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Protecting the Protectors: Indemnification of Trustees of Delaware Statutory Trusts

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The board members of registered investment companies (sometimes referred to herein as funds) play a critical role in protecting the interests of shareholders. In order to encourage the diligent discharge of their duties, the board members of registered investment companies in turn need to be protected. Indemnification and advancement, along with insurance,¹ are key components of the protections available to board members with respect to the discharge of their duties.² The importance of adequate indemnification of board members has been recognized by the Delaware Supreme Court, which has said that indemnification:

serves the dual policies of: (a) allowing corporate officials to resist unjustified

lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity.³

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The Securities and Exchange Commission (SEC) has also recognized the importance of adequate indemnification in attracting qualified men and women to serve as fund board members.⁴ This article discusses indemnification and advancement under Delaware law of trustees of Delaware statutory trusts (DSTs), which have become increasingly popular for the organization of investment companies registered under the Investment Company Act of 1940, as amended (1940 Act).⁵ In addition, this article will highlight some of the differences between Delaware law applicable to the indemnification of and advancement of expenses to corporate directors and the law applicable to the indemnification of and advancement of expenses to DST trustees. It is important to note that federal laws, including the 1940 Act, impose limits on the indemnification of board members of registered investment companies. The nature and scope of these limits are beyond the scope of this article but are important to take into account.⁶

Indemnification and Advancement Under Delaware Law

Indemnification is generally understood as the payment, directly or by reimbursement, by a company of amounts owed by another with respect to judgments or settlements of claims, as well as defense costs relating thereto. Typically, the right to indemnification is granted by statute, contract or via an entity's organizational documents and often only accrues once the indemnitee has made payment to a third party and the dispute with that party is final.⁷ The ability to receive funds in advance of such a judgment for defense costs is referred to as "advancement." Under Delaware law, advancement is a separate and distinct legal right from indemnification, and the right to advancement is not dependent on the right to indemnification.⁸ Thus, while indemnification rights provide board members with the rights to be reimbursed for fees and expenses, absent advancement rights board members are obligated to pay out of pocket in the first instance. Because defense costs can be significant, advancement rights are often viewed as indispensable by board members.

Indemnification and Advancement Under the DSTA

DSTs are separate legal entities that are governed by the Delaware Statutory Trust Act (DSTA)⁹—they are not subject to the Delaware General Corporation Law (DGCL),¹⁰ Delaware's statute applicable to Delaware corporations. Adopted in 1988, the DSTA has quickly become the model for similar statutes in other jurisdictions. The DSTA provides a broad framework for the formation and operation of DSTs, with few mandatory rules and few default or gap-filler rules. The DSTA largely defers to the drafter of the governing instrument of a DST to set forth those matters that will govern the internal affairs of a DST and much of the conduct of its business. This deference is made explicit in the DSTA, which expressly states that its policy is to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments.¹¹

Indemnification of trustees of DSTs is addressed in Section 3817(a) of the DSTA, which simply provides that "subject to the standards and restrictions, if any, set forth in the governing instrument, a statutory trust shall have the power to indemnify and hold harmless any trustee or beneficial owner or other person from and against any and all claims and demands whatsoever." Section 3817(b) of the DSTA provides that the absence of indemnification provisions in a DST's governing instrument is not to be construed as depriving any trustee or other person of any right to indemnity that is otherwise available to such person under the laws of the State of Delaware. The power of a DST to indemnify its trustees is thus extremely broad.

The DSTA does not contain provisions that practitioners generally familiar with the law applicable to Delaware corporations might expect would be present. For example, Section 3817 of the DSTA does not:

- (1) Provide mandatory indemnification rights in favor of trustees;
- (2) Impose minimum standards of conduct that must be met by an indemnitee (though, as discussed below, there are likely limits under Delaware law as to the

- type of conduct for which there may be indemnity);
- (3) Provide default rules for the process of determining when indemnification is appropriate;
 - (4) Address advancement; or
 - (5) Distinguish between indemnification for third-party claims and indemnification for actions brought by or in the name of the trust, including derivative actions.

Consistent with its policy to defer to the terms of the governing instrument, the DSTA generally leaves all of these matters to the terms of the governing instrument. Drafters of governing instruments for DSTs thus have the ability to tailor terms to the needs and wishes of their clients to an extent not available in many other jurisdictions or indeed not available to organizers of Delaware corporations.

The DSTA's freedom of contract policy, coupled with the lack of default and mandatory rules, is in stark contrast to the DGCL—Delaware's much more well-known entity statute—which contains detailed statutory provisions with respect to indemnification and advancement. A summary of certain provisions of the DGCL follows in the next section in order to highlight the contrast. Although the following summary focuses on the indemnification and advancement provisions of the DGCL, we note that, while there are various differences, the indemnification and advancement regime of the Maryland Corporations and Associations Article, Maryland's statute applicable to Maryland corporations is, broadly speaking, similar to the DGCL's indemnification and advancement regime.

Indemnification and Advancement Under the DGCL

The statutory authority for indemnification and advancement under the DGCL is contained in Section 145. Sections 145(a) and (b) of the DGCL set forth provisions relating to the power of a Delaware corporation to indemnify its directors, officers and employees—neither section makes mandatory the right of indemnification. Section 145(a) applies only to third-party actions

and not to actions brought by or in the name of the corporation.¹² Section 145(b) applies only to actions brought by or in the name of the corporation, including derivative actions. While both Sections 145(a) and (b) are very broad in their coverage, each has statutory limits as to when indemnification may be available. For example, to be indemnified under Section 145(a), an indemnitee must have acted in good faith and in a manner that the indemnitee reasonably believed to be in or not opposed to the best interest of the corporation. Additionally, with respect to any criminal proceeding, the indemnitee must have had no reasonable cause to believe that the indemnitee's conduct was unlawful.

In addition to the permissive indemnity rights under Sections 145(a) and (b), the DGCL also provides for mandatory indemnification rights for both current and former directors and officers in certain situations. Specifically, pursuant to Section 145(c), the corporation is required to indemnify its former and current directors and officers for expenses to the extent that any such person is successful on the merits or otherwise in defense of such suit, action or proceeding.

Section 145(d) of the DGCL sets forth procedures for determining whether a prospective indemnitee has met the statutory standards of conduct. The determination as to whether a prospective indemnitee who is then a director or officer of the corporation has met the standards of conduct must be made:

- (1) By a majority vote of the directors who are not party to the suit, action or proceeding for which the indemnitee seeks indemnification, even though less than a quorum;
- (2) By a committee of such directors designated by a majority vote of such directors, even though less than a quorum;
- (3) If there are no such directors or if such directors so direct, by independent legal counsel in a written opinion; or
- (4) By the stockholders.

Section 145(e) permits a corporation to advance expenses (including attorneys' fees) incurred by a current director or officer in defending an action, suit or proceeding upon

an undertaking by or on behalf of such director or officer to repay any advanced amounts if it is ultimately determined that such person is not entitled to be indemnified by the corporation as authorized by Section 145. Additionally, Section 145(e) permits a corporation to advance such expenses (including attorneys' fees) incurred by former directors and officers, among other persons, upon such terms and conditions as the corporation deems appropriate.

Delaware Case Law under the DSTA

In contrast to the extensive case law under the DGCL, the authors are only aware of two Delaware cases expressly addressing indemnification and advancement rights of trustees of DSTs: *Nakahara v. NS 1991 American Trust*¹³ and *Simon v. Navellier Series Fund*.¹⁴ In *Nakahara*, two trustees of a DST sought advancement of legal fees and expenses from the trust pursuant to express advancement rights in the trust's governing instrument. An indirect beneficiary of the trust intervened and challenged the trustees' right to advancement, claiming that the DSTA did not permit the trust to advance legal fees and expenses. The *Nakahara* court held that notwithstanding the DSTA's silence regarding advancement rights of trustees, a DST has the power to advance legal fees to its trustees.¹⁵

Though its holding is narrow, *Nakahara* provides significant guidance regarding indemnification and advancement rights generally under the DSTA. For example, in response to the plaintiff's arguments that relied upon the provisions of the DGCL in support of their arguments under the DSTA, the *Nakahara* court considered the DSTA's and the DGCL's different treatment of indemnification and advancement and concluded that the "two statutes are simply too different to draw any conclusions from a comparison of their various provisions."¹⁶ The court stated that while flexible in many respects, the DGCL does place limits on how a corporation may be organized. In contrast to the DGCL, the court found that the DSTA's highly permissive language was intended to give DSTs broad freedom in establishing their internal affairs. In particular, the court noted that the language of Section

3817(a) of the DSTA "compels a permissive interpretation, with the language intended to authorize as much as possible and exclude only that which is expressly prohibited" and that Section 3817 of the DSTA allows DSTs to indemnify and advance litigation expenses to its trustees in any way "that is consistent with general contracting principles."¹⁷ In light of *Nakahara*, care must be taken when looking to Delaware corporate law for guidance with respect to indemnification matters for DSTs given the difference in the statutory regimes.

In *Navellier*, a trustee of a registered investment company organized as a DST sought indemnification from the DST pursuant to the indemnification provisions of the DST's governing instrument. The DST and the trustee also had entered into a separate indemnification agreement, which contained an exclusive forum selection clause requiring all disputes related to indemnification to be decided in the courts in Reno, Nevada. The court dismissed the trustee's claim and held that, notwithstanding the absence of a forum selection clause in the governing instrument's indemnification provisions, the dispute must be litigated in the courts of Reno, Nevada pursuant to the exclusive forum selection clause contained in the separate indemnity agreement. The court reached its conclusion seemingly because of imprecise drafting of the separate indemnity agreement, which led the court to view the indemnification provisions in the governing instrument and those in the separate indemnification agreement as an integrated whole.¹⁸ *Navellier* is perhaps best remembered as providing support for a fund's ability to enter into indemnification agreements (discussed in more detail below) with its board members even when the governing instrument otherwise provides indemnification and as a reminder of the importance of precise drafting.

Typical Provisions in Fund Governing Instruments

Given the brevity of the DSTA's treatment of indemnification—particularly when contrasted with the DGCL—and the lack of gap filler provisions, it is easy to see why the governing instruments of 1940 Act funds typically contain relatively detailed provisions relating to indemnification

and advancement. For example, many funds' governing instruments contain provisions relating to the procedures for determining whether indemnification or advancement is appropriate (these procedures are often modeled on the DGCL provisions and SEC guidance as to what is consistent with the 1940 Act), including the establishment of litigation committees, provisions relating to who controls the defense of an action, rights of participation and settlement, and provisions relating to how disputes over the granting of indemnification and advancement are resolved.

Delaware Common Law Indemnification Rights of Trustees

In the absence of indemnification provisions in a DST's governing instrument, Section 3817(b) of the DSTA preserves indemnification rights otherwise available to trustees or other persons under Delaware law. In addition, Section 3809 of the DSTA provides that the laws of Delaware pertaining to trusts generally are applicable to DSTs except to the extent that a DST's governing instrument provides otherwise. Thus, in the unlikely event that a fund's governing instrument is silent as to indemnification of the trustees, Delaware law does provide some base level of indemnity rights. These indemnity rights are not statutory rights but are instead derived from common law principles and their application (and adequacy) to a trustee of a DST operating as a registered investment company is uncertain.

Public Policy Limits to Indemnification of Trustees Under Delaware Trust Law

Notwithstanding the DSTA's approval of indemnification of trustees for "any and all claims and demands whatsoever" and the extremely broad authorization suggested by *Nakahara*, there are other provisions of the Delaware Code which suggest that the broad indemnification permissible under the DSTA is still subject to certain limits, including public policy limits.¹⁹ In the statutory laws governing Delaware trusts in general, one section allows for governing instruments to expand, restrict, eliminate or otherwise vary the standard of care, indemnification rights and liabilities of

fiduciaries of a Delaware trust.²⁰ However, this section also provides that it shall not be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary's own wilful misconduct. In this context, Delaware law defines wilful misconduct as "intentional wrongdoing, not mere negligence, gross negligence or recklessness."²¹ The outer limits of permissible indemnification under Delaware law may be somewhat academic for 1940 Act funds, given the 1940 Act's limitations on exculpation and indemnification.

Indemnification Agreements

While indemnification and advancement rights for DSTs are usually granted to board members in the governing instrument, such rights, as *Navellier* indicates, can also be granted pursuant to a separate indemnification agreement. Indemnification agreements are bilateral agreements between a fund and an individual board member whereby the fund agrees to provide indemnification (and usually advancement) to the board member on the terms and conditions set forth in the indemnification agreement. Depending on the terms and conditions of the indemnification agreement and the relevant provisions of the fund's governing instrument, an indemnification agreement can serve a variety of purposes, including providing trustees with indemnification and advancement rights that supplement or expand the rights provided in the fund's governing instrument.²² The use of indemnification agreements by registered investment companies has not been as common as it has been for public companies generally (the precise reasons for this are not entirely clear). However, it is the authors' impression that more and more funds organized as DSTs are entering into indemnification agreements with their board members. This section will discuss what purposes such agreements can serve and some of the issues that should be considered when considering their adoption.

Purposes Served by Indemnification Agreements

Indemnification agreements can serve a variety of different purposes, only some of

which may be relevant to any particular fund. In order to understand the purposes that may be served by an indemnification agreement for a DST and its trustees, it is perhaps instructive to first discuss the purposes that indemnification agreements have historically served for directors of Delaware corporations, where their use is much more common. As previously noted, the DSTA and the DGCL have different statutory provisions with respect to indemnification generally; broadly speaking, while the purposes indemnification agreements serve are generally the same for board members of DSTs and Delaware corporations, there are some differences discussed below. These differences are important to understand since there is often a temptation to use forms of indemnification agreements that were designed to work with the DGCL and adapt them for use with DSTs.

The starting point for discussing indemnification agreements for Delaware corporations is Section 145(f) of the DGCL, which expressly states that the indemnification and advancement provisions provided by Section 145 are not exclusive.²³ Thus, Delaware corporations are permitted to indemnify a corporate director by means of an indemnification agreement.²⁴ The purposes such agreements typically serve are: (1) to make indemnification and advancement by the corporation mandatory in a situation where the governing documents of the corporation or the DGCL provide that indemnification is permitted but not mandatory,²⁵ (2) to provide greater specificity as to board members' rights of indemnification and advancement and the procedural requirements for obtaining indemnity and advancement of expenses,²⁶ and (3) to create a personal contract right that cannot be amended without the consent of the individual board member who is a party to the contract. Whether an indemnification agreement can also provide indemnification rights for corporate directors that are contrary to the limitations or prohibitions set forth in Section 145 of the DGCL is an open question because there are no reported Delaware cases that address this point.²⁷

While each of the purposes referenced above can be important from the perspective of a corporate director, the security of a personal contract right is often viewed as the most important

purpose an indemnification agreement can serve. The importance of such a personal right was highlighted by the Delaware Chancery Court in *Schoon v. Troy Corp.*²⁸ In *Schoon*, the Delaware Court of Chancery held that a former director of a Delaware corporation was not entitled to advancement under the corporation's bylaws because the board of directors had amended the bylaws to eliminate the right of former directors to advancement prior to the corporation's action against a former director but after the director had joined the board. The court rejected the former director's claim that the corporation could not unilaterally terminate his right to advancement because his right vested upon his joining the board. The court instead found that a director's right to advancement vested when the corporation's obligations under the bylaws were triggered by a lawsuit, not upon the director taking office. If the former director had had an indemnification agreement, the board of directors would not have been able to unilaterally eliminate the former director's right of advancement. Section 145(f) of the DGCL was amended in 2009 to effectively reverse the *Schoon* ruling in most situations. However, there is still utility for indemnification agreements as personal contract rights for corporate directors because this amendment to the DGCL only addresses the elimination of indemnification and advancement rights after the occurrence of the act or omission for which indemnification or advancement is sought and not their elimination generally for prospective actions.

In the context of DSTs, the purposes that indemnification agreements serve are similar to those applicable to corporations. However, because of the differences between the law applicable to DSTs and Delaware corporations highlighted above, indemnification agreements' relative importance to board members of a given fund will be highly dependent on the terms of the fund's governing instrument. For example, as noted above, it is common for relatively detailed provisions for mandatory indemnification and advancement to be set forth in the governing instrument of a DST, thus obviating the need for greater specificity that often applies in the context of Delaware corporations. An indemnification agreement as a personal contract right perhaps has more significance for board members of a DST

than is the case for corporate directors. This is because the DSTA does not contain a provision similar to that found in Section 145(f) of the DGCL adopted in the wake of *Schoon*. In addition, the DSTA does not have a provision similar to DGCL Section 145(j), which makes clear that indemnification generally continues to be available under Section 145 even after the person ceases to be a director.

As a result, many funds organized as DSTs incorporate the protections provided in Sections 145(f) and 145(j) directly into the fund's governing instrument. But since the protections are in the governing instrument and are not statutory rights, they are subject to the amendment provisions of the governing instrument and general contract law principles applicable to amendments generally. Thus, though careful drafting can make these provisions difficult to eliminate without the consent of the affected board members, it is not certain that such provisions would be impervious to elimination by a board so inclined to do so in all situations (particularly with shareholder approval). Indemnification agreements protect against this risk and thus should be considered by DST boards that have concerns in this area.

Interplay with Governing Instrument Provisions

As indicated above, it is common for the governing instruments of registered investment companies organized as DSTs to contain more detailed provisions for indemnification and advancement than is typically the case for the governing instruments of Delaware corporations. If a DST's board has determined that it is appropriate to enter into indemnification agreements with individual members, then it is important, as *Navellier* highlights, when drafting the indemnification agreements that the provisions of the fund's governing instrument be analyzed carefully because the DSTA defers to the governing instrument with respect to any standards or restrictions that might apply to a DST's power to indemnify.

Conclusion

In order to attract the best candidates to serve as registered investment company board

members, a fund should provide comprehensive indemnification and advancement rights. The flexibility of the DSTA and its policy of giving maximum effect to the principle of freedom of contract provide investment funds a variety of options to meet that objective. This flexibility is in contrast to the approaches of many statutes governing corporations, including the DGCL, which tend to be more restrictive. The authors believe that this flexibility is one of the reasons why Delaware statutory trusts are the pre-eminent choice for the formation of registered investment companies in the United States.

Notes

1. This article does not discuss insurance. Insurance, however, is an important component of personal liability protection for fund directors. For a discussion of insurance in the context of registered investment companies, see ICI Mutual Risk Management Study, "Mutual Fund D&O / E&O Insurance: A Guide for Insureds," (2009) ICI Mutual Insurance Company.
2. For a discussion of the litigation risks facing independent directors of investment companies, see ICI Mutual Risk Management Study, "Independent Director Litigation Risk: A Practical Guide to Understanding and Reducing Risk to Fund Independent Directors in Civil Litigation," (2006) ICI Mutual Insurance Company.
3. *VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998).
4. See, e.g., SEC Release No. IC-10700 (May 16, 1979) and SEC Release No. IC-24083 (Oct. 14, 1999).
5. As to the growth of the use of DSTs as registered investment companies, see J. Weston Peterson, "Investment Companies Organized as Delaware Statutory Trusts: Practical Considerations for Drafting Governing Instruments," *The Investment Lawyer*, Vol.15, No.1 (Jan. 2008).
6. For a discussion of the federal law limits on indemnification and advancement see David A. Sturms, "The Basics of Indemnification and Insurance for Investment Company Directors," 2003 Investment Company Institute, Investment Company Director's Conference (Oct. 2003), at pp.5-7.
7. *Certaineed Corp. v. Celotex Corp.*, 2005 WL 217032, at *3 (Del. Ch. Jan. 24, 2005) (addressing accrual of indemnity rights under common law); *Simon v. Navellier Series Fund*, 2000 WL 1597890, at *9 (Del. Ch. Oct. 19, 2000) (noting in *dicta* that it makes little sense for a court to decide indemnity claims in advance of a final non-appealable judgment).
8. *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 212 (Del. 2005).
9. 12 Del. C. §§ 3801-3862.

10. 8 Del. C. §§ 101- 398.
11. See 12 Del. C. § 3825(b).
12. Cochran v. Stifel Fin. Corp., 2000 WL 286722, at *11 (Del. Ch. Mar. 8, 2000).
13. 739 A.2d 770 (Del. Ch. 1998).
14. 2000 WL 1597890 (Del. Ch. Oct. 19, 2000).
15. Although the *Nakahara* court held that DSTs have the power to advance litigation expenses and the trustees had satisfied all the prerequisites imposed by the governing instrument, the court refused to authorize advancement of the trustees' litigation expenses. Instead, the court denied advancement because it found that the trustees had "unclean hands." *Id.* at *3.
16. *Nakahara*, 739 A.2d at 782 (emphasis in original).
17. *Id.* at 782-84.
18. See *Navellier*, 2000 WL 1597890, at *8.
19. The DSTA does place limits on the exculpation of trustees and other persons. Section 3806(e) of the DSTA provides that a governing instrument may not eliminate liability for a bad faith violation of the implied covenant of good faith and fair dealing. Although this section could be construed as a limit on a DST's ability to indemnify its trustees and other persons, the section does not expressly apply to indemnification rights.
20. 12 Del. C. § 3303(a).
21. 12 Del. C. § 3301(g).
22. Subject to the caveats discussed *infra* in *Interplay with Governing Instrument Provisions*.
23. See 8 Del. C. § 145(f). There is no similar provision in the DSTA. This absence, however, should not be interpreted to mean DSTs generally cannot enter into indemnification agreements, particularly in light of *Navellier*.
24. See, e.g., 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.12[E] (3d ed. 1998).
25. As noted herein, DGCL Sections 145(a) and (b) provide that a corporation has the power to indemnify as provided in the statute but do not mandate indemnification. See 8 Del. C. § 145(a)-(b). DGCL Section 145(c), on the other hand, is a mandatory provision. See *id.* § 145(c).
26. Balotti notes that a non-Delaware court in *PepsiCo, Inc. v. Cont'l Cas. Co.*, 640 F.Supp. 656 (S.D.N.Y. 1986), has stated that an indemnification agreement could grant indemnity rights that supersede the statutory provisions in the DGCL, though Balotti considers it questionable that a Delaware court would be as sweeping. See Balotti & Finklestein, *supra* n.24, § 4.12[E].
27. See *id.*
28. 948 A.2d 1157 (Del. Ch. 2008).

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