

CHAPTER 5

Indemnification of Directors and Officers

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§ 5.01 Indemnification Basics

[1]—The Concept of Indemnification

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 cost of defending their honesty and integrity.”¹ Indemnification serves the purpose of inducing capable men and women to serve as corporate directors, secure in the knowledge that expenses incurred by them in the course of their corporate duties will be borne by the corporation.²

¹ VonFeldt v. Stifel Financial Corp., 714 A.2d 79, 84 (Del. 1998) (en banc). See also:

New York: Schmidt v. Magnetic Head Corp., 468 N.Y.S.2d 649, 656 (N.Y. App. Div. 1983) (“all [statutory indemnification schemes] were enacted to induce capable and responsible businessmen to accept positions in corporate management”).

² See, e.g.:

Third Circuit: Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 898 (3d Cir. 1953) (holding that the “purpose of statutes such as Delaware’s [indemnification provision] is to encourage capable men to serve as corporate directors, secure in the

[2]—Historical Background

[a]—Common Law Theories

Prior to the enactment of indemnification statutes, common law principles of the law of trusts and the law of agency were advanced for determining the liability of directors. Under the law of trusts, generally if a trustee is not at fault he or she can be indemnified from the assets of the trust.³ Under agency law, a master (the corporation) may be liable under the doctrine of *respondent superior* for the acts of the servant (the director) within the scope of his or her duties.⁴

[b]—Statutory Development

Before World War II, indemnification statutes did not exist and the matter was governed exclusively by common law.⁵ For example, Delaware's first general corporation law, enacted in 1899, made no provision for the indemnification of corporate directors and officers.⁶

knowledge that expenses incurred by them . . . will be borne by the corporation they serve.”).

State Courts:

Delaware: Mayer v. Executive Telecard, Ltd., 705 A.2d 220, 222 (Del. Ch. 1997); Merritt-Chapman & Scott Corp. v. Wolfson, 264 A.2d 358, 360 (Del. Super. 1970) (noting that “indemnification statutes were enacted in Delaware, and elsewhere, to induce capable and responsible businessmen to accept positions in corporate management.”).

³ See, e.g., Jessup v. Smith, 223 N.Y. 203, 207, 119 N.E. 403, 404 (N.Y. 1918) (“[a] trustee who pays his own money for services beneficial to the trust has a lien for reimbursement. But if he is unable or unwilling to incur liability himself, the law does not leave him helpless. In such circumstances, he has the power, if other funds fail, to create a charge [on the trust assets], equivalent to his own lien for reimbursement, in favor of another by whom the services are rendered.”).

⁴ See, e.g.

Third Circuit: Du Puy v. Crucible Steel Co., 288 F. 583, 585 (W.D. Pa. 1923) (noting, in the context of a director's indemnification, that “[w]henver an agent is called upon by his principal to do an act which is not manifestly illegal and which he does not know to be wrong, the law implies a promise on the part of the principal to indemnify the agent for such losses as flow directly and immediately from the very execution of the agency.”).

State Courts:

Minnesota: Hoch v. Duluth Brewing & Malting Co., 173 Minn. 375, 375-376, 217 N.W. 503, 503 (Minn. 1928).

See also *Restatement (Second) of Agency* § 439 (1957).

⁵ See VonFeldt v. Stifel Financial Corp., 714 A.2d 79, 84 (Del. 1998).

⁶ See *id.*

In the 1940's, however, a codification movement gained momentum as state legislatures sought to clarify “what had become an intolerable common-law [sic] muddle.”⁷ In 1941, New York became the first state to enact a statute providing for the indemnification of corporate directors and officers.⁸ Delaware quickly followed in 1943.⁹ The Delaware provision has been used as a template for many state corporation indemnification statutes and is similar to that of the Model Act.¹⁰

[3]—Distinguishing Indemnification from Insurance

Indemnification and insurance are distinguishable in a number of respects, although they both can provide protection from loss. In essence, indemnification is a shifting of financial responsibility from the indemnified director, officer, employee or agent to the company. Insurance, on the other hand, is a shifting of risk to a third party, an insurance company, which expects to make a profit from accepting this risk because it anticipates that premiums will exceed loss payouts. Insurance generally does not cover known, pre-existing problems. Indemnification often expressly covers known, historical events.

⁷ See *id.* See also *New York Dock Co. v. McCollom*, 173 Misc. 106, 109, 16 N.Y.S.2d 844, 847 (N.Y. Sup. 1939) (noting that pre-statute indemnification “seems to be a rule of guidance rather than a rule of law. Whether or not it is to be applied in a particular case seems to rest in the sound discretion of the court in view of all surrounding facts and circumstances.”).

⁸ See *Schmidt v. Magnetic Head Corp.*, 468 N.Y.S.2d 649, 656 (N.Y. App. Div. 1983).

⁹ 8 Del. Code Ann. § 145. See *VonFeldt v. Stifel Financial Corp.*, 714 A.2d 79, 84 (Del. 1998) (en banc).

¹⁰ See *Waltuch v. Conticommunity Services, Inc.*, 88 F.3d 87, 97 (2d Cir. 1996).

§ 5.02 Statutory Indemnification

[1]—Governing Law

[a]—State of Incorporation

Generally, indemnification of directors and officers is governed by the law of the state of incorporation.¹

[b]—Impact of Mergers and Reorganizations

In a merger, the surviving corporation succeeds by operation of law to the assets and liabilities of the merged or dissolved corporation.² If the merged or dissolved corporation's certificate of incorporation or bylaws provide for indemnification, the merger agreement may require that the surviving corporation have comparable provisions in its organic documents and that it agree to not amend those provisions and to indemnify the former directors and officers of the merged or dissolved corporation. A different issue arises when the merging corporations are incorporated in different jurisdictions, including cases in which a company reincorporates in another state pursuant to a merger. Some indemnification statutes limit indemnification of directors and officers of the merged or dissolved corporation to so much as the merged or dissolved corporation could have indemnified its directors and officers had its separate existence continued.³ This limitation is designed to prevent forum shopping by directors and officers of known claims.

¹ See, e.g., *Edgar v. MITE Corp.*, 457 U.S. 624, 645, 102 S.Ct. 2629, 2642, 73 L.Ed.2d 269 (1982) (noting that “only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.”).

But see:

State Statutes:

California: Cal. Corp. Code § 2115 (California law applies to corporations substantially owned by California shareholders or conducting business in California).

New York: N.Y. Bus. Corp. L. § 725 (f) (New York indemnification provisions apply to foreign corporations doing business in New York).

² See, e.g., 8 Del. Code Ann. § 259.

³ See, e.g., 8 Del. Code Ann. § 145(h).

[2]—Scope of Coverage

[a]—Who May Claim Protection

[i]—Directors, Officers, Employees and Agents

Indemnification statutes typically cover any person who is or was a party to a pending or threatened action, suit or proceeding by reason of the fact that the person is or was a director, officer, employee or agent of the corporation.⁴ Whether an individual is subject to a proceeding “by reason of” the fact that he or she is or was a director, officer, employee or agent is not always entirely clear and “[s]urprisingly, there is little guidance in this area from the Delaware courts.”⁵ However, both the language and the purpose of such statutes—to encourage capable individuals to serve and 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”—support an expansive interpretation.⁶

⁴ See generally 8 Del. Code Ann. § 145. See also:

California: Cal. Corp. Code § 317(d) (an agent is entitled under § 317(c) to mandatory indemnification if he or she is successful on the merits); *First Interstate Bank of Arizona, N.A. v. Murphy, Weir & Butler*, 210 F.3d 983, 989-90 (9th Cir. 2000).

Delaware: 8 Del. Code Ann. § 145 (a), (b) (unlike present and former directors and officers, however, employees and agents are not entitled under § 145(c) to mandatory indemnification if they are successful on the merits or otherwise). For a discussion of “agents” in the context of statutory indemnification, see *Cochran v. Stifel Financial Corp.*, No. CIV.A. 17350, 2000 WL 286722 at *16-20 (Del. Ch. Mar. 8, 2000).

Illinois: Ill. Bus. Corp. Act § 5/8.75(a), (b), and (c) (employees and agents are entitled under § 518.75(c) of the Illinois statute to mandatory indemnification if they are successful on the merits or otherwise).

New York: N.Y. Bus. Corp. L. § 723(a) (a *person* who is successful is entitled to mandatory indemnification) (emphasis added).

⁵ See *Grove v. Daniel Valve Co.*, 874 S.W.2d 150, 152 (Tex. App. 1994). See also *Heffernan v. Pacific Dunlop GNB Corp.*, 965 F.2d 369, 372 (7th Cir. 1992) (applying Delaware law).

⁶ See *Heffernan*, N. 5 *supra* (reversing summary judgment against former director in his suit seeking to establish his rights to indemnification and advances with respect to action against him alleging failure to disclose corporation’s environmental and other liabilities when he sold his stock therein—although the former director had sold his own stock and had also been a shareholder and an investment banker, the court could not, as a matter of law, rule out the possibility that his status as a former director

[ii]—Directors, Officers, Employees and Agents of Affiliated Entities

Indemnification statutes also typically authorize (and require in the case of directors and officers who are successful on the merits or otherwise) indemnification of persons who serve at the request of the corporation as directors, officers, employees or agents of other entities, including, but not limited to, subsidiaries and joint ventures.⁷

[b]—What Matters Trigger Coverage as an “Action, Suit or Proceeding”

In addition to court proceedings, pending and threatened grand jury investigations, internal corporate investigations and SEC investigations are covered by indemnification statutes.⁸

might have been one reason why he was sued).

See also *Hibbert v. Hollywood Park, Inc.* 457 A.2d 339 (Del. 1983) (plaintiffs entitled to indemnification for legal fees and related costs incurred with respects to suits filed by them in their unsuccessful bid for reelection to defendant's board); *Shearin v. The E.F. Hutton Group, Inc.*, 652 A.2d 578 (Del. Ch. 1994) (recognizing that such statutes encompass indemnification claims deriving from lawsuits brought by directors, officers, agents, etc., insofar as such suits were brought as part of the individual's duties to the corporation and its shareholders, but finding that the case at bar could not be considered a manifestation of the plaintiff's corporate responsibilities).

For additional discussion of the “by reason of” requirement, see:

Third Circuit: *Witco Corp. v. Beekhuis*, 38 F.3d 682 (3rd Cir. 1994).

State Courts:

Delaware: *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. Super. 1974); *Cochran v. Stifel Financial Corp.*, 2000 WL 286722 (Del. Ch. Mar. 8, 2000); *Cochran v. Stifel Financial Corp.*, 2000 WL 1847676 (Del. Ch. Dec. 13, 2000).

⁷ See, e.g.:

California: Cal. Corp. Code § 317(a) (for the purposes of indemnification under California law, “agent” includes a person who was serving “at the request” of the corporation).

Delaware: 8 Del. Code Ann. § 145(a), (b). For a discussion of the “at the request” requirement, see *VonFeldt v. Stifel*, 714 A.2d 79 (Del. Super. 1998); *Cochran v. Stifel Financial Corp.*, No. CIV.A. 17350, 2000 WL 286722 (Del. Ch. Mar 8, 2000).

Illinois: Illinois Bus. Corp. Act. § 58.75 (a), (b).

New York: N.Y. Bus. Corp. L. § 722 (a). See also *Sequa Corp. v. Gelmin*, 828 F. Supp. 203, 207 (S.D.N.Y.1993).

⁸ See, e.g., *Stewart v. Continental Copper & Steel Industries, Inc.*, 67 A.D.2d 293, 301, 414 N.Y.S.2d 910, 915-916 (N.Y. App. Div. 1979) (former officers of Delaware corporation entitled to mandatory indemnification under § 145(c) of the Delaware corporation law in connection with appearance before grand jury). See also 8 Del. Code Ann. § 145(a) (corporation is empowered to indemnify in connection with a pending or threatened action, suit or proceeding “whether civil, criminal,

Because indemnification statutes typically cover any person who “is or was a party” to an action, suit or proceeding, directors and officers may be indemnified when they are plaintiffs as well as defendants if the action, suit or proceeding relates to the person’s duties to the corporation and its shareholders and is not brought to advance the individual’s own interests.⁹ Indemnification statutes usually limit mandatory indemnification and advancement of expenses, however, to the *defense* of an action, suit or proceeding.¹⁰ Although indemnification of plaintiffs and advancement of their expenses is permissive under certain statutory provisions, several corporations have (perhaps inadvertently) become obligated—through the adoption of bylaw provisions and/or indemnification agreements that provide for mandatory indemnification either by tracking the statute and substituting “shall” for “may,” or by requiring indemnification “to the full extent permitted by applicable law”—to indemnify, and advance the expenses of, directors and officers who sue the corporation.

[c]—What Expenses Are Covered

Generally, a director or officer may seek indemnification for, at a minimum, expenses and attorneys’ fees resulting from litigation in which they are involved as a result of their corporate duties.¹¹ In some circumstances, directors and officers may also seek reimbursement for judgments, fines and settlement costs resulting from litigation arising out of their corporate responsibilities.¹² Whether particular expenses are covered depends on the nature of the action. For example, Delaware law draws a distinction between third party actions and

administrative or investigative”).

⁹ See, e.g., *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 344 (Del. 1983); *Shearin v. The E.F. Hutton Group, Inc.*, 652 A.2d 578, 594 (Del. Ch. 1994).

¹⁰ See, e.g., 8 Del. Code Ann. § 145(c), (e). See also § 5.02[3], [4][a] *infra*.

¹¹ See, e.g.,

California: Cal. Corp. Code § 317.

Delaware: 8 Del. Code Ann. § 145.

Illinois: Ill. Bus. Corp. Act § 5/8.75.

New York: N.Y. Bus. Corp. L. §§ 722, 723.

¹² See, e.g.,

California: Cal. Corp. Code § 317(b).

Delaware: 8 Del. Code Ann. § 145(a).

Illinois: Ill. Bus. Corp. Act § 5/8.75(a).

New York: N.Y. Bus. Corp. L. § 722(a), (c).

actions by or in the right of the corporation.¹³ Delaware permits directors and officers to be indemnified for amounts paid pursuant to judgments or settlements, as well as attorneys' fees and other expenses, in the case of third party suits.¹⁴ However, in the case of actions brought "by or in the right of the corporation," which includes both derivative suits and suits brought by the corporation itself, Delaware permits indemnification only for attorneys' fees and expenses, and does not authorize indemnification of judgments or amounts paid in settlement.¹⁵ Further, except for limited circumstances, Delaware does not permit indemnification of any kind with respect to any action in which the director or officer seeking indemnification was found liable to the corporation.¹⁶

Unlike Delaware, New York allows indemnification of settlements in direct or derivative actions brought by the corporation.¹⁷ New York law permits indemnification of settlement payments and reasonable litigation expenses, but does not authorize indemnification of judgments and fines in such actions;¹⁸ indemnification of judgments and fines, as well as settlement payments and reasonable litigation expenses, is permitted in the case of third party actions.¹⁹

A director or officer is entitled to indemnification only for costs and expenses that are reasonable.²⁰ Whether attorneys' fees are reasonable in the context of indemnification depends on (1) the time and labor required, the difficulty of the questions involved, and the skill required

¹³ See *Cochran v. Stifel Financial Corp.*, No. CIV. A. 17350, 2000 WL 286722, at *11 (Del. Ch. March 8, 2000).

¹⁴ 8 Del. Code Ann. §145 (a). See also *Cochran v. Stifel Financial Corp.*, No. CIV. A. 17350, 2000 WL 286722, at *11 (Del. Ch. March 8, 2000).

¹⁵ 8 Del. Code Ann. § 145(b). However, the rule barring indemnification of judgments in actions by a corporation does not apply to actions by a wholly-owned subsidiary of the corporation. See *Cochran v. Stifel Financial Corp.*, No. CIV. A. 17350, 2000 WL 286722, at *11 (Del. Ch. March 8, 2000).

¹⁶ 8 Del. Code Ann. § 145(b). See also *Yiannatsis v. Stephanis*, 653 A.2d 275, 280-281 (Del. 1995) (holding that a corporate director was not entitled to indemnification of attorneys' fees under 8 Del. Code Ann. § 145(b) where the director was found to have breached her duty of loyalty to the corporation by usurping a corporate opportunity).

¹⁷ N.Y. Bus. Corp. § 722(c); see also *Biondi v. Beekman Hill House Apartment Corp.*, 709 N.Y.S.2d 861, 863-864 (N.Y. 2000).

¹⁸ See *Biondi v. Beekman Hill House Apartment Corp.*, 709 N.Y.S.2d at 863-864.

¹⁹ See *id.*

²⁰ See, e.g., *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 823-824 (Del. 1992).

to perform the legal service; (2) the likelihood that a retainer will preclude other employment by the attorney; (3) the fee customarily charged in the community for similar services; (4) the amount involved in the litigation and the results obtained; (5) the time limits imposed by the litigation; (6) the nature and length of the professional relationship with the client; (7) the experience, reputation and ability of the attorney; and (8) whether the fee is fixed or contingent.²¹

In some cases, indemnity for “defense expenses” may include costs incurred by a director or officer in advancing counterclaims as well as in resisting the claims advanced against him or her.²²

In addition, overruling a number of prior cases, and running contrary to the predominant rule that generally a director or officer may seek indemnification only for fees and expenses incurred in defending the underlying action,²³ the Delaware Supreme Court held in *Stifel Financial Corp. v. Cochran*²⁴ that under Delaware law²⁵ a director or officer is entitled to indemnification for those fees and expenses incurred in successfully prosecuting the indemnification action itself.

The indemnification provision at issue in *Stifel* provided for mandatory indemnification of litigation expenses “to the fullest extent permitted by Delaware law.” Previously in Delaware, in order for a director to be entitled to the recovery of fees incurred in an

²¹ See *Galdi v. Berg*, 359 F. Supp. 698, 700 (D. Del. 1973).

²² See, e.g., *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 824 (Del. 1992) (construing an undertaking by a corporation to indemnify “costs incurred in defending any action” to include costs incurred in maintaining counterclaims in federal court, because Fed. R. Civ. Proc. 13 required that all counterclaims arising from the same transaction be asserted or be thereafter barred).

²³ See, e.g.:

Second Circuit: *In re Health Management Systems, Inc. Securities Litigation*, 82 F. Supp.2d 227, 230 (S.D.N.Y. 2000).

State Courts:

Delaware: *Mayer v. Executive Telecard*, 705 A.2d 220, 221-223 (Del. Ch. 1997).

New York: *Baker v. Health Management Systems, Inc.*, 772 N.E.2d 1099, 1104 (N.Y. 2002).

But see:

Delaware: *Chamison v. Healthtrust, Inc.*, 735 A.2d 912, 926-927 (Del. Ch. 1999) (allowing recovery of “fees on fees” where the former director’s suit to recover indemnification was necessitated by the corporation’s “unreasonable refusal to acknowledge its contractual obligation to indemnify”).

²⁴ *Stifel Financial Corp. v. Cochran*, No. 548-49, 2002 Del. LEXIS 393, at *18-19 (Del. June 13, 2002).

²⁵ 8 Del. Code Ann. § 145.

indemnification action, the corporation had to expressly so provide in its bylaws or in separate indemnification agreements.^{25.1}

The decision in *Stifel* was grounded primarily in the court's view that encouraging qualified individuals to serve as directors is a desirable policy goal. The court recognized that allowing broad indemnification rights is consistent with the reality that the corporation itself is responsible for putting the director through the litigation. The court also commented that allowing fees on fees prevents corporations from using their "deep pockets" to make litigation prohibitively expensive for directors. The court further found that precluding fees on fees would result in incomplete indemnification and would be contrary to the purpose of Delaware's indemnification statute,^{25.2} which is to protect directors from personal liability for corporate expenses.^{25.3}

Despite the award of fees for fees in *Stifel*, corporations "remain free to tailor their indemnification bylaws to exclude fees on fees if that is a desirable goal."^{25.4} For example, an effective strategy might be to limit indemnification to actions in which the indemnified party is a defendant. The implication is that Delaware courts will enforce indemnification provisions as they are written. In light of *Stifel*, corporations should revisit their indemnification provisions to clarify the extent of liability they are willing to assume should a director pursue an indemnification action.

In addition, the California Corporation Code expressly provides for the recovery of attorneys' fees and expenses incurred in establishing an indemnity claim.²⁶

[3]—Advancement of Costs

Indemnification statutes and corporate bylaws and agreements usually provide for the advancement of attorneys' fees and other legal expenses to directors and officers in connection with the defense of civil, criminal or investigative actions, suits or proceedings arising out of their corporate duties.²⁷ The right to receive these advances is not

^{25.1} Mayer v. Executive Telecard, 705 A.2d 220, 221-223 (Del. Ch. 1997). But see Chamison v. Healthtrust, Inc., 735 A.2d 912, 926-927 (Del. Ch. 1999).

^{25.2} 8 Del. Code Ann. § 145.

^{25.3} *Stifel*, N. 24 *supra*, 2002 Del. LEXIS 393, at *16, 18.

^{25.4} *Id.*, 2002 Del. LEXIS 393 at *19

²⁶ Cal. Corp. Code § 317(a), (d).

²⁷ See, e.g.:

conditioned on the merits of the underlying action.²⁸ Thus a director or officer may be entitled to the advancement from the corporation of his or her legal fees even if wrongdoing against the corporation is alleged.²⁹

On the other hand, corporate bylaws may deny advancement of costs in connection with suits *by* the director or officer against the corporation.³⁰

The advancement of legal expenses typically is conditioned upon receipt of an undertaking by the director seeking indemnification to repay the advance if it is determined that he or she is not entitled to be indemnified by the corporation.³¹ The director is not required to secure the “undertaking to repay” or demonstrate financial ability to repay the corporation.³² However, if it ultimately is determined that the director is not entitled to indemnification, he or she will be required to repay the expenses advanced by the corporation.³³ In this regard, it should be noted that one state Attorney General reportedly has sought

California: Cal. Corp. Code § 317(f).

Delaware: 8 Del. Code Ann. § 145 (e).

Illinois: Ill. Bus. Corp. Act § 5/8.75(e).

New York: N.Y. Bus. Corp. L. § 724(c) (advancement is allowed if the person seeking indemnification has raised a genuine issue of fact or law).

²⁸ See, e.g., *Ridder v. CityFed Financial Corp.*, 47 F.3d 85, 87 (3d Cir. 1995).

But see N.Y. Bus. Corp. L. § 724(c) (requiring the person seeking advancement to demonstrate the existence of a genuine issue of fact or law).

²⁹ See, e.g., *U.S. v. Weissman*, No. S2 94 CR 760 CSH, 1997 WL 539774 (S.D.N.Y. Aug. 28, 1997); *Sierra Rutile, Ltd. v. Katz*, No. 90 Civ. 4913, 1997 WL 431119 at * 1 (S.D.N.Y. July 31, 1997) (holding that a court may order a corporation to advance litigation expenses notwithstanding the corporation’s allegations that the director or officer engaged in wrongdoing against the corporation).

³⁰ See *Gentile v. SinglePoint Financial, Inc.* 788 A.2d 111 (Del. 2001) (director not entitled to advancement of costs under by-laws for actions in which director was plaintiff).

³¹ See, e.g.,

California: Cal. Corp. Code § 317(f).

Delaware: 8 Del. Code Ann. § 145(e). See also *Advanced Mining Systems, Inc. v. Fricke*, 623 A.2d 82, 84 (Del. Ch. 1992).

New York: N.Y. Bus. Corp. L. § 723(c).

³² See *Havens v. Attar*, C.A. No. 15134, 1997 WL 55957 at *13 (Del. Ch. Jan. 30, 1997).

³³ See, e.g.:

Delaware: 8 Del. Code Ann. § 145(e). See also *Advanced Mining Systems, Inc. v. Fricke*, 623 A.2d 82, 84 (Del. Ch. 1992).

New York: N.Y. Bus. Corp. L. § 725(a). See also *Sierra Rutile v. Katz*, 1997 WL 431119 at * 1 (S.D.N.Y. July 31, 1997).

to *prevent* advancement of expenses on the ground that the directors and officers in question may not have the ability to repay if found guilty of fraud.³⁴

[4]—Types of Indemnification

[a]—Mandatory Indemnification

Indemnification statutes typically categorize the entitlement to indemnification as either “permissive” or “mandatory.”³⁵ “Permissive” indemnification provisions afford a corporation the power, but do not impose a duty, to indemnify its directors and officers. Implementation of the permissive authority requires action by the board of directors, who have discretion to decide on a case-by-case basis whether to grant indemnification absent a governing provision in the articles of incorporation or bylaws or an agreement with the director or officer in question.³⁶

Mandatory indemnification provisions, on the other hand require the corporation to indemnify the director or officer.³⁷ Typically, when a director or officer demonstrates “success on the merits,” a mandatory indemnification provision provides him or her with a judicially enforceable right to indemnification.³⁸ As noted above, some (but not all) states extend mandatory indemnification beyond directors and

³⁴ Glater, “Oregon Asks Court to Block Legal Aid to Enron,” *The New York Times*, Feb. 25, 2002, at A19.

³⁵ See, e.g.:

California: Cal. Corp. Code §§ 317(c) (permissive), (d) (mandatory).

Delaware: 8 Del. Code Ann. §§ 145(b) (permissive), (c) (mandatory).

Illinois: Ill. Bus. Corp. Act §§ 5/8.75(b) (permissive), (c) (mandatory).

New York: N.Y. Bus. Corp. L. §§ 722 (permissive), 723 (mandatory).

³⁶ See *Advanced Mining Systems, Inc. v. Fricke*, 623 A.2d 82, 83 (Del. Ch. 1992).

³⁷ See, e.g.:

Delaware: 8 Del. Code Ann. § 145(c) (a director is entitled to mandatory indemnification if he or she has been “successful, on the merits or otherwise”).

California: Cal. Corp. Code § 317(d) (providing for mandatory indemnification only if the director or officer has “succeeded on the merits”).

Illinois: Ill. Bus. Corp. Act. § 5/8.75(c) (providing for mandatory indemnification if the director or officer has been “successful, on the merits or otherwise”).

New York: N.Y. Bus. Corp. L. § 723(a) (providing for mandatory indemnification if the director or officer has been “successful, on the merits or otherwise”).

³⁸ See N. 37 *supra*. See also *Dunlap v. Sunbeam Corp.*, No. CIV. A 17048, 1999 WL 1261339 at * 5 (Del. Ch. July 9, 1999).

officers to employees and agents.³⁹

Indemnification statutes typically allow corporations to grant indemnification rights beyond those provided by the statute.⁴⁰ Many corporations have, via charter provision, bylaw and/or agreement, extended indemnification coverage and provide for mandatory indemnification in circumstances in which indemnification would otherwise be only permissive.⁴¹ Courts generally construe contractual language providing that a corporation “shall” indemnify its directors and officers to provide mandatory indemnification.⁴²

³⁹ See generally 8 Del. Code Ann. § 145. See also:

California: Cal. Corp. Code § 317(d) (an agent is entitled under § 317(c) to mandatory indemnification if he or she is successful on the merits); *First Interstate Bank of Arizona, N.A. v. Murphy, Weir & Butler*, 210 F.3d 983, 989-90 (9th Cir. 2000).

Delaware: 8 Del. Code Ann. § 145 (a), (b) (unlike present and former directors and officers, however, employees and agents are not entitled under § 145(c) to mandatory indemnification if they are successful on the merits or otherwise). For a discussion of “agents” in the context of statutory indemnification, see *Cochran v. Stifel Financial Corp.*, No. CIV.A. 17350, 2000 WL 286722 at *16-20 (Del. Ch. Mar. 8, 2000).

Illinois: Ill. Bus. Corp. Act § 5/8.75(a), (b), and (c) (employees and agents are entitled under § 518.75(c) of the Illinois statute to mandatory indemnification if they are successful on the merits or otherwise).

New York: N.Y. Bus. Corp. L. § 723(a) (a *person* who is successful is entitled to mandatory indemnification) (emphasis added).

⁴⁰ See, e.g.:

California: Cal. Corp. Code § 317(g) (requiring that any additional rights to indemnification be authorized in articles of the corporation).

Delaware: 8 Del. Code Ann. § 145(f).

Illinois: Ill. Bus. Corp. Act § 5/8.75(f).

New York: N.Y. Bus. Corp. L. § 721 (requiring that any additional rights of indemnification be contained in or authorized by the certificate of incorporation or bylaws). See also *Biondi v. Beekman Hill House Apt. Corp.*, 709 N.Y.S.2d 861, 864 (N.Y. 2000) (noting that in 1986, the New York legislature amended § 721 to expand indemnification to include any additional rights conferred by a corporation in its certificate of incorporation or bylaws).

⁴¹ See *VonFeldt v. Stifel Financial Corp.*, 714 A.2d 79, 81, n. 5 (Del. 1998) (noting that “virtually all” public corporations have extended indemnification agreements via bylaw to cases in which statutory indemnification is typically only permissive); *Advanced Mining Systems, Inc. v. Fricke*, 623 A.2d 82, 83 (Del. Ch. 1992).

⁴² See, e.g.:

Second Circuit: *Cambridge Fund v. Abella*, 501 F. Supp. 598, 616-617 (S.D.N.Y. 1980) (noting that use of the word “shall” in an indemnity agreement evinced an intent to render the indemnification mandatory).

State Courts:

[b]—Permissive Indemnification

When a director or officer is not “successful on the merits or otherwise” and consequently not entitled to mandatory indemnification, indemnification under statutory provisions is permissive and will be subject to a determination as described below.⁴³

[i]—Third Party Actions

Delaware law permits indemnification of directors and officers for judgments, fines and amounts paid in settlement, as well as attorneys’ fees and other expenses, incurred in third party actions.⁴⁴ In the absence of a statutory or non-statutory provision mandating or prohibiting such indemnification, a determination of whether the corporation will indemnify the director or officer must be made on a case-by-case basis by disinterested directors, independent legal counsel, or by the stockholders.⁴⁵

Under New York law, the decision whether to indemnify a director or officer if no statutory or non-statutory provision mandates or prohibits it must be made by “the board acting by a quorum consisting of directors who are not parties to such action or proceeding” If a quorum is not obtainable, or if a quorum of disinterested directors so directs, the decision must be made by “the board upon the opinion in writing of independent legal counsel that indemnification is proper in the circumstances” or by the shareholders.⁴⁶ In New York, “independent legal counsel” is defined as “an attorney who is free from past connection with the corporation or the persons to be

Delaware: Citadel Holding Corp. v. Roven, 603 A.2d 818, 823 (Del. 1992) (noting that the use of the word “shall” in an indemnity agreement renders indemnification mandatory); VonFeldt v. Stifel Financial Corp., No. Civ. A. 15688, 1999 WL 413393 at *3 (Del. Ch. June 11, 1999) (holding that use of the phrase “shall indemnify” in a corporate bylaw not only mandates indemnification, but also places the burden on the corporation to demonstrate that indemnification is not required). Cf. Gentile v. Singlepoint Financial, Inc., 788 A.2d 111 (Del. 2001) (bylaw provision mandating advancement of expenses only for an “Indemnitee who . . . was or is threatened to be made a named defendant or respondent in a Proceeding” did not require advancement to a director whose involvement was as a plaintiff).

⁴³ See Advanced Mining Systems, Inc. v. Fricke, 623 A.2d 82, 83 (Del. Ch. 1992).

⁴⁴ 8 Del. Code Ann. § 145(a). See also VonFeldt v. Stifel Financial Corp., No. Civ. A. 15688, 1999 WL 413393 at * 2 (Del. Ch. June 11, 1999).

⁴⁵ See 8 Del. Code Ann. § 145(d).

⁴⁶ See N.Y. Bus. Corp. L. § 723(b). See also Schmidt v. Magnetic Head Corp., 468 N.Y.S.2d 649, 655 (N.Y. App. Div. 1983).

indemnified.”⁴⁷

The determination that must be made is whether the director or officer seeking indemnification acted in “good faith” and in a manner he or she “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” that his or her “conduct was unlawful.”⁴⁸ The good faith requirement is central to the policy behind corporate indemnification statutes because it “would not make sense for a corporation to have the power to indemnify agents who do not act in its best interests.”⁴⁹

[ii]—*Derivative Actions or Actions by the Corporation*

Indemnification statutes typically provide for indemnification in actions brought by or in the right of the corporation.⁵⁰ As in third party actions, disinterested directors or the stockholders⁵¹ must decide whether the director or officer seeking indemnification acted in “good faith” and in a manner he or she reasonably believed to be in the best interests of the corporation.⁵²

⁴⁷ Schmidt v. Magnetic Head Corp., 468 N.Y.S.2d 649, 657 (N.Y. App. Div. 1983).

⁴⁸ See, e.g.:

California: Cal. Corp. Code § 317(b) (the lower “or not opposed to” standard is not included in the California statute).

Delaware: 8 Del. Code Ann. § 145(a). See also VonFeldt v. Stifel Financial Corp., No. Civ. A. 15688, 1999 WL 413393 at * 2 (Del. Ch. June 11, 1999).

Illinois: Ill. Bus. Corp. Act § 5/8.75(a).

New York: N.Y. Bus. Corp. L. § 722(a) (the lower “or not opposed to” standard in New York applies only to service for other entities, such as subsidiaries). See also Schmidt v. Magnetic Head Corp., 468 N.Y.S.2d 649, 655 (N.Y. App. Div. 1983).

⁴⁹ VonFeldt v. Stifel Financial Corp., No. Civ. A. 15688, 1999 WL 413393 at * 2 (Del. Ch. June 11, 1999).

⁵⁰ See, e.g.,

California: Cal. Corp. Code § 317(c).

Delaware: 8 Del. Code Ann. § 145(b).

Illinois: Ill. Bus. Corp. Act § 5/8.75(b).

New York: N.Y. Bus. Corp. L. § 722(c).

⁵¹ See, e.g.,

California: Cal. Corp. Code § 317(e).

Delaware: 8 Del. Code Ann. § 145(d).

Illinois: Ill. Bus. Corp. Act § 5/8.75(d).

New York: N.Y. Bus. Corp. L. § 723 (b).

⁵² See, e.g.,

California: Cal. Corp. Code § 317(c).

Under Delaware law, a principal difference between indemnification in third party actions and indemnification in actions brought by or on behalf of the corporation is that in the latter case indemnification “in respect of any claim, issue or matter as to which such person shall have been adjudged liable to the corporation” is not permitted. Further, while in third party actions indemnification for judgments, fines, and settlements is permitted, indemnification in actions brought by or on behalf of the corporation is limited to expenses and attorneys’ fees.⁵³

New York, on the other hand, permits indemnification with respect to “judgments, fines, amounts paid in settlement and reasonable expenses, including attorneys’ fees” if the director or officer acted in good faith in both third party actions and actions brought by or on behalf of the corporation.⁵⁴

[5]—Requirements for Obtaining Relief

[a]—Success on the Merits or Otherwise

In general, state statutes mandate indemnification only when a director or officer has been successful on the merits “or otherwise.”⁵⁵

Delaware: 8 Del. Code Ann. § 145(b).

Illinois: Ill. Bus. Corp. Act § 5/8.75(b).

New York: N.Y. Bus. Corp. L. § 722(a).

⁵³ 8 Del. Code Ann. § 145(b). See also *Cochran v. Stifel Financial Corp.*, No. CIV. A. 17350, 2000 WL 286722, at *11 (Del. Ch. March 8, 2000).

⁵⁴ N.Y. Bus. Corp. § 722(a).

⁵⁵ See, e.g.,

Delaware: 8 Del. Code Ann. 145(c).

Illinois: Ill. Bus. Corp. Act § 58.75(c).

New York: N.Y. Bus. Corp. L. § 723(a).

But see:

California: Cal. Corp. Code § 317(d) (providing for mandatory indemnification if the director or officer has been successful on the merits or “in defense of any claim, issue, or matter”). See also *American National Bank & Trust Co. v. Schigur*, 83 Cal. App.3d 790, 793-794, 148 Cal. Rptr. 116, 117-118 (Cal. App. 1978) (holding that “[t]he language in the Model Business Corporations Act, from which [Cal. Corp. Code § 317] subdivision (d) was derived, provided for mandatory indemnification to the extent of success “on the merits or otherwise.” The expression “or otherwise” does not appear in the California enactment; from this omission we infer a legislative intent that mandatory indemnification should depend upon a judicial determination of the actual merits of the agent’s defense just as permissive indemnification depends upon a determination by the corporation, as provided in [Cal. Corp. Code § 317] subdivision (e), that the agent’s acts met the statutory standards.”).

When a director or officer wins the underlying action on the merits, the effect of a statute providing for mandatory indemnification is clear. In such circumstances, it does not matter whether the corporation's board votes to disapprove indemnification: the statute provides the director with a judicially enforceable right to indemnification.⁵⁶

What is less clear is the right to indemnification when a director or officer achieves something less than a total victory on the merits. Delaware law permits mandatory indemnification when a director succeeds on the merits "or otherwise."⁵⁷ Accordingly, Delaware law mandates indemnification when a director succeeds on the basis of a "technical defense," such as one based on a statute of limitations.⁵⁸

If a favorable judgment is appealed, the defendant is not successful on the merits until a favorable and final ruling.⁵⁹ However, a post-dismissal dispute concerning a settlement agreement does not render the settlement "unsuccessful."⁶⁰

Since most claims against directors and officers are settled,⁶¹ whether a settlement constitutes a "success on the merits" may be critical. A settlement that results in the dismissal of the case with prejudice and without liability on the part of the defendant has been held to be a success under statutory language identical to the Delaware provision in question.⁶² A dismissal without prejudice, however, does

⁵⁶ See *Dunlap v. Sunbeam Corp.*, No. CIV. A 17048, 1999 WL 1261339 at * 5 (Del. Ch. July 9, 1999).

⁵⁷ 8 Del. Code Ann. § 145(c).

⁵⁸ See *Galdi v. Berg*, 359 F. Supp. 698, 701-702 (D. Del. 1973).

⁵⁹ See *Haelen v. Epstein*, 450 N.Y.S.2d 536, 537 (N.Y. App. Div. 1982).

⁶⁰ See *Mayer v. Executive Telecard, Inc.*, 1997 WL 16669 at * 3 (S.D.N.Y. January 17, 1997).

⁶¹ See *Gagliardi v. Trifoods International, Inc.*, 683 A.2d 1049, 1054 (Del. Ch. 1996) (noting that "very, very few" directors and officers liability suits reach trial).

⁶² See, e.g.:

Second Circuit: *Waltuch v. Conticommodity Services, Inc.*, 88 F.3d 87, 96 (2d Cir. 1996); *Wiesner v. Air Express International Corp.*, 583 F.2d 579 (2d Cir. 1978) (applying Illinois law).

Third Circuit: *B & B Investment Club v. Kleinert's, Inc.*, 472 F. Supp. 787 (E.D. Pa. 1979) (applying Pennsylvania law).

Ninth Circuit: *Safeway Stores, Inc. v. National Union Fire Insurance Co.*, 64 F.3d 1282, 1290 n. 24 (9th Cir. 1995).

But cf.:

State Courts:

California: *American National Bank & Trust Co. v. Schigur*, 83 Cal. App.3d 790,

not constitute a “success on the merits” triggering mandatory indemnification.⁶³

Delaware law also mandates indemnification when a director is partially successful on the merits.⁶⁴ For example, a director was entitled to mandatory indemnification under Delaware law regarding a criminal action in which the director successfully defended three counts, even though he failed to defend the fourth count.⁶⁵

Unlike Delaware, the Model Act requires the director to be “wholly successful” and rejects mandatory indemnification for partially successful litigants.⁶⁶

[b]—Good Faith

Permissive indemnification typically is authorized only when the director or officer seeking indemnification acted in “good faith” and in a manner he reasonably believed to be in the best interests of the corporation.⁶⁷ The good faith requirement is central to the policy behind corporate indemnification statutes because it “would not make

793-794, 148 Cal. Rptr. 116, 117-118 (Cal. App. 1978) (holding that “[t]he language in the Model Business Corporations Act, from which [Cal. Corp. Code § 317] subdivision (d) was derived, provided for mandatory indemnification to the extent of success “on the merits or otherwise.” The expression “or otherwise” does not appear in the California enactment; from this omission we infer a legislative intent that mandatory indemnification should depend upon a judicial determination of the actual merits of the agent’s defense just as permissive indemnification depends upon a determination by the corporation, as provided in [Cal. Corp. Code § 317] subdivision (e), that the agent’s acts met the statutory standards.”).

⁶³ See, e.g., *Galdi v. Berg*, 359 F. Supp. 698, 702 (D. Del. 1973) (noting that a director must be vindicated by a decision on the merits or by a dismissal with prejudice on technical grounds). But see *Waltuch v. Conticommodity Services, Inc.*, 88 F.3d 87, 96 (2d Cir. 1996) (finding a director successful on the merits even though the corporation paid a settlement on the director’s behalf).

⁶⁴ See 8 Del. Code Ann. § 145(c).

⁶⁵ See *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 141 (Del. Super. 1974) (holding that “in a criminal action, any result other than a conviction must be considered a success”).

⁶⁶ See, e.g., *Model Business Corporations Act* § 8.51.

⁶⁷ See, e.g.: *Sixth Circuit: Owens Corning v. National Union Fire Insurance Co.*, 257 F.3d 484, 494 (6th Cir. 2001).

State Courts:

California: Cal. Corp. Code § 317(b).

Delaware: 8 Del. Code Ann. § 145(a), (b). See also *VonFeldt v. Stifel Financial Corp.*, No. Civ. A. 15688, 1999 WL 413393 at * 2 (Del. Ch. June 11, 1999).

Illinois: Ill. Bus. Corp. Act § 5/8.75 (a), (b).

New York: N.Y. Bus. Corp. L. § 722(a).

sense for a corporation to have the power to indemnify agents who do not act in its best interests.”⁶⁸

Unlike permissive indemnification, however, mandatory indemnification provisions generally have no good faith requirement. Rather, a director who demonstrates “success on the merits” is entitled to indemnification under such provisions without a separate determination as to good faith.⁶⁹

[6]—Nonexclusivity

Indemnification statutes typically allow corporations to grant indemnification rights beyond those provided by the statute (that is, the statutes are “nonexclusive”).⁷⁰ In fact, many corporations have, via charter provision, bylaw and/or agreement, expanded indemnification coverage and provide for mandatory indemnification in circumstances under which indemnification would otherwise be only permissive (that is, when the director or officer has not demonstrated success on the merits).⁷¹ Courts, moreover, generally construe contractual language providing that a corporation “shall” indemnify its directors and officers as providing mandatory indemnification.⁷² When a

⁶⁸ See *VonFeldt v. Stifel Financial Corp.*, No. Civ. A. 15688, 1999 WL 413393 at * 2 (Del. Ch. June 11, 1999).

⁶⁹ See *Green v. Westcap*, 492 A.2d 260 (Del. Super. 1985)

⁷⁰ See, e.g.:

California: Cal. Corp. Code § 317(g).

Delaware: 8 Del. Code Ann. § 145(f).

Illinois: Ill. Bus. Corp. Act § 5/8.75(f).

New York: N.Y. Bus. Corp. L. § 721. See also *Biondi v. Beekman Hill House Apt. Corp.*, 709 N.Y.S.2d 861, 864 (N.Y. 2000) (noting that in 1986, the New York legislature amended Section 721 to expand indemnification to include any additional rights conferred by a corporation in its certificate of incorporation or by-laws).

⁷¹ See *VonFeldt v. Stifel Financial Corp.*, 714 A.2d 79, 81, n. 5 (Del. 1998) (noting that “virtually all” public corporations have extended indemnification agreements via by-law to cases where indemnification is typically only permissive); *Advanced Mining Systems, Inc. v. Fricke*, 623 A.2d 82, 83 (Del. Ch. 1992).

⁷² See, e.g.:

Second Circuit: *Cambridge Fund v. Abella*, 501 F. Supp. 598, 617 (S.D.N.Y. 1980) (noting that use of the word “shall” in an indemnity agreement evinced an intent to render the indemnification mandatory).

State Courts:

Delaware: *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 823 (Del. 1992) (noting that the use of the word “shall” in a indemnity agreement renders indemnification mandatory); *VonFeldt v. Stifel Financial Corp.*, No. Civ. A. 15688, 1999 WL 413393 at *3 (Del. Ch. June 11, 1999) (holding that use of the phrase “shall indemnify” in a

corporation adopts a charter provision or bylaw or enters into an agreement that expands indemnification to provide mandatory indemnification in circumstances that otherwise would only permit it, the director seeking indemnification must demonstrate “good faith.”⁷³

[7]—Authorization for Insurance Coverage

Indemnification statutes usually also specifically authorize corporations to purchase and maintain insurance on behalf of directors, officers, employees and agents “whether or not the corporation would have the power to indemnify” such persons against liabilities under the statute.⁷⁴

corporate bylaw not only mandates indemnification, it places the burden on the corporation to demonstrate that indemnification is not required).

⁷³ See, e.g.:

Delaware: VonFeldt v. Stifel Financial Corp., No. Civ. A. 15688, 1999 WL 413393 at *2 (Del. Ch. June 11, 1999).

New York: Biondi v. Beekman Hill House Apt. Corp., 709 N.Y.S.2d 861, 864 (N.Y. 2000) (noting that N.Y. Bus. Corp. L. § 721 allows corporations to expand indemnification to include additional rights provided that “no indemnification may be made to or on behalf of any director or officer if . . . his acts were committed in bad faith”).

⁷⁴ See, e.g.:

California: Cal. Corp. Code § 317(i).

Delaware: 8 Del. Code Ann. § 145(g).

Illinois: Ill. Bus. Corp. Act § 5/8.75(g).

New York: N.Y. Bus. Corp. L. § 726 (imposing limitations and conditions on insurance).