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THE RIGHT PROTECTION: MORE ON ADVANCEMENT AND INDEMNIFICATION

In three recent opinions, the Delaware Court of Chancery has addressed the scope of indemnification and advancement bylaws and has made some statements that may come as a surprise to corporate practitioners. In one of those cases, the Court held that an unvested right to indemnification or advancement in a corporation's bylaws could be eliminated through an amendment to those bylaws.

By John Mark Zeberkiewicz and Blake Rohrbacher *

The Delaware courts have had an interesting year in interpreting bylaws, with stockholder proposals and the advance notice provisions regulating their submission taking center stage,[1] but it is the recent cases on advancement and indemnification that may have the greatest direct impact on individual directors and officers. We discuss three of those cases and their practical effects, suggesting next steps for corporations, management, and their counsel.

SCHOON: BYLAW AMENDMENTS AND FORMER DIRECTORS

In March 2008, the Court of Chancery decided *Schoon v. Troy Corp.*, a case in which two plaintiffs sued the Troy Corporation for advancement – Richard Schoon, a current Troy director, and William Bohnen, a former Troy director.[2] Bohnen was a major Troy stockholder through his family's investment vehicle, Steel Investment Company, which was entitled to one board seat through its ownership of Troy's series B common stock. Bohnen served as a director of Troy until his resignation in February 2005, at which time Steel designated Schoon as its representative on Troy's board.

In January 2004, Steel decided to sell its stake in Troy and made a books and records demand to value its interest. Schoon separately sought books and records and later filed an action pursuant to Section 220 of the Delaware General Corporation Law. In response, Troy

[1] *See, e.g.*, *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008); *Levitt Corp. v. Office Depot, Inc.*, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008); *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335 (Del. Ch. 2008).

[2] *Schoon v. Troy Corp.*, 948 A.2d 1157, 1159–60 (Del. Ch. 2008). The case was appealed, but the appeal was dismissed after the parties reached a settlement.

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filed affirmative defenses against him – but not against Bohnen – including a claim of breach of fiduciary duty, in October 2005.[3]

In early November 2005, the Troy board (except Schoon) amended Troy's bylaws to remove "the word 'former' from its definition of the directors entitled to advancement."[4] In January 2006, Troy filed an amended pleading, asserting fiduciary claims against both Schoon and Bohnen.

Both Schoon and Bohnen sought advancement from Troy. The court granted Schoon's claims for advancement,[5] but denied Bohnen's claims on the grounds that he was not covered by Troy's advancement bylaw, as amended in November 2005.[6] Bohnen argued that his right to advancement under the bylaws was a contract right that, following the Delaware Superior Court's holding in *Salaman v. National Media Corp.*,[7] could not be unilaterally impaired. Interestingly, the Court of Chancery recognized that *Salaman* was controlling, but used that case to deny Bohnen's claim for advancement.

The *Schoon* court noted that the *Salaman* court, "[r]elying on the principle that 'the right to advancement and indemnification is a vested contract right which cannot be unilaterally terminated,'" held that a defendant-director's rights "vested when the defendant's obligations were triggered, or on the date of the [filing] of the pleading" against the director.[8] As a result, the corporation in *Salaman* was prohibited from amending its bylaws to eliminate retroactively the director's vested indemnification and advancement rights.

In *Schoon*, however, the Court of Chancery held that, because there was "no evidence that Troy was even contemplating claims against Bohnen at the time of the amendments," Bohnen's right to advancement had not vested before the amendments.[9] Bohnen's right to advancement was, accordingly, subject to the amended bylaws. Because the bylaws excluded former directors from advancement, and because "Bohnen resigned before Troy initiated its fiduciary duty claims against him," the court held Bohnen not entitled to advancement.[10]

UNDERBRINK: RETROACTIVE ADVANCEMENT

In *Underbrink v. Warrior Energy Services Corp.*, the Court of Chancery dealt with the opposite issue – whether a corporation could adopt a mandatory advancement bylaw with retroactive effect.[11] The plaintiffs in this case were directors of Warrior until the time of its secondary public offering on April 19, 2006. On April 13, 2006, the board amended Warrior's bylaws to provide each director mandatory advancement for any action or proceeding "'arising out of any event or occurrence related to the fact that [he] is or was a director.'"[12]

Two directors were later sued for actions they took as directors, and they sought advancement from Warrior. Warrior refused to advance the expenses, claiming, among other things, that the bylaw was void because its

[3] *Id.* at 1161.

[4] *Id.*

[5] *Id.* at 1170.

[6] *Id.* at 1168.

[7] 1992 WL 808095 (Del. Super. Oct. 8, 1992).

[8] *Schoon*, 948 A.2d at 1165.

[9] *Id.* at 1166.

[10] *Id.* at 1167. Bohnen also claimed that the bylaw amendment, even if effective, failed to eliminate his right to advancement, because a separate provision of the bylaws provided that the indemnification and advancement rights "'shall continue as to a person who has ceased to be a director.'" *Id.* at 1166. The *Schoon* court interpreted this provision to mean that a director's right to indemnification and advancement, if vested while that director was in office, could not subsequently be terminated by the director's resignation or removal. *Id.* at 1167.

[11] *Underbrink v. Warrior Energy Services Corp.*, 2008 WL 2262316 (Del. Ch. May 30, 2008).

[12] *Id.* at *7.

adoption constituted a breach of the directors' fiduciary duties.[13] The court applied the deferential business judgment standard of review and upheld the bylaw's validity.[14]

The court held that the mere fact that the directors received benefits from the mandatory advancement bylaw did not implicate a review under the stringent entire-fairness standard.[15] Citing to precedent indicating that the decision to adopt a mandatory advancement bylaw would be granted the presumptions of the business judgment rule, even if adopted in the face of imminent litigation,[16] the court refused to apply entire fairness because the decision at issue related to the advancement of expenses "'sometime in the future'" rather than the extension of "'particular litigation expenses.'"[17]

ZAMAN: SUCCESSFUL AGENTS

In May 2008, the Court of Chancery issued *Zaman v. Amedeo Holdings, Inc.*, a complicated case involving advancement and indemnification, two plaintiffs, five defendants, three underlying actions, and the royal family of Brunei.[18] Without engaging in more factual recitation than is necessary,[19] the capsule summary is that the Derbyshires (husband and wife) had been appointed as directors, officers, and sometime agents for a web of corporations beneficially owned by the younger brother of the Sultan of Brunei, Prince Jefri.[20] The Derbyshires were then sued by Prince Jefri and some of the corporations for various breaches of duty, first in New York federal court and then in New York state court. The federal action – for which jurisdiction was premised on a RICO claim – was dismissed on May 17, 2007.[21] The federal court dismissed the RICO claim and then dismissed the remaining claims, which were state-law claims, without prejudice for lack of subject-matter jurisdiction. The next day (May 18), those state-law claims were largely re-pleaded in the New York state court.[22]

The Derbyshires sought indemnification for the New York federal action and advancement for the New York state action, which was still ongoing. The court granted much of the relief sought by the Derbyshires, but it made some significant rulings along the way regarding the defendants' bylaws.

It first bears mentioning that the defendants' bylaws contained fairly standard language, stating that each corporation

> shall indemnify and hold harmless, to the fullest extent permitted by applicable law . . . any person who was or is made or is threatened to be made a party or is otherwise involved in any threatened, pending, or completed action, suit, or proceeding . . . by reason of the fact that he, or a person for whom he is the legal representative, is or was a director or officer of the corporation or is or was serving at the request of the corporation as a director, officer, employee, or agent of another corporation or of a partnership . . . against all liability and loss suffered and expenses (including attorneys' fees) reasonably incurred by such indemnitee.[23]

Because some of the claims against the plaintiffs were brought because of actions they took only in their capacities as "agents" – as opposed to directors or officers – the court needed to determine whether they were eligible for indemnification under Section 145(c) of the Delaware General Corporation Law.[24] Section

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[13] *Id.* at *10. Warrior also argued that the directors were not entitled to advancement for actions taken prior to the April 13 amendment because Warrior had not received consideration in exchange for the agreement to advance expenses. *Id.* at *9. On that issue, the court found that, even assuming consideration to be necessary, the additional five days of service that Warrior obtained from the directors was sufficient. *Id.* at *10.

[14] *Id.* at *13.

[15] *Id.* at *11.

[16] *Id.* (citing *Orloff v. Schulman*, 2005 WL 5750635 (Del. Ch. Nov. 23, 2005)).

[17] *Id.* at *13.

[18] *Zaman v. Amedeo Holdings, Inc.*, 2008 WL 2168397 (Del. Ch. May 23, 2008). The case was appealed, but the appeal was later dismissed.

[19] *Cf. id.* at *13 (describing a "mind-numbing recitation of the multitudinous claims" brought against the plaintiffs in the underlying actions).

[20] *Id.* at *1.

[21] *Id.* at *12.

[22] *Id.*

[23] *Id.* (omissions in original) (emphasis omitted).

[24] The plaintiffs' indemnification claims were based solely on Section 145(c) (governing mandatory indemnification), the court held, because they had waived their claims under Section

145(c) provides that a corporation *must* indemnify directors or officers to the extent that the directors or officers have been successful in defending a suit against them.[25] In a holding that may surprise some readers of the statute, the court held that the Derbyshires were entitled to mandatory indemnification even in their capacities as agents.[26] That is, even though Section 145(c) by its terms applies only "[t]o the extent that a *present or former director or officer of a corporation* has been successful on the merits or otherwise,"[27] the court held the defendants bound to indemnify their successful agents.[28]

The court's reasoning rested on the interplay of Section 145(c) and the defendants' bylaws, which provided for mandatory indemnification "to the fullest extent permitted" under Delaware law. "[A]s a contractual matter," the court held, "if the Derbyshires acted in an indemnifiable capacity [*i.e.*, as agents], the defendants must indemnify if § 145(c) would authorize them to do so if the Derbyshires were directors or officers."[29] The court also stated that, "if Delaware law mandates indemnity for success by a director or officer, a corporation is not prohibited by Delaware law from providing indemnity to an agent who was successful."[30] Therefore, the court continued, "[h]aving promised to indemnify persons they ask to serve as agents of other corporations to the fullest extent permitted by Delaware law, the defendants are bound if a person is sued in an indemnifiable capacity and is successful."[31]

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footnote continued from previous page…

145(a) (governing permissive indemnification) by asserting them too late. *Id.* at *16.

[25] 8 *Del. C.* § 145(c). The Derbyshires argued that they had been successful in the New York federal action by getting the RICO claim dismissed. *See infra* note 28.

[26] *Zaman*, 2008 WL 2168397, at *16.

[27] 8 *Del. C.* § 145(c) (emphasis added).

[28] *Zaman*, 2008 WL 2168397, at *16. Possibly as noteworthy is the court's other holding that, when the New York federal court dismissed the state-law claims against the Derbyshires, the Derbyshires were "successful on the merits or otherwise" under Section 145(c). *Id.* at *24. The New York federal court dismissed the federal RICO claim with prejudice but dismissed the state-law claims without prejudice for lack of subject-matter jurisdiction. This holding may be significant because earlier conventional wisdom had held that, to constitute a "success," a dismissal had to be with prejudice. *See, e.g.*, *Galdi v. Berg*, 359 F. Supp. 698 (D. Del. 1973); *B & B Inv. Club v. Kleinert's, Inc.*, 472 F. Supp. 787 (E.D. Pa. 1979).

Although only one claim (the federal RICO claim) was dismissed with prejudice, the *Zaman* court held that the Derbyshires' success was total because "[s]uccess on the RICO count caused the dismissal of the entire proceeding." *Zaman*, 2008 WL 2168397, at *22. The state-law claims dismissed by the federal court were (largely) re-pleaded in the New York state court one day later. Nevertheless, the *Zaman* court held that the Derbyshires had achieved complete success because the federal action itself was over; that the Derbyshires faced the state-law claims again, after a one-day hiatus, was irrelevant. *Id.* ("At the time of the dismissal, no claims were pending against the Derbyshires anywhere.").

[29] *Id.* at *16.

[30] *Id.*

[31] *Id.* The court also revisited prior precedent regarding whether advancement is available for the prosecution of counterclaims. This question often arises in the context of bylaws providing for mandatory advancement of costs incurred "in defending any proceeding." The Delaware Supreme Court held in its 1992 *Roven* case that the "in defending" language applied to affirmative defenses and compulsory counterclaims. *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 824 (Del. 1992). Since then, the Delaware courts have generally allowed advancement for compulsory counterclaims and denied it for permissive counterclaims. *See, e.g.*, *Reinhard & Kreinberg v. Dow Chem. Co.*, 2008 WL 868108, at *3 (Del. Ch. Mar. 28, 2008). The issue arose in *Zaman* because, although the Derbyshires' counterclaims had been compulsory in the New York federal court, they were merely permissive in the New York state court. *Zaman*, 2008 WL 2168397, at *34. The *Zaman* court granted the Derbyshires advancement, interpreting the holding in *Roven* thus: "the costs of prosecuting a counterclaim should be subject to advancement if the counterclaim would qualify as a compulsory counterclaim[] under the traditional counterclaim test used by both Delaware and federal civil procedure *and* when that counterclaim so directly relates to a claim against a corporate official such that success on the counterclaim would operate to defeat the affirmative claims against the corporate official." *Id.* at *35 (footnote omitted).

Another recent case interpreting "in defending" language in bylaw provisions is *Sun-Times Media Group, Inc. v. Black*, 954 A.2d 380 (Del. Ch. 2008). The court in *Sun-Times* held that, under *Roven*, appealing a criminal conviction is "defending, in the sense of § 145(e)'s use of defending a proceeding." *Id.* at 398. The *Sun-Times* court also held that "advancement through the final disposition of a proceeding is best read as temporally connected to the 'ultimate determination' of entitlement to indemnification, which only becomes ripe once the underlying proceeding is truly final" and that the "'final disposition' of an 'action, suit or proceeding' is most plausibly read as meaning the final, non-appealable conclusion of a proceeding." *Id.* at 397.

But the court's reasoning is not unassailable. It does not necessarily follow that, simply because Section 145(c) exists, "a corporation is not prohibited by Delaware law from providing indemnity to an agent who was successful." First, only directors and officers are included in Section 145(c) – the General Assembly expressly excluded "agents" from coverage by Section 145(c) in 1997.[32] Second, because agents are not included in Section 145(c), they must look to Section 145(a) for indemnification (if the action is not derivative), and Section 145(a) requires for indemnification that "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."[33] But the court held that the Derbyshires had waived their claim under Section 145(a),[34] and nowhere in the opinion did the court appear to make a finding of the plaintiffs' good faith or the plaintiffs' reasonable belief that their actions were in the corporations' best interests.

Interestingly, Vice Chancellor Strine made similar arguments in his 2000 *Cochran* opinion.[35] There, his argument was based in part on Section 145(f), which provides that the statutory rights to advancement and indemnification are not exclusive and that rights to advancement and indemnification may be provided by bylaw or agreement.[36] In short, the Vice Chancellor's rationale appeared to be that, because Section 145(f) *could* allow a corporation to indemnify agents contractually because they succeed on the merits, a bylaw provision providing indemnification to "the fullest extent of the law" requires that the court force a corporation to do so.[37] The *Cochran* case was affirmed in part and reversed in part, but the Delaware Supreme Court did not reach those particular arguments. It is therefore unclear whether the Court of Chancery's dicta has effectively written "agents" back into Section 145(c) under circumstances where the corporation provides its agents with mandatory indemnification "to the fullest extent permitted by Delaware law."

PRACTICAL IMPLICATIONS

The implications of *Schoon* are fairly straightforward. Rights to mandatory indemnification and advancement that arise out of bylaws are subject to change by the corporation's board of directors. It is clear after *Schoon* that, unless a suit was contemplated before the date of any bylaw amendment, these rights to indemnification or advancement are not automatically vested. One potential means of addressing this issue, from the standpoint of a potential indemnitee, is to include language in the bylaws providing that any modification to the advancement or indemnification provisions shall not adversely affect any right or protection of the indemnitee with respect to acts or omissions occurring prior to the time of the modification.

Directors and officers also may want to ensure that their rights to indemnification and advancement are clearly spelled out in a separate agreement. To attract and retain highly qualified and competent officers and directors, corporations should also have those same goals in mind. Still, as illustrated in the cases discussed above, the fact remains that boards are sometimes reluctant to honor indemnification and advancement agreements, and may in fact attempt to impair the rights under those agreements, particularly when the potential indemnitee is no longer affiliated with, or on good terms with, the corporation.[38] Thus, a potential indemnitee may also consider negotiating for a provision in a separate indemnification agreement that allows the determination whether indemnification is proper to be made, at the indemnitee's request, by independent counsel.

The implications of *Underbrink* are also fairly simple. Directors need not worry too much about liability for amending their bylaws to provide advancement rights, even retroactive advancement rights, so long as they do

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[32] *See* 71 Del. Laws ch. 120, § 5 (1997).

[33] 8 *Del. C.* § 145(a).

[34] *Zaman*, 2008 WL 2168397, at *16; *see also supra* note 24.

[35] *Cochran v. Stifel Fin. Corp.*, 2000 WL 286722, at *17–20 (Del. Ch. Mar. 8, 2000), *aff'd in part, rev'd in part*, 809 A.2d 555 (Del. 2002).

[36] *See generally* 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.12[E] (3d ed. Supp. 2008) (discussing Section 145(f)).

[37] This is different from allowing Section 145(f) to authorize indemnification of a putative indemnitee without a finding that the person acted in good faith, which is generally not allowed under Delaware law. *See Cochran*, 2000 WL 286722, at *20. The difference is the showing of success on the merits or otherwise. *See id.*

[38] *See Sun-Times*, 954 A.2d at 399 n.75 (noting that, "as this court has addressed the 'reflexive challenges to advancement claims that have proliferated in such number before this court recently,' companies are being forced to search even harder for increasingly strained arguments that will allow them to delay living up to seemingly clear advancement obligations").

so fairly, within the confines of their business judgment, and with respect to future – not any particular – litigation expenses.

The implications of *Zaman* are more complex. The bylaws interpreted in *Zaman* were fairly standard, but the court held them to override the good-faith standard in Section 145(a) and the "agent" exclusion in Section 145(c) and to mandate advancement for permissive counterclaims. Corporations may therefore wish to review their bylaws in light of *Zaman* and make changes they feel necessary to ensure that their bylaws regarding advancement and indemnification embody the intended rights.

In that context, it bears mention that the *Zaman* defendants' bylaws included a provision that each corporation "'shall have the burden of proving that the indemnitee was not entitled to the requested indemnification or advancement of expenses.'"[39] This provision arose several times in the *Zaman* opinion, ensuring that, "as to any issue where the evidence is equally balanced, the [plaintiffs seeking indemnification and advancement would] prevail."[40] This provision seemed to play a role in the court's decision on the Section 145(c) issue and on whether the Derbyshires had achieved success through a dismissal without prejudice. A burden-shifting bylaw makes mandatory advancement and indemnification even *more* mandatory, if such a thing were possible.[41] Corporations should be aware of this issue before any claims for advancement or indemnification arise, because they will certainly be aware of it afterward.■

[39] *Zaman*, 2008 WL 2168397, at *13.

[40] *Id.* at *16.

[41] *See generally* John Mark Zeberkiewicz & Blake Rohrbacher, *No Surprises: The Mandatory Nature of Mandatory Advancement and Indemnification*, Corp. Governance Advisor, Nov./Dec. 2007, at 21.