INDEMNIFICATION

BY WENDELL FENTON*

Mr. Fenton: I know it's the end of the day, and I am sort of reminded of a dinner at the White House when President Kennedy was President, when he had the members of the American Academy of Arts and Sciences, and eight Nobel laureates, and a very distinguished group, and he observed that the dining room of the White House had never had such an intellectually distinguished group, except possibly when Thomas Jefferson dined alone.

In the event that you all leave and I end up lecturing to myself, I can perhaps take some comfort from those words.

Indemnification is, as we have seen based on Ed's talk, really the cornerstone of the Delaware scheme of corporation law because it's the peg on which an outsider, or an insider, can hang their hat to protect themselves against enormous expenses and incredible burdens in the event that their stewardship is challenged.

It is interesting that indemnity wasn't even needed when the Corporation Laws began, and it's only a concept that has arisen quite recently. 1943, I think, was when the first Delaware Indemnification Statute was adopted.¹ Prior to that there was some question under common law whether officers or directors were entitled to indemnification. I think in my outline I cite two cases that come out on different sides of the issue.

Under the analogy which was always made in those happy days of corporate law of directors to trustees, it is quite clear that under a trust law a trustee is entitled to indemnification from the trust if he has acted properly and if he is sued as the result of actions he took while acting properly as a trustee. I have never really understood why the problem which people say existed under Common Law did arise.

Interestingly, and almost going full circle in a recent case in chancery court before Chancellor Marvel, we were setting up a dissolution trust which was going to have some $20 or $30 million in it to be run by some of the directors of the dissolved company. The former directors wanted, in the order setting up the trust indemnification language, and they wanted to see section 145 ² which is quite different from the indemnification provision usually found in trust dissolutions where there is indemnification. Chancellor Marvel charged

---

¹ 44 Del. Laws ch. 125 § 1.
us with researching the issue and trying to determine whether or not there was anything in 145 that was inconsistent with Delaware trust cases dealing with indemnification. We couldn't find anything, he couldn't find anything, so now we have gone full circle and incorporated the language of 145 into a decree setting up a dissolution trust, for the benefit of trustees.

Anyway, as I said, initially there wasn't a Delaware Indemnification Statute needed. One was adopted in 1943. It was ambiguous in its scope. Directors didn't really know how much protection it gave them. In some instances it was overbroad in that it seemed to permit indemnification of amounts paid in settlement of a derivative action. In other areas it was overnarrow because the classes of persons entitled was too restricted.

Therefore, the 1967 statute was proposed, and that is the one we are living under now. The goals of the Indemnification Statute are easy, I think. You want to get good people to act as corporate officials, you want to discourage unmeritorious claims, you don't want to encourage suits and drain on the corporate treasury, and you therefore want to provide a mechanic for the officers and the directors to be able to defend. And finally, you want the officers and directors to have a little certainty as to where they stand. You don't want them to take on the burdens of being an officer or a director without having some certainty that if they are challenged and they have acted properly, they will come out all right.

The 1967 Statute, section 145, details classes of people covered, and it's quite broad. It covers directors, officers, employees, agents and persons who are acting in any of those capacities at the request of the corporation.5

It deals with two types of actions: third party actions 4 and derivative actions.6 In the third party action indemnification is available for everything, for expenses (including attorney's fees), judgments, fines and amounts paid in settlement if the person who is seeking indemnification acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation; and for a criminal action, if he had no reason to believe that his action was unlawful.6

But there is a limit. The amounts expended must have been actually and reasonably incurred.7 I think that limitation does give

3. Id.
4. Id. §145(a).
5. Id. §145(b).
6. Id. §145(a).
7. Id.
the corporation some protection for certain reasons which we will come to later. Further, the statute provides that the finding of a particular court does not bind the board in making the indemnification determination.8

The other type of action which is addressed in the Indemnification Statute is the derivative action. There, the only indemnification which is available, and this makes sense, is indemnification for expenses if the person acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation.9

The statute goes further. The statute also has the limitation there that the amounts expended must have been actually and reasonably incurred, and then it goes further and says that if the person has been adjudged not to have met the standard of performance to which a director or officer would normally be held, or was guilty of misconduct in performance of duty, the indemnification is not available.10

The board can't grant indemnification under the permissive language of 145 unless the initial court which found the liability, or the chancery court in a separate action, determines that such person has, given all the facts and circumstances, met the appropriate standard and is entitled to be indemnified.11

It is also interesting, I think, that the Indemnification Statute has been little litigated here. Only three or four cases have dealt with it. So much of what I am going to say is based on our judgment of how the courts would judge these matters if the matter came to be challenged.

If an officer or director has been "successful on the merits or otherwise" in one of the types of action covered, indemnification is mandatory.12 We know what success on the merits is, more difficult is the "or otherwise." If you are before a grand jury (and it happens more and more times that an officer is called before a grand jury), and he goes through a long proceeding and a lot of expensive lawyers, suppose that he isn't indicted. Is that "success on the merits or otherwise" to make indemnification for him mandatory?

If he is not indicted, we take the position that that is success, but on the merits or otherwise? What if he is named as an unindicted co-conspirator? I don't think we have had to deal with that one yet, but that's a possibility. He wasn't indicted, and the purpose of the grand jury proceeding is to go out there and to come up with an

8. Id.
9. Id. § 145(b).
10. Id.
11. Id.
12. Id. § 145(c).
indictment, but he, personally, is not indicted. I think the court would probably find that he is entitled to be indemnified under that circumstance.

The other thing that makes indemnification mandatory is a bylaw provision, or charter provision, and it's very typical in the Delaware Corporation to have a provision either in the charter or in the bylaws to the effect that the corporation shall indemnify the officers and directors to the fullest extent permitted by law. Indeed, some corporate charters and bylaws go so far as to restate 145 in its entirety in mandatory terms. The bylaw making indemnification mandatory to the fullest extent permitted has been approved in a superior court case, surprisingly.

The critical point in the indemnification procedure is in section 145(d) where the statute provides that the board has to take specific action in a particular case that the indemnification is proper, and that section sets forth the mechanics of that determination.

Indemnification shall be made in a specific case on the finding that the director, officer, employer or agent has met the standard, and shall be made by the board of directors by a majority vote, consisting of directors who are not party to the action, suit or proceeding. 13

We have questioned a number of times whether a committee of the board can make this finding. Section 141(c) of the General Corporation Law provides in very, very broad terms the powers of the board committees, and the powers of a board committee are not limited by the language of 141(c) to take away the power of the committee to act in indemnification matters. Indeed, that language only takes away the power in certain particular instances, and the language makes it very clear that the powers of a board committee are otherwise plenary except as specifically limited in the resolution creating such committee.

Yet that provision seems to be inconsistent with the quorum requirement set forth in 145(d)(1) and since, I don't think that a person seeking indemnification who receives it wants to later be at risk to have to return it, I think that a corporation would be well advised to assume that the language in 145(d)(1) would override the broad language authorizing committee action in 141(c) and make the full board, with appropriate quorum, take the action, or at the very least, have a committee which has as many people as would form a quorum of the board to take that action. I think that such a restriction would probably make indemnification determination by a board committee rather useless.

13. Id. § 145(d)(1).
If there is no majority vote of a quorum of directors who are disinterested available, or if the disinterested directors so request, the appropriate determination supporting indemnification can be made by independent outside counsel. There is no definition in the Statute of what independent counsel is. Does independent counsel really mean an outside law firm? Would it mean the outside law firm that the company generally uses? Most corporations have inside lawyers, and they have an outside counsel whom they use for certain problems. Is that regular outside counsel independent?

What if—this is a typical example—you have a corporation headquartered outside of Delaware who has a regular outside counsel outside of Delaware in the city where they are headquartered, and every two or three years they have a question where that outside counsel wants Delaware counsel’s advice? Would that Delaware counsel be independent for purposes of this definition, because he does have a pre-existing, albeit somewhat tenuous, relationship with the company? Or does the independent outside counsel have to be one with no connection whatsoever with the company, having no contact with them in a business sense? There is no answer to that.

What kind of an opinion is the outside counsel to give? What is the scope of his opinion? It has been my view that the outside counsel, when he is called to give these indemnification opinions, and it usually happens after there has been a very long lawsuit when some members of management have been found liable, it has been my experience and my view that the role of the counsel at that point is to advise the outside directors who hired him, or the board in general that hired him, as to what the scope of his opinion ought to be.

I have always thought that when indemnification is granted in those instances, one is very, very likely to be judged by hindsight in a plaintiff’s suit later, and the function of the independent outside counsel is to give the board an opinion that will stand up on cross examination before a hostile jury in a district court somewhere.

So we take the position that we must have complete access to whatever documents we want to determine what the scope of our opinion is going to be, to decide what documents we are going to look at, and to have work on the matter. For example, I think of a case where officers and directors were tagged with liability in connection with the failure of a joint venture with another corporation of something in the range of $30 million. The case had taken eight weeks, there were literally thousands of pages of depositions, thousands and thousands of documents, and we were asked to prepare an opinion.

14. Id. § 145(d) (2).
We didn't want to have to look at every document, we didn't want to have to read every deposition because we didn't think that that would necessarily be appropriate for the purpose of making the limited findings which we had to make, i.e., findings that the directors and officers challenged met the standard set forth in the Statute, and that is that they acted in good faith and they acted in a manner that they reasonably believed to be in, or not opposed to, the best interests of the corporation.

In that particular case, after analyzing the allegations of the complaint, we were satisfied with reading every document that had been marked to be introduced in evidence at the trial, whether, or not it was actually an exhibit. We felt that that was required because trial tactics may have made one or the other of the parties determine to hold something back. We also read all the trial transcripts, but we did not feel that we had to read all of the depositions.

I don't think we would accept the role of an outside task of giving an opinion as an outside counsel under these circumstances if the scope of our examination had been dictated to us.

The final source of authority for indemnification in this particular case would be the stockholders. May a person seeking indemnification exercise his voting rights? I don't know the answer to that. The Tanzer case reaffirms the right of stockholders to vote their stock in their own interest. I don't know whether that stockholder could vote. I would think he could vote.

Expenses are permitted to be advanced under section 145 in advance of the final disposition of the case, and I think this section is very critical to the whole indemnification picture and very important, especially to the less affluent members of the board and the less affluent officers. It's significantly different from section 143 which authorizes loans to employees and officers. Section 145(e) does not require, in our view, anything other than a receipt of an undertaking by or on behalf of the director, officer or employee to repay such an amount even if it is ultimately determined that he is not entitled to indemnification.

There is no requirement under 145(e) that the expense advance benefit the corporation, and that's in sharp distinction from section 143 where that finding has to be made. That difference is one that I think

15. Id. §145(d) (3).
18. Id. §143.
is extremely understandable in view of the policy behind 145 to encourage officers and directors.

If a director is seeking an advance to defend himself in a derivative suit, the facile and easy solution would be to deny an expense advance because analytically the corporation is benefited if it is successful in the derivative action, which is brought in the name of the corporation. On the other hand, the corporation is also benefited by enabling directors to defend themselves. To put on the board the difficult problem of balancing the benefit of the derivative action with the benefit of the director being able to defend himself would be an impossible burden on the directors in making the determination. Therefore, no such determination is required.

Second, I think 143 calls for a credit determination. 143 provides that the loan, guaranty or other assistance may be with or without interest, and may be secured or unsecured. The fact that the board is supposed to make the the determination as to whether it should be secured or unsecured seems to me to force the board under 143 to make a credit determination. There is no such requirement under 145(e). And I think that's appropriate because you don't want to penalize the impecunious officer or director and you want him to be able to mount the best defense that he can.

There also is no requirement under 145(e) as a condition of advance that the board undertake an analysis of the likelihood that the particular person requesting the advance has met the standards of the statute. This is made very clear, I think in the history of the statute, the history of the various sections of the statute, since its initial passage. If you look at page 15 of the materials provided showing the amendment to 145(e), you will see that amendment took out any obligation of the board to look forward to see if the relevant tests would be met.

That analysis may lead you to the conclusion that there can always be an advance of expenses, especially where bylaws specifically mandate indemnification. Most of the bylaw provisions only address indemnification and not advances. However, they may think they have to do it. I don't think this is right. I think that if the corporation is financially embarrassed, the corporation certainly has no obligation and it would be improper to make an expense advance.

I also think that if an officer or director is shelling out money to defend himself in a case that appears hopeless, the directors could refuse an advance on the grounds that the money wasn't being reasonably spent.

I do think that in general 145 sets forth the public policy of the State of Delaware with respect to indemnification. I don't think that
a chief executive officer could come into a corporation and enforce a provision in his employment agreement which would permit money paid in settlement of a derivative suit that had gone against him to be paid by the corporation, as that flies clearly in the face of 145. I do think that 145 would permit an arrangement such as the following:

You have a large retail chain and one of their major problems is shoplifting, and they have security guards who are ordered to be especially careful in apprehending shoplifters. Periodically these security guards apprehend someone and take him away. Then the guards determine that such person was not in fact a shoplifter. Later the guard gets sued for false arrest, and, indeed, convicted.

It seems to me that if, as a condition in the employment contract, those security guards have extracted a right of indemnification in the event that a supervisor determines that they had acted in good faith and in a manner that they reasonably believed to be in, or not opposed to, the best interests of the corporation, notwithstanding the conviction, they could be indemnified and that would be upheld by our courts. That case hasn't come up yet.

On insurance, insurance is specifically permitted by this section, and I would just point out an area which I think is interesting.

In Delaware, there is no separate non-profit corporation law, and charities are incorporated under the General Corporation Law. A charitable board would be entitled to indemnification under this section, and yet I think that most people on a charitable board, in the event they are sued (and they are getting sued more and more), I think in those cases the directors of a charitable corporation would really be very loathe to call upon the corporation to indemnify them. And I think the donors to charitable corporations would be very upset if the corporation does use their contributions to indemnify the officers and directors.

Therefore, I think that it is appropriate for charitable corporations to consider seriously getting insurance for their officers and directors. In many instances I know the directors and officers themselves stood the cost of that insurance and donated the funds to the corporation to buy it.

There is much more to be said, but time does not permit.

19. Id. § 145(q).
APPENDICES

Selected Outlines Prepared for Symposium Presentations

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Inspection of Stock List, Book and Records ..........</td>
</tr>
<tr>
<td>B. Cash Mergers: A Current View .......................</td>
</tr>
</tbody>
</table>