

Recent Delaware Case Law Regarding Fiduciary Duties to
Creditors, Advancement and Indemnification and Deal
Protection Devices

Elizabeth M. McGeever

Prickett, Jones & Elliott, P.A.

Ms. McGeever is a director at Prickett, Jones & Elliott, P.A. in
Wilmington, Delaware.

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1. Introduction.

Each year Delaware Courts issue many opinions that affect corporations around the world. This past year was no exception. This paper reviews several recent cases that provide insight on how lawyers can effectively counsel Delaware corporations and their managers in the areas of fiduciary duties to creditors, indemnification and advancement, deal protection devices in merger agreements, and derivative actions.

At the outset, however, we want to call your attention to *Sample v. Morgan*,¹ where the Court of Chancery held that a non-Delaware lawyer and his law firm were subject to jurisdiction in Delaware based on their involvement in counseling a Delaware corporation. In *Sample*, an Ohio lawyer advised top management officials of Randall Bearings, Inc. to take the following steps to effectuate an alleged entrenchment plan: 1) amend the certificate of incorporation to change the par value of shares from \$1.00 to \$.001;² 2) create an Equity Incentive Plan and advise the board to distribute 200,000 shares to top management;³ 3) help ensure that a 30% block of shares held by the recently deceased CEO ended up in hands favorable to top management;⁴ and 4) engage the services of a corporate service company in Delaware to accomplish the filing of the certificate amendment.⁵

Under Delaware law, to assert personal jurisdiction over a non-resident defendant, there must first be a statutory basis to serve the defendant with process. If a statutory basis for service exists, the court must then determine whether the exercise of jurisdiction over the defendant comports with the Due Process Clause of the Fourteenth Amendment of the United States Constitution.⁶ In this case, the lawyer and his law firm were served pursuant to 10 *Del. C.* § 3104(c)(1), transacting business within the state, and 10 *Del. C.* § (c)(3), causing tortious injury within the state.⁷ The court concluded that the filing of the certificate amendment with the Delaware

Secretary of State's office easily satisfied both statutory bases. "[T]he filing of a corporate instrument in Delaware that facilitated the transactions under challenge in litigation in this court has been repeatedly recognized as sufficient to constitute the transaction of business under 10 *Del. C.* § 3104(c)(1)."⁸ Moreover, the filing of the certificate amendment also satisfied the tortious injury requirement in Section 3104(c)(3) because the action injured a Delaware corporation.⁹ The court also found that exercising jurisdiction over the lawyer and the law firm comported with due process. The lawyer and law firm advertise that the firm regularly advises public corporations in matters of corporate law. In addition, as an experienced practitioner of corporate law, the lawyer knew that claims for breach of fiduciary duty arising from the activities he helped the board accomplish would be litigated in Delaware.¹⁰ Therefore, the lawyer should have "reasonably anticipated . . . that his . . . actions might result in the forum state exercising personal jurisdiction over him in order to adjudicate disputes arising from those actions."¹¹

2. Fiduciary Duties to Creditors.

In 2007, the Delaware Supreme Court answered many questions surrounding fiduciary duties to creditors. It is well-settled that directors of solvent corporations owe duties to its shareholders. When a corporation becomes insolvent, those duties shift to the corporation's creditors. Therefore, creditors have standing to bring *derivative* claims against insolvent corporations. In *N. Am. Catholic Educ. Programming Found. v. Gheewalla*,¹² the Delaware Supreme Court held that a creditor of a corporation operating within the zone of insolvency can not bring a *direct* claim against its directors for breach of fiduciary duty.

In *Gheewalla*, the plaintiff, North American Catholic Educational Programming Foundation ("NACEPF"), owned a significant number of radio wave spectrum licenses.¹³ In 2001, NACEPF formed an alliance with other radio wave

spectrum license holders and contracted with Clearwire to have Clearwire acquire certain licenses from the alliance when the licenses became available. In all, Clearwire was obligated to pay the alliance over \$24 million.¹⁴ In 2002, the market for these licenses collapsed, forcing Clearwire out of business in late 2003. NACEPF, in its capacity as a creditor, brought a direct action against two directors of Clearwire who served at the behest of Goldman Sachs & Co., claiming, among other things, that the two directors breached their fiduciary duties by "(1) not preserving the assets of Clearwire for its benefit and that of its creditors when it became apparent that Clearwire would need to be liquidated and (2) holding on to NACEPF's . . . license rights when Clearwire would not use them, solely to keep Goldman Sachs's investment 'in play.'"¹⁵

The defendants moved to dismiss on two related grounds - lack of personal jurisdiction under Court of Chancery Rule 12(b)(2) and failure to state a claim under Court of Chancery Rule 12(b)(6). Plaintiffs premised jurisdiction over the defendants on 10 *Del. C.* § 3114, which provides jurisdiction over directors in cases alleging a violation of fiduciary duty.¹⁶ Thus, to assert jurisdiction over the defendants, the court needed to find, as a matter of law, that a creditor can bring a direct claim for breach of fiduciary duty. If it could not, there would be no basis to assert jurisdiction over the defendants. The Court of Chancery held that NACEPF could not bring a direct action against Clearwire's directors.

The Supreme Court affirmed the Court of Chancery's dismissal. It agreed that "creditors' existing protections - [including] their negotiated agreements, their security instruments, the implied covenant of good faith and fair dealing, fraudulent conveyance law, and bankruptcy - render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary."¹⁷ Recognizing the need to provide directors of

Delaware corporations with definitive guidance, the Supreme Court explained: "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."¹⁸ Likewise, the court made clear that creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against its directors.

Approximately three months after *NACEPF* was decided, the Supreme Court summarily affirmed the Court of Chancery's decision in *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*,¹⁹ which dismissed a creditor's claims for deepening insolvency. In *Trenwick*, the Court of Chancery provided additional definitive guidance to directors of financially troubled corporations: "If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success."²⁰

3. Indemnification and Advancement.

Indemnification and advancement claims continue to be litigated in Delaware. Three cases recently decided by the Court of Chancery illustrate the importance of carefully drafting instruments containing indemnification and advancement rights. Directors, officers and employees are entitled to advancement only if it is provided for in a clearly worded by-law or contract. Therefore, it is critical that drafters precisely define who and to what extent directors, officers and employees are entitled to advancement. In another case, the Court of Chancery restricted fees incurred in seeking indemnification to successful litigants.

In *Thompson v. The Williams Cos.*,²¹ the Court of Chancery rejected a former employee's claim that he was entitled to unconditional indemnification and advancement. The plaintiff, Thompson, a former, non-officer, non-director employee of Williams Power Company sought reimbursement of approximately \$500,000 in past legal fees and advancement of all future legal fees to defend conspiracy and fraud allegations related to his employment at the company's natural gas trading desk.²² Williams' advancement by-law provided that the company would advance expenses for "employees and agents . . . upon such terms and conditions, if any, as the Board of Directors deems appropriate."²³ Williams' indemnification by-law required the company to indemnify employees "if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the Company, and, with respect to any criminal action or proceeding, has no reasonable cause to believe the conduct was unlawful"²⁴ Williams did not believe that Thompson satisfied the conditions for advancement, but nonetheless offered to advance legal expenses incurred post-indictment upon Thompson's execution of a secured undertaking.²⁵ That undertaking required Thompson to represent to the Williams board that he acted at all times in good faith and did not believe his actions to be unlawful and required Thompson to provide adequate security to repay the amounts advanced if it was later determined that he was not entitled to advancement. Thompson refused to agree to those terms and conditions and sued Williams, claiming that the terms and conditions were unreasonable and violated the covenant of good faith and fair dealing.²⁶

By-laws providing advancement are contracts, and therefore, are interpreted like contracts.²⁷ The court summarily rejected Thompson's argument that because the by-law itself did not set forth the specific terms and conditions, he was entitled to complete advancement. The by-law expressly provided that the board could condition

advancement on terms it deemed appropriate. Thus, the court quickly turned to what it found to be the key question: whether the conditions set forth by the board were appropriate.²⁸ That question, the Vice Chancellor explained, turned on whether the conditions were rationally related to a proper corporate interest.²⁹ That standard was easily satisfied; securing repayment of funds is a legitimate corporate purpose. The fact that Thompson did not have the means to fully secure the funds did not make the conditions unreasonable.³⁰ The security condition “very much resembles the credit criteria of other lending institutions, which demand at least (and often more than) dollar-for-dollar security on mortgages and other loans”³¹ Likewise, the court rejected Thompson’s claim that the terms violated the covenant of good faith and fair dealing because the company provided other employees with more favorable terms. The court explained that it would “not read 14th Amendment-like protections against unequal treatment into discretionary advancement contracts governing the relationship of corporations and their executives.”³²

Whether terms and conditions to advancement are rationally related to a legitimate corporate interest is not an overly challenging standard to satisfy. As the court noted, arbitrary conditions, *i.e.*, conditions that are not rationally related to a legitimate corporate purpose, would include “a requirement that Thompson walk a tight-rope between skyscrapers” or “a demand that Thompson post security worth five times the amount advanced.”³³

The need for careful drafting of advancement by-laws is further illustrated in *Bernstein v. TractManager, Inc.*³⁴ In *Bernstein*, the court denied advancement to a former director and officer of TractManager, Inc. to defend claims arising from acts performed while he was a manager of TractManager, LLC, TractManager, Inc.'s predecessor entity.

Bernstein was a manager and co-founder of TractManager, LLC. TractManager, LLC's by-laws did not

provide for advancement. In 2003, TractManager, LLC was converted into TractManager, Inc., a Delaware corporation. TractManager, Inc.'s indemnification by-law provides: "Each person who was or is made a party . . . in any action . . . by reason of the fact that he or she is or was a director or an officer . . . shall be indemnified and held harmless by the corporation to the fullest extent authorized by the [DGCL] . . . against all expense, liability and loss . . . reasonably incurred or suffered by such indemnitee in connection therewith . . ." ³⁵ TractManager, Inc.'s advancement by-law provides: "In addition to the right to indemnification . . . , an indemnitee shall also have the right to be paid by the corporation the expenses (including attorneys fees) incurred in defending any such proceeding in advance of its final disposition . . ." ³⁶

Bernstein argued that TractManager, Inc.'s by-laws are broad enough to confer advancement rights to former managers of TractManager, LLC. ³⁷ "While the business of TractManager, LLC continued on in the corporate form following the 2003 conversion, there is no reason to infer that the directors who approved the new certificate of incorporation and by-laws intended to change, adjust, or expend any of the existing rights or duties governing TractManager, LLC." ³⁸ Further, because the authors of TractManager, Inc.'s bylaws "could have employed words granting the manager or officers of TractManager, LLC this right but did not . . . [the] court will not rewrite a contract by reading words into it that the parties clearly did not intend." ³⁹

The court also denied Bernstein advancement to defend claims arising from acts that occurred while Bernstein was an officer or director of TractManager, Inc. because there was no nexus or causal connection between any of the underlying proceedings and Bernstein's official capacity. Therefore, Bernstein was not being sued "by reason of the fact that Bernstein was a director or officer of the corporation" as required by TractManager, Inc.'s by-laws. ⁴⁰

Moreover, Bernstein did not qualify as an agent under the bylaws by serving as TractManager, Inc.'s attorney. "Otherwise, outside attorneys retained by corporations would be able to seek advancement whenever they are accused of malpractice so long as their employing corporations have adopted a maximal bylaw extending coverage to the limits of [8 *Del. C.*] § 145."⁴¹

In another advancement case, *Sassano v. CIBC World Markets Corp.*,⁴² the court held that a former employee was entitled to mandatory advancement under the company's by-laws. Sassano, a former employee of CIBC, sought advancement for five actions, all essentially alleging that he violated state and federal securities laws for helping certain clients of CIBC engage in "frequent trading and market timing of mutual funds."⁴³ The by-law at issue in *Sassano* was not as clear as the by-law at issue in *Thompson*. Instead, CIBC's by-laws provide for mandatory advancement to all "officers with management supervisory functions and directors."⁴⁴ There are two types of officers identified in CIBC's by-laws: executive officers appointed by the board of directors and nominal officers.⁴⁵ Nominal officers are defined as "[a]ll other employees of the corporation who have officer titles are, and shall be treated only as, departmental and divisional executives of the Corporation whose authority is limited and circumscribed to activities within their department or division and so designated by the President pursuant to Section 2 [of the by-laws]."⁴⁶ Sassano argued that he was a nominal officer who exercised supervisory functions, and therefore, was entitled to mandatory advancement.

Because by-laws are a contract among the shareholders of a corporation, "the rules that govern the interpretation of statutes, contracts, and other written instruments apply to the interpretation of corporate charters and by-laws."⁴⁷ Therefore, as it did in *Thompson* and *Bernstein*, the court employed standard principles of contract

interpretation to determine whether Sassano was a nominal officer with management supervisory functions as those terms were defined by the company's by-laws. The court ultimately concluded that Sassano met the definition and therefore, was entitled to mandatory advancement under CIBC's by-laws.

Thompson, Bernstein and Sassano serve as useful reminders to drafters of advancement and indemnification provisions that such provisions should be drafted with precision. The need for careful drafting is highlighted by the fact that Delaware's public policy favors advancement.⁴⁸ Creation of ambiguous provisions may result in providing for greater indemnification and advancement than the company envisioned.

In *Levy v. HLI Operating Co.*,⁴⁹ the Court of Chancery held that once a co-indemnitor reimburses an indemnitee, the indemnitee lacks standing to assert a claim for indemnification against other non-paying co-indemnitors. The co-indemnitor can, however, maintain a cause of action for equitable contribution against the non-paying co-indemnitors. The court also held in *Levy* that "a contract provision that mandates indemnification for fees on fees in *unsuccessful* litigation is invalid"⁵⁰

The plaintiffs in *Levy*, outside directors of HLI, sued HLI for indemnification of money they paid in connection with settling a securities fraud action. The directors, however, were fully indemnified for all out-of-pocket expenses by JLL Fund, a 34% shareholder who appointed the outside directors.⁵¹ The court rejected the outside directors claim for indemnification against HLI, holding that "[w]hen a purported indemnitee has all of his indemnifiable expenses paid in full and cannot show an out-of-pocket loss, he has no claim for indemnification under [8 *Del. C.* §] 145."⁵² If the indemnitee was indemnified by a co-indemnitor, however, the co-indemnitor may have a cause of action against remaining co-indemnitors for contribution.⁵³

The Court of Chancery also decided that, as a matter of law, agreements providing for "fees on fees" regardless of whether the indemnitee is successful obtaining indemnification are void.⁵⁴ "A party must succeed (at least to some extent) on its underlying indemnification action to have a legally cognizable claim for monies expended in forcing its indemnitor to make it whole."⁵⁵

4. Deal Protection Measures.

In the mergers and acquisitions area, the reasonableness of deal protection devices was litigated in several cases in 2007. The lesson to be gleaned from these cases is that there is no bright line rule when it comes to the appropriateness of any set of deal protection measures. Instead, the appropriateness of deal protection devices turns on a fact-intensive inquiry and will be viewed in the context of the specific deal. When challenging deal protection measures, the plaintiff bears the burden of "specifically demonstrating how a given set of deal protections operate in an unreasonable, preclusive, or coercive manner, under the standards of this Court's *Unocal* jurisprudence, to inequitably harm shareholders."⁵⁶

In *Louisiana Mun. Police Employees' Retirement Sys. v. Crawford*,⁵⁷ the Court of Chancery enjoined a vote of Caremark shareholders with respect to a merger between Caremark and CVS because the shareholders were not adequately informed of their right to seek appraisal and the structure of fees paid to Caremark's bankers. In doing so, the court discussed the appropriateness of certain deal protection measures in the merger agreement.

Crawford involved a no premium, "merger of equals" transaction between Caremark and CVS.⁵⁸ The plaintiffs in *Crawford* argued, among other things, that the Caremark directors breached their fiduciary duties by agreeing to a merger that contained the following deal protection devices: 1) a "force the vote" requirement on both boards; 2) a no

