DIRECTORS' AND OFFICERS' LIABILITY

ADVANCEMENT OF LEGAL EXPENSES

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When directors and officers are sued, advancement by the corporation of attorneys' fees and related expenses associated with civil and regulatory proceedings may be essential in order to mount a meaningful defense. The Delaware Court of Chancery's recent decision in *Tafeen v. Homestore, Inc.*[1] draws needed attention to the competing interests of corporations in (a) offering liberal indemnification rights to encourage able executives to serve, while (b) seeking to preserve the ability to deny advancement payments the board believes are against the interests of the corporation. Chancellor Chandler's decision is notable for its rebuke to corporations "[c]ontent to adopt advancement and indemnification bylaws drafted with holes large enough to drive a truck through and which suddenly 'find religion'" and insist on a rigorous interpretation of loosely written bylaws. The decision also addresses an important interpretive issue regarding the effect of section 402 of the Sarbanes-Oxley Act, which prohibits public companies from extending credit in the form of personal loans to directors or executive officers, on the advancement of legal expenses.

Delaware's Statutory Indemnification/Advancement Scheme

Corporate indemnification serves two objectives: securing competent directors and officers and encouraging them to resist claims perceived to be meritless. Together with D&O insurance and DGCL § 102(b)(7) (authorizing a provision in the certificate of incorporation eliminating or limiting the liability of directors for damages for non-intentional, non-bad faith breaches of duty), corporate indemnification is a cornerstone of the effort to reduce the risk of personal liability arising out of board conduct.

Section 145 of the DGCL sets forth Delaware's statutory basis for indemnification and advancement, and may be briefly summarized. As in New York, the Delaware statute distinguishes between indemnification for third-party actions and derivative actions. As to non-derivative actions, § 145(a) permits (but does not require) a corporation to indemnify directors and officers made or threatened to be made a party to an action for attorneys' fees actually and necessarily incurred, as well as judgments or amounts paid in settlement in civil, criminal, administrative or investigative proceedings. The indemnitee must have acted in good faith and for a purpose that he or she reasonably believed to be in the corporation's best interests. The statute expressly provides that the termination of a case by judgment or

settlement does not, by itself, create a presumption that the standard of conduct has not been satisfied.

The statutory authorization for indemnification in derivative actions is narrower. In the derivative context, the corporation may indemnify directors and officers only for "expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action."[2] The statute does not authorize reimbursement of settlements paid or judgments in derivative actions.[3] The distinction reflects that in a derivative action the director or officer has allegedly breached a duty to the corporation, while in a third party suit, the director or officer presumably acted in the best interests of the corporation when he purportedly damaged a third party, making it reasonable to expect broad corporate reimbursement. Section 145(g), however, authorizes corporations to purchase insurance covering such non-indemnifiable amounts. The same standard of conduct applies for reimbursement in derivative lawsuits as in third-party actions. Indemnification (including legal fees) becomes mandatory when the director or officer "has been successful on the merits or otherwise in defense" of any proceeding described in §145.[4]

"Advancement" is payment by the corporation during the pendency of a proceeding of expenses (principally attorneys' fees) that would be indemnifiable at the conclusion of the proceeding. The statute authorizes a corporation to advance attorneys' fees and other expenses to directors and officers upon receipt of an undertaking by or on behalf of the indemnitee to repay such amount if it is ultimately determined that indemnification is not appropriate. The undertaking to repay does not have to be secured. Although Delaware law does not require corporations to advance legal expenses, many corporations include mandatory advancement provisions in the corporate bylaws.

Indemnification is never self-executing; a decisionmaker always must determine whether the proposed indemnitee acted in an indemnifiable capacity and meets the applicable standard of conduct. Section 145(d) provides that the determinations may be made by (a) a majority vote of directors who are not parties to the pertinent proceeding, even if less than a quorum; (b) by a committee of such non-defendant directors designated by majority vote of such directors, even if less than a quorum, or (c) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, or (d) by the stockholders.

***Tafeen* Decision**

Tafeen illustrates the enforcement of advancement rights under section 145 of the DGCL. Homestore's announcement that it would restate significantly its earnings for several quarters sparked a host of criminal and regulatory investigations and civil litigation, including actions by its D&O insurers to rescind D&O policies. Tafeen is a former officer of Homestore and his alleged conduct has drawn civil, regulatory and criminal investigatory attention. He requested advancement of legal fees and expenses incurred in connection with these maters under Homestore's bylaws, which mandated (i) indemnification "to the fullest extent permitted by"

Delaware law; and (ii) advancement of attorneys' fees upon receipt of an undertaking to repay amounts advanced if it should be determined ultimately that indemnification is not appropriate. Tafeen signed a form undertaking furnished by Homestore but received no funds. He sued, and Homestore sought summary judgment on diverse grounds addressed by Chancellor Chandler.

Emphasizing that indemnification and advancement are available only if the proposed indemnitee is sued "by reason of the fact" that he was an officer, Homestore argued that allegations in the underlying suits suggesting that Tafeen was sued because of "personal greed" barred indemnification. The court rejected the argument as an inappropriate invitation to adjudicate the merits of the underlying suits. Joining a solid line of case law interpreting the "by reason of" requirement of §145 broadly and in favor of indemnification, the court stated that the requirement only ensures that a nexus exists between the underlying proceeding and the officer's corporate function or capacity; the officer's motivation is irrelevant to the inquiry. Vice Chancellor Noble recently applied a similar interpretation in *Scharf v. Edgcomb Corp.*,[5] ruling than an SEC investigation into a director's alleged involvement in an insider trading scheme arose "by reason of" board service because any nonpublic information acquired by the director was obtained by reason of his board service. It bears emphasis that the "by reason of" requirement is not meaningless. For example, claims brought by a corporation against an officer for excessive compensation or breaches of a non-competition agreement would be classic employer-employee disputes not brought "by reason of" the director's position at the corporation.

Homestore's conduct-based argument that Tafeen should not receive advancement because the proof in the underlying proceeding will ultimately preclude indemnification fared no better. Noting that Delaware law views the rights to indemnification and advancement as "'correlative but nonetheless independent and discrete entitlements,'" the court held that Tafeen was entitled to advancement "even if [his] repayment of advanced expenses may ultimately turn on a right to indemnification."[6]

The court also considered a "novel" equitable defense to advancement asserted by Homestore based on its concern that Tafeen had undertaken to shelter his assets by purchasing an expensive home in Florida (a state with protective homestead laws against creditor claims), which would render hollow his undertaking to repay any advanced funds upon a determination that he was not entitled to indemnification. The court ruled that if Homestore's allegation is proved at trial, the doctrine of unclean hands could be invoked to override the policies favoring advancement and permit the corporation to withhold payment of legal expenses. Whether Tafeen sheltered assets with the intent to frustrate a potential reimbursement of amounts advanced presented a factual question for trial. The court emphasized that directors and officers are "now on notice that they will not be permitted to use the [indemnification] statute itself after taking improper actions at the expense of the corporation's stockholders."

The court also addressed an important interpretive issue under section 402 of the Sarbanes-Oxley Act, which prohibits public companies from extending credit in the form of a personal loan to directors or executive officers. The breadth and ambiguity of the statutory language employed has engendered concern that, notwithstanding the historic state law regulation of advancement, the prohibition might be interpreted to extend beyond the specific problems targeted (*e.g.*, executives receiving personal loans to purchase securities or other property that did not benefit the corporation or its shareholders) to bar advancement of legal expenses. Chancellor Chandler declined to address what effect, if any, section 402 has on advancement to current directors and officers, but ruled that the plain statutory language "clearly" applies to any "'director or executive officer,' *not* 'current or former director or officer.' Not only is this clear and unambiguous, it leads to a perfectly logical conclusion."

Noting that the purpose of Section 402 is to prohibit loans to corporate decision makers, the court observed that "[o]nce a director or officer steps down from her position, becoming a former director or officer, the ability to control corporate decision making is diminished considerably. Though not completely eliminated, Congress did not see former officers and directors as sufficient threats to specifically address in Sarbox." The court buttressed its conclusion by reference to the Securities Exchange Act's definition of "executive officer," which employs the present tense to describe the functions performed by certain officers for a registrant.

Chancellor Chandler pointedly rejected Homestore's argument that providing advancement to Tafeen would cause it severe financial hardship. Homestore could have lessened its credit risk, he wrote, "simply by drafting its bylaws differently." Moreover, advancement would be less of an inducement for board service "if the company could simply avoid its advancement obligation when times are difficult." The remedy for Delaware corporations that wish to avoid hardship occasioned by advancement requests is prospective, *i.e.*, through drafting tougher requirements than the "strikingly lax" minimum requirements of §145. For example, the bylaws could require secured undertakings, permissive advancement, board oversight of the litigation process and other measures narrowing the availability of advancement. Finally, Chancellor Chandler admonished that "[g]iven the high incidence of advancement proceedings, directors should be mindful of their fiduciary duties to stockholders, and the possibility of stockholder action, when reviewing and adopting advancement and indemnification bylaws. In my view, the fact that § 145 is a broad, enabling statute does not confer license to adopt loosely written bylaws that impose excessive credit risks on a company and its stockholders."

[1] 2004 WL 556733 (Del. Ch. Mar. 22, 2004).

[2] 8 Del. C. § 145(b).

[3] *TLC Beatrice Intern. Holdings, Inc. v. CIGNA Ins. Co.*, 1999 WL 33454 (S.D.N.Y. 1999).

[4] 8 Del. C. § 145(c).

[5] 2004 WL 718923 (Del. Ch. Mar. 24, 2004).

[6] *Tafeen*, 2004 WL 556733, at *6.