misrepresenting this trading activity in annual representations to the firm and within the firm's proprietary system designed to identify any such conflicts. The accounting firm has sued its now-former partner to recover

for the damages he caused, or may be deemed to have caused, his firm. The accounting firm seeks partial summary judgment on the question of liability.

II. BACKGROUND

A. *The Parties*

Plaintiff Deloitte LLP is a Delaware limited liability partnership that,
through its subsidiaries, provides audit, consulting, financial advisory, risk management, and tax services to a variety of clients throughout the United States.

Plaintiff Deloitte & Touche LLP ("D&T" and, collectively with Deloitte LLP, "Deloitte" or the "Partnerships") is a Delaware limited liability partnership that provides audit and risk management services to clients throughout the United States.

Defendant Thomas P. Flanagan ("Flanagan"), a Certified Public Accountant, was a partner of one or both of the Partnerships or of a predecessor of Deloitte LLP for 30 years until his resignation on September 5, 2008. At the time of his resignation from Deloitte, Flanagan served as an advisory partner in Deloitte's Chicago office for a number of D&T's audit clients.

B. *Deloitte's Independence Policies*

All partners of Deloitte are obligated to sign a Memorandum of Agreement with each of the Partnerships (collectively, the "MOAs"), setting forth their rights and obligations as fiduciaries to the Partnerships. Among other obligations, the MOAs mandate that partners be just and faithful to the Partnerships and not engage in any conduct or activity inconsistent with the letter or spirit of Deloitte's rules regarding independence. These independence policies (the "Policies") are set forth in Deloitte's Independence and Ethics Manual and apply to the partners and to the professional and administrative employees of Deloitte.

The Policies have long prohibited partners and employees of Deloitte from owning any securities in the firm's "Attest Clients"[1] and, in

[1]The Independence Manual defines "Attest Clients" as clients for whom "attest services" such as audits, reviews of financial statements, or other "agreed-upon procedures or engagements," are performed. Affidavit of James Curry in Supp. of Pls.' Mot. for Partial Summ. J. ("Curry Aff."), Exs. 13-15 at § .021, Exs. 9-10 at § .030.

order to facilitate compliance, the Partnerships provided a regularly-updated client list to all personnel, and directed Deloitte employees to review the list before making any investments. The Policies also prohibit any and all insider trading, whether or not the non-public information was obtained by way of their employment.

To assist in monitoring compliance with the independence requirements, the Policies require partners and other professional personnel to enter current and accurate information concerning all investments held by them, their spouse or spousal equivalent, or their dependents into Deloitte's "Tracking & Trading System," which would flag and report any unauthorized holding. Finally, the Policies require partners and other professional personnel to provide an annual representation to the Partnerships that they had complied with the Policies (the "Annual Representation").

C. *Flanagan's Alleged Misconduct*

Flanagan consistently made Annual Representations to the Partnerships that, *inter alia*: (a) he was familiar with the Independence Manual and the Policies; (b) he had reviewed the list of Restricted Entities; (c) he had "accurately and completely describe[d] all stocks, debt securities, mutual funds, unit investment trusts, 529 plan accounts, and brokerage accounts held by [him], [his] spouse or spousal equivalent, and dependents"; (d) at no time during the relevant year "did [he], [his] spouse or spousal equivalent, and/or his dependents have a financial interest in a Restricted Entity"; and (e) he had not "serve[d] as the trustee of a trust or as executor or administrator of an estate that had a financial interest in a Restricted Entity."[2]

The Complaint asserts that, notwithstanding such representations, Flanagan, in fact, traded in the shares of Deloitte clients in more than 300 instances over several years.[3] Almost none of these trades were recorded in

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[2]Curry Aff., Exs. 17-23.

[3]The unauthorized trades occurred in accounts with Kovitz Investment Group, Inc. and Banc of American Investment Services, Inc. which Flanagan either owned or served as the trustee for, or that were owned by his wife or children. The accounts maintained at Kovitz Investment Group were "Thomas & Betsy Flanagan JTWROS," "Betsy P. Flanagan IRA R/O," "Betsy P. Flanagan Trust," "Thomas P. Flanagan Trust," "Thomas P. Flanagan IRA R/O," "Luke R. Pascale Irrevocable Trust," "Michael L. Flanagan IRA R/O," and "Brien Flanagan IRA R/O." The accounts held at Banc of America were "Thomas P. Flanagan/Betsy P. Flanagan" (the "Flanagan BOA Account"), "Mia Pascale/Thomas Flanagan" (the "Pascale/Flanagan Account"), "Luke R. Pascale

the Tracking & Trading System. However, in 84 instances Flanagan recorded unauthorized holdings in the system but later that same day made an entry "correcting" the previous entry or indicating that he had disposed of the securities.[4] Such entries exploited the manner by which the system flagged unauthorized trading and thereby allowed Flanagan to escape review by Deloitte compliance personnel.[5] In many instances, the "correcting" entry reported in the Tracking & Trading system did not actually happen—Flanagan continued to hold the securities.[6]

D. *Deloitte's Discovery of Flanagan's Wrongdoing*

Deloitte was unaware of any wrongdoing by Flanagan until August 2008, when it was contacted by the Securities and Exchange Commission (the "SEC") seeking the names and titles of all personnel who made up the engagement team for D&T audit client Walgreen Company between January and July 2007. Flanagan was the advisory partner for Walgreen Company and had contact with the company's top executives and audit committee. Walgreen had announced the acquisition of the company Option Care in July 2007. Flanagan allegedly purchased stock in Option Care roughly one week before Walgreen publicly announced the acquisition, but had not disclosed this trade to Deloitte. Later that month, the SEC again contacted Deloitte, asking which of a list of provided companies had D&T served as auditor and, further, for which of those audit clients had Flanagan served. Upon receiving these inquiries, Deloitte sought out Flanagan, who only then advised the Partnerships that he was aware of the regulatory investigation into his trading activity and that he had already spoken with SEC officials only to break off communication with them and to retain counsel. Shortly after these revelations, on September 9, 2008, Flanagan notified Deloitte that he was retiring, effective immediately.

In October 2008, in response to a request by Deloitte's attorney, Flanagan's then-counsel sent a letter confirming that, between at least December 2004 and June 2008, Flanagan had engaged in, or directed or

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Irrevocable Trust" (the "Pascale Trust Account-BOA"), and "NFS/FMTC Rollover IRA FBO Brien Flanagan."

[4]Def. Thomas B. Flanagan's Response in Opp'n to Pls.' Mot. for Partial S.J. ("Flanagan"), Ex. B ("Flanagan Exception Report").

[5]Flanagan, Ex. A ("Curry Deposition"), at 112-14.

[6]*Compare* Flanagan, Ex. B *with* Transmittal Affidavit of Paul J. Lockwood ("Lockwood Aff."), Ex. 20.

otherwise caused, a large number of trades in at least twenty Restricted Entities, including clients with which he had directly worked.[7]

E. *Claims Subject to Motion for Summary Judgment*

Deloitte requests partial summary judgment as to the question of liability on its claims for breach of fiduciary duty (Count I of the Amended Complaint), breach of contract (Count II), common law fraud (Count III) and equitable fraud (Count IV).

III. DISCUSSION

A. *The Summary Judgment Standard*

Court of Chancery Rule 56 allows for summary judgment when the record shows that "there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."[8] The burden is initially on the moving party, and the Court views the evidence in the light most favorable to the nonmoving party.[9] The movant is required to present some evidence, either direct or circumstantial, to support all of the elements of the claims in question.[10] "However, once the moving party has satisfied its initial burden of 'demonstrating the absence of a material factual dispute,' the burden shifts to the nonmovant to present some specific, admissible evidence that there is a genuine issue of fact for a trial."[11] Where both sides put forth conflicting evidence such that there is an issue of material fact, summary judgment must be denied.[12] A fact is material if it "might affect the outcome of the suit under the governing law."[13] There is a genuine issue of material fact "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party."[14] It is not enough that the nonmoving party put forward a mere scintilla of evidence; there must be enough evidence that a rational finder of fact could find some material fact

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[7]Curry Aff., Ex. 25. The Restricted Entities at issue include many well-known publicly traded companies. No useful purpose would be served by listing them here.

[8]Ct. Ch. R. 56(c).

[9]*In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 356 (Del. Ch. 2008).

[10]*Watson v. Taylor*, 829 A.2d 936 (TABLE), 2003 WL 21810822, at *2 (Del. Aug. 4, 2003).

[11]*Id.* (quoting *Levy v. HLI Operating Co., Inc.*, 924 A.2d 210, 219 (Del. Ch. 2007)).

[12]*Id.*

[13]*Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986).

[14]*Id.*

that would favor the nonmoving party in a determinative way, drawing all inferences in favor of the nonmoving party.[15]

In addition, Chancery Court Rule 56(c) provides that summary judgment "may be rendered on the issues of liability alone although there is a genuine issue as to the amount of damages, or some other matter."[16] Consequently, Delaware courts have, with some regularity, granted motions for partial summary judgment as to liability while leaving questions of damages or remedy for trial.[17]

B. *The Scope of Activity Considered*

Flanagan has raised certain defenses for a number of his trades. He has asserted that all questionable trades made before October 29, 2005, are barred by the three-year statute of limitations for breach of contract, breach of fiduciary duty, and fraud claims, as well as by the doctrine of laches.[18] In addition, Flanagan claims that he is not liable for any trades made in accounts maintained at Kovitz Investment Group, LLC, because these accounts were discretionary and Flanagan did not personally direct trading in them. Flanagan also contends that certain of his trades were permitted under SEC and American Institute of Certified Public Accountants ("AICPA") rules—specifically, the trading of securities of clients that he did not serve and that were not clients of the Chicago office—and that Deloitte's Independence Manual is unclear and subject to various interpretations, including that adhering to SEC and AICPA rules sufficed for purposes of the MOAs. Finally, Flanagan argues that a disputed issue of material fact exists regarding how clearly Deloitte communicated to its partners and employees which entities were, in fact, Restricted Entities, and that Deloitte has failed to prove which entities were restricted, when they were restricted, and that Flanagan was informed that they were restricted.

This Court does not presume to evaluate each and every one of Flanagan's suspect trades. Indeed, a single instance of intentional trading in

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[15]*Cerberus Int'l, Ltd. v. Apollo Mgmt., L.P.*, 794 A.2d 1141, 1150 (Del. 2002).

[16]Ct. Ch. R. 56(c).

[17]*See, e.g., Those Certain Underwriters at Lloyd's, London v. Nat'l Installment Ins. Servs., Inc.*, 2007 WL 1207106, at *6 (Del. Ch. Feb. 8, 2007, *rev.* Apr. 16, 2007); *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757, 759 (Del. Ch. 1986); *Pfizer Inc. v. Advance Monobloc Corp.*, 1999 WL 743927, at *16 (Del. Super. Sept. 2, 1999).

[18]Flanagan asserts that Deloitte was put on inquiry notice regarding violations of the MOAs after he reported holding Restricted Entities in the Tracking & Trading system, and its failure to investigate his questionable trades prevents the statute of limitations from being tolled, thus barring any claims based upon pre-October 2005 conduct.

a Restricted Entity and a knowing misrepresentation of the same would seemingly be sufficient to establish not only a breach of both the MOAs and the fiduciary duties owed to Deloitte, but also the principal elements of common law fraud and equitable fraud. The question of which of the contested trades, if any, ought to be ignored due to Flanagan's divers defenses, listed above, may bear on the ultimate question of damages, but it is not necessary for this Court to address these defenses within the context of this motion for partial summary judgment unless, *in toto*, the defenses would serve to undermine at least one essential factual predicate for each of Deloitte's claims. A review of the record indicates that they do not. Consequently, and for simplicity's sake, this Court will focus only on a subset of trades for which Flanagan has not proffered a defense and which appear most obviously in violation of Deloitte's Independence Policies.[19]

1. Trading in Allstate Corporation

On July 17, 2006, Flanagan attended a meeting of the audit committee for Allstate Corporation ("Allstate"), a Deloitte client for which he provided audit services. During the meeting, a draft of Allstate's earning release for the quarter ending June 30, 2006, was circulated.[20] The following day, Flanagan purchased call options in Allstate shares through the Pascale Trust Account-BOA, for which he was trustee.[21] On July 19, Allstate publicly issued its earnings release, announcing a significant increase in its full-year EPS guidance, causing a spike in share price.[22] Flanagan sold the Allstate call options on July 20 for roughly an 85% gain.[23]

2. Trading in Best Buy Co., Inc.

Deloitte also asserts that a series of trades made by Flanagan over the course of a few years in Best Buy Co., Inc. ("Best Buy"), a company for which he directly provided audit services, also establishes his liability.

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[19]In so doing, the Court cites to some certain arguably unauthenticated documents, such as emails and board minutes, which Flanagan asserts should not be considered. The Court only draws from these documents to provide context, and not to establish any essential element of Deloitte's claims. The critical element, that these were all Restricted Entities at the time, was admitted by Flanagan's then-counsel in an October 22, 2008, letter to Deloitte's counsel. *See*Curry Aff., ¶¶ 38-39; Ex. 25.

[20]Lockwood Aff., Ex. 32.

[21]*Id.*, Ex. 33.

[22]*Id.*, Ex. 34, at 1.

[23]*Id.*, Ex. 33.

On December 9, 2005, at 12:34 a.m., Flanagan received an email attaching a draft of Best Buy's third quarter earnings release.[24] The draft indicated that Best Buy was going to announce earnings below market expectations.[25] Later that same day, Flanagan purchased put options in Best Buy through the Pascale/Flanagan account.[26] On December 13, 2005, Best Buy's earnings release was made public.[27] On December 14, Flanagan sold these put options for a return of approximately 67%.[28]

A year later, on December 9, 2006, Flanagan again received an email attaching a draft of Best Buy's upcoming earnings release, which similarly indicated that Best Buy would release earnings figures below the consensus estimate of market analysts.[29] On December 11, Flanagan purchased Best Buy put options through the Pascale Trust Account-BOA.[30] The following day, Best Buy released its earnings announcement, resulting in a share price decline.[31] On December 13, Flanagan sold his put options for another 67% return.[32]

On June 15, 2007, Flanagan received yet another draft earnings release indicating that Best Buy would miss earnings estimates.[33] On June 18, Flanagan purchased put options through the Pascale Trust Account-BOA and the Flanagan BOA Account.[34] The following day, the earnings release was made public.[35] From June 19 through June 21, Flanagan sold his put options for returns between 32% and 42%.[36]

On September 12, 2007, Flanagan attended a Best Buy audit committee meeting held in advance of the company's quarterly earnings release.[37] Later that day, Flanagan purchased Best Buy call options through the Pascale Trust Account-BOA.[38] On September 18, the company released

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[24] *Id.*, Exs. 35-37.
[25] *Id.*, Ex. 36.
[26] *Id.*, Ex. 38.
[27] *Id.*, Ex. 39.
[28] *Id.*, Ex. 38.
[29] *Id.*, Exs. 40-41.
[30] *Id.*, Ex. 42.
[31] *Id.*, Ex. 43.
[32] *Id.*, Ex. 42.
[33] *Id.*, Exs. 44-46.
[34] *Id.*, Exs. 47-48.
[35] *Id.*, Ex. 49.
[36] *Id.*, Exs. 47-48.
[37] *Id.*, Ex. 50, at 1.
[38] *Id.*, Exs. 51-52.

earnings above consensus market estimates.[39] That same day, Flanagan sold the call options for a 95% return.[40]

On February 13, 2008, Flanagan received an email from Best Buy regarding its fiscal year 2008 guidance and attaching a draft press release that stated that the company was lowering its earnings guidance based upon lower-than-expected revenue growth.[41] On the same day, Flanagan purchased put options through the Pascale Trust Account-BOA and the Flanagan BOA Account.[42] The company released the revised earnings guidance on February 15, 2008.[43] Flanagan sold the put options on March 5, 2008 for 36% return.[44]

On March 28, 2008, Flanagan received an email from Best Buy that attached the company's upcoming earnings release, showing that earnings would be higher than market estimates.[45] On April 1, 2008, Flanagan purchased call options through the Pascale Trust Account-BOA. The following day, Best Buy released its earnings and Flanagan sold his call options, making a 31% return.[46]

3. Trading in Motorola Corporation

Flanagan is also alleged to have improperly traded in options of Motorola Corporation ("Motorola"), another of Deloitte's clients. On January 4, 2008, Flanagan received an email from a Deloitte partner in Boston informing him that Motorola's CEO had stated in a private meeting that the company's performance "will be significantly worse than anybody's imagined" and that a huge, across-the-board, cost reduction was in the works.[47] On January 14, Flanagan purchased Motorola put options through the Flanagan BOA account.[48] The following week, Motorola issued its earnings release, causing shares to plummet.[49] Flanagan sold his put options on the day of the announcement for a 1,400% return.[50]

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[39] *Id.*, Ex. 53.
[40] *Id.*, Exs. 51-52.
[41] *Id.*, Exs. 54-55.
[42] *Id.*, Exs. 56-57.
[43] *Id.*, Ex. 58.
[44] *Id.*, Exs. 56-57.
[45] *Id.*, Exs. 59-60.
[46] *Id.*, Exs. 61-62.
[47] *Id.*, Ex. 63.
[48] *Id.*, Ex. 64.
[49] *Id.*, Ex. 65.
[50] *Id.*, Ex. 64.

C. *The Breach of Contract Claim*

Summary judgment is frequently appropriate for breach of contract claims because, under Delaware law, the interpretation of a contract is a question of law.[51] As part of that review, the court strives to determine the parties' shared intent, interpreting the contractual language "using their common or ordinary meaning, unless the contract clearly shows that the parties' intent was otherwise."[52] If the contractual language is plain and unambiguous, the Court should give binding effect to its ordinary and usual meaning.[53] Nevertheless, there remains, of course, the question of whether any material facts regarding the conduct of the contracting parties are in dispute.

1. The Memoranda of Agreement[54]

Article 9 of the MOAs requires partners to "be just and faithful to the Partnership . . . in all actions and in respect of the business and reputation of the Partnership,"[55] and obligates them not to "engage in any conduct or activity . . . contrary or inconsistent with the letter or spirit of the rules relating to independence and conflicts of interest."[56] In addition, partners must "submit to the Partnership . . . as requested a written report . . . setting forth such information as the Board may deem appropriate to ascertain compliance . . . with the rules relating to independence, outside activities and conflicts of interest. . . ."[57]

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[51] *Schuss v. Penfield Partners, L.P.*, 2008 WL 2433842, at *6 (Del. Ch. June 13, 2008).

[52] *Cove on Herring Creek Homeowners' Ass'n v. Riggs*, 2005 WL 1252399, at *1 (Del. Ch. May 19, 2005) (quoting *Paxon Commc'ns Corp. v. NBC Universal, Inc.*, 2005 WL 1038997, at *9 (Del. Ch. Apr. 29, 2005)).

[53] *Rhone-Poulec Basic Chems. Co. v. Amer. Motorists Ins. Co.*, 616 A.2d 1192, 1195 (Del. 1992). Ambiguity does not necessarily exist simply because the parties disagree on a contract's proper construction. *United Rentals, Inc. v. Ram Holdings, Inc.*, 2007 WL 4496338, at *15 (Del. Ch. Dec. 21, 2007).

[54] The MOAs are governed by, and are to be construed in accordance with, Delaware law. Curry Aff., Exs. 2, 6, 8 (the "Deloitte LLP MOAs"), at § 14.02; Exs. 3, 7 (the "D&T MOAs"), at § 13.02.

[55] Curry Aff., Exs. 2-3, 6-8, at § 9.02.

[56] Curry Aff., Exs. 2-3, 6-8, at § 9.021.

[57] Curry Aff., Exs. 2-3, 6-8, at § 9.023.

2. The Independence Policies

The Policies state that partners and other employees of Deloitte are "prohibited from having a direct Financial Interest or material Indirect Financial Interest in a Restricted Entity."[58] The Policies define "Financial Interest" broadly, encompassing, *inter alia*, "the ownership or guarantee of debt or equity securities, options, warrants, long or short security positions, and rights or other commitments to acquire such securities."[59] The Policies also give broad definition to the term "Restricted Entity," including within its scope all of D&T's audit clients, as well as any affiliates of these clients.[60]

The Policies additionally bar employees from trading in the securities of or relating to companies about which they possess material non-public information, and require employees to notify Deloitte of any circumstances in which they had a prior notice of a transaction by a client that might affect their personal interests, such as a Financial Interest held by the employee in a client's proposed acquisition target.[61] The Policies also warn of the appearance of impropriety, noting that "[i]n view of the sensitivity that often accompanies allegations of use of insider information, all personnel should avoid circumstances that might cause embarrassment to the Firm."[62]

The Policies unambiguously prohibit any trades in Restricted Entities, and the MOAs mandate adherence to both the "spirit and letter" of the Policies. Deloitte asserts that, between 2001 and 2008, Flanagan made investments in Restricted Entities more than 300 times. Flanagan has raised a number of defenses and possible material factual disputes with respect to a number of these trades, listed above. However, as the Policies do not provide a *de minimis* exception for trading in Restricted Entities, this Court need only find that there is no issue of genuine fact with respect to a single trade in a Restricted Entity in order to find that Flanagan breached Article 9 of the MOAs.

Flanagan has not offered a defense for the trades in Allstate, Best Buy, and Motorola, discussed above. Whether or not Deloitte maintained

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[58]Curry Aff., Exs. 9-12, at ¶ .201.

[59]Curry Aff., Exs. 9-12, at ¶ .030. This extends to any securities held by a spouse or dependent, as well. *Id.* at ¶ .038.

[60]*Id.* at ¶ .040.

[61]*Id.* at ¶¶ .234-.235. In such an instance, the Policies state that "[a]ppropriate steps should be taken to ensure that the individual does not provide any professional services to the client and the Member should divest of the Financial Interest as soon as practicable." *Id.* at ¶ .235.

[62]*Id.* at ¶ .235.

an updated Restricted Entities list or whether or not the Policies were clear as to which types of entities ought to be considered Restricted Entities, Flanagan was on actual notice that these three entities were clients of Deloitte, because he personally provided them audit services[63] or previously acknowledged their status as Restricted Entities.[64] Consequently, Flanagan's trading in these entities, and his failure to properly report his trades either in Deloitte's Tracking & Trading System or in his Annual Representations, constituted a breach of Article 9 of the MOAs.

D. *The Breach of Fiduciary Duty Claim*

Deloitte asserts that Flanagan has breached the fiduciary duties of good faith and loyalty he owed to the Partnerships under "common law, the Delaware Revised Uniform Partnership Act, and the MOAs" by "willfully violating his obligations to honor Deloitte's policies on independence and conflicts of interest," and by concealing this wrongful conduct through intentional misrepresentations to Deloitte.[65] These breaches, Deloitte contends, "resulted in substantial damage to the Partnerships," including the payment of compensation to Flanagan that Deloitte contends he waived the right to receive by virtue of his conduct.[66]

The MOAs countenance an express fiduciary obligation of partners to the Partnerships, stating that "[e]ach active party shall be just and faithful to the Partnership . . . in all actions and in respect of the business and reputations of the Partnership."[67] Flanagan's conduct here—in particular, his misrepresentations with respect to his holdings—suffices to constitute a breach of his duty to be "just and faithful to the Partnership." Thus, Deloitte's motion for summary judgment on its breach of fiduciary duty claim is granted.[68]

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[63]Flanagan, Ex. A, at 187-88, 224.

[64]In his 2002 Annual Representation, Flanagan disclosed that he had owned and sold interests in two Restricted Entities, one of which was Motorola. Curry Aff., Ex. 12.

[65]Am. Compl. ¶¶ 69-70.

[66]Am. Compl. ¶ 71.

[67]Curry Aff., Exs. 2-3, 6-8, at § 9.02.

[68]The Court need not determine the more interesting doctrinal question of whether Deloitte's breach of fiduciary duty claim, arising out of the same set of operative facts as its breach of contract claim, ought to be dismissed as duplicative of the contract claim, or whether the existence of any preexisting equitable duties or the language of the MOAs would preclude such a dismissal. *Compare, e.g.*, *Solow v. Aspect Resources, LLC*, 2004 WL 2694916, at *4 (Del. Ch. Oct. 19, 2004) *with R.J. Assoc., Inc. v. Health Payor's Org. Ltd. P'ship*, 1999 WL 550350, at *10 (Del. Ch. July 16, 1999); *Cantor Fitzgerald, L.P. v. Cantor*, 724 A.2d 571, 582 (Del. Ch. 1998). Flanagan has not raised this question, and it is not likely to have an effect on any eventual damages

E. *The Equitable Fraud Claim*

Deloitte also brings a claim against Flanagan for equitable fraud, or negligent misrepresentation. To prevail on an equitable fraud claim, Deloitte must establish: (1) that Flanagan had a pecuniary duty to provide accurate information; (2) that Flanagan supplied false information; (3) that Flanagan failed to exercise reasonable care in obtaining or communicating the information; and (4) that Deloitte suffered a pecuniary loss in reliance upon the false information.[69] In addition to overt misrepresentations, fraud can also "occur through deliberate concealment of material facts, or by silence in the face of a duty to speak."[70]

The MOAs and the Policies facially establish that Flanagan had an obligation to accurately complete the Annual Representations and to maintain a complete and accurate record of his holdings in Deloitte's Tracking & Trading system at all times.[71] Flanagan has conceded that his Annual Representations, wherein he asserted that "[a]t no time during the Period did I, my spouse or spousal equivalent, and/or my dependents have a financial interest in a Restricted Entity for which I was a Member that was not permissible per the *Independence Manual*," were not accurate,[72] and that he failed to enter numerous unauthorized trades in the Tracking & Trading System[73] or else inputted and subsequently removed trades in the system before warnings to Deloitte compliance personnel were triggered, even where he continued to hold the securities in question.[74] Flanagan suggests that there is no evidence that he, himself, used the Tracking & Trading System, and that any failure to correctly input his trades was likely

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award because an adequate remedy for Deloitte's breach of contract claim would seemingly subsume any entitlements Deloitte may have under its breach of fiduciary duty claim.

[69]*Steinman v. Levine*, 2002 WL 31761252, at *15 (Del. Ch. Nov. 27, 2002).

[70]*Kronenberg v. Katz*, 872 A.2d 568, 585 n.25 (Del. Ch. 2004) (quoting *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 144-45 (Del. Ch. 2003)).

[71]Section 9.023 of the MOAs establishes the obligation to "submit to the Partnership at least annually as requested a written report signed by [Flanagan] setting forth such information as the Board may deem appropriate to ascertain compliance by [Flanagan] with the rules relating to independence, outside activities and conflicts of interest. . . ." The Policies state that "[a]ll Professional Personnel are required to provide a written statement that they (1) have read the Firm's independence and ethics policies, (2) understand their applicability, including the applicability to immediate family members and Close Relatives, and (3) have complied with such policies." Curry Aff., Exs. 9-12, at .P06. Additionally, "[a]ll Partners . . . are responsible for ensuring that the Deloitte Tracking & Trading system . . . has current and accurate information concerning investments. . . ." Curry Aff., Exs. 9-12, at .P08.

[72]*Compare* Curry Aff., Ex. 25 *with* Curry Aff., Exs. 17-24.

[73]*Compare* Curry Aff., Ex. 25 *with* Flanagan, Ex. B.

[74]Flanagan, Ex. B.

an error by his secretary.[75] Nevertheless, as Flanagan was personally responsible for the accuracy of the information and directly attested to its truthfulness, the Court must still conclude that Flanagan supplied false information and, at the very least, failed to exercise reasonable care in obtaining or communicating this information to Deloitte.[76]

Flanagan asserts that Deloitte has not put forward any evidence regarding the Partnerships' reliance on his misrepresentations: therefore, a disputed issue of material fact exists with respect to this element. The Policies, however, state that "[i]t is fundamental to our professional practice and ethics that each of us strives to adhere to the highest standards of independence, integrity, and objectivity and to be free from conflicts of interest."[77] This statement simply codifies what would seem to be a truism about the accounting profession: that because an auditor sells, at base, its independence and integrity, the firm relies heavily on the purported honesty and independence of its professionals.[78] Indeed, "[a]n accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work."[79] Thus, there is no issue of material fact with respect to Deloitte's reliance on Flanagan's misstatements.

As there are no issues of material fact relating to any of the necessary elements of Deloitte's equitable fraud claim, summary judgment on this claim is granted.

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[75]Flanagan at 21.

[76]This is despite the fact that the sheer number of unreported trades in Restricted Entities (hundreds over the course of eight years) makes Flanagan's explanation of data entry errors by his secretary a rather implausible one.

[77]Curry Aff., Exs. 9-12, at 1.

[78]The AICPA Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures (SAS No. 1) states that "[i]t is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. . . . Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence." AICPA SAS No. 1, AU § 220.03. *See also U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.").

[79]*DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990).

F. *The Common Law Fraud Claim*

In contrast to equitable fraud claims, common law fraud requires that the plaintiff establish scienter, that the defendant committed the misstatement recklessly or with intent. Flanagan asserts that Deloitte has not met its burden of proving intent, in part because it has not offered any evidence establishing custody for the emails and board minutes that it uses to establish that Flanagan had access to material non-public information.

Scienter is "'a mental state embracing intent to deceive, manipulate or defraud.'"[80] A plaintiff may establish scienter by demonstrating either a "deliberate or reckless misrepresentation of a material fact" by defendants.[81] A reckless statement is one "involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care. . . ."[82] Thus, to succeed on a motion for summary judgment, Deloitte must show that a jury could not reasonably find that Flanagan's misstatements were not an extreme departure from the standards of ordinary care.[83]

To prove scienter, a plaintiff "need not produce direct evidence of the defendant's state of mind."[84] "Circumstantial evidence may often be the principal, if not the only, means of proving bad faith."[85] The Third Circuit has endorsed a variant of the totality of circumstances approach in establishing scienter for securities fraud cases presenting highly suspicious circumstances.[86] Plaintiffs can establish scienter with facts "establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior"[87] where they are plead with particularity and give rise to a "strong inference" of scienter.[88]

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[80]*Dirks v. SEC*, 463 U.S. 646, 663 n.23 (1983) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976)).

[81]*Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 273 (3d Cir. 1998).

[82]*In re Digital Island Sec. Litig.*, 357 F.3d 322, 332 (3d Cir. 2004) (quoting *In re Advanta Corp.Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999)).

[83]*See In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1247 (3d Cir. 1989).

[84]*McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir.1979).

[85]*Id.*

[86]*See, e.g.*, *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997) ("We will not infer fraudulent intent from the mere fact that some officers sold stock. . . . Instead, plaintiffs must allege that the trades were made at times and in quantities that were suspicious enough to support the necessary strong inference of scienter.").

[87]*Weiner v. Quaker Oats Co.*, 129 F.3d 310, 318 n.8 (3d Cir. 1997).

[88]*Advanta*, 180 F.3d at 534-35. *But see Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) (suggesting that scienter cannot be inferred solely on the basis of motive and