

RECENT DELAWARE LAW DEVELOPMENTS IN ADVANCEMENT AND INDEMNIFICATION: AN ANALYTICAL GUIDE

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TABLE OF CONTENTS

INTRODUCTION	82
I. THE STATUTORY AND POLICY FRAMEWORK	84
II. THE RECENT CASE LAW.....	86
A. <i>Who Is Entitled to Advancement and Indemnification</i>	86
1. “By reason of the fact”	86
2. “Agent”	88
3. “At the request of”	89
B. <i>When An Indemnitee Is Entitled to Indemnification</i>	90
C. <i>Who Must Provide Advancement and Indemnification</i>	93
D. <i>What Types of Actions and Expenses Are Covered</i>	97
1. Counterclaims	97
2. Actions brought by the indemnitee as a plaintiff.....	107
3. When a right to “indemnification” also includes a right to “advancement”	110
4. Fees on fees	112
5. Elimination or impairment after the pertinent act or omission	113
E. <i>Which Standard of Review Applies to the Implementation of Advancement Rights</i>	115

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F. <i>Direct Warnings from the Delaware Courts on Advancement and Indemnification</i>	123
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INTRODUCTION

There has recently been a flurry of cases—along with some new statutory law—in Delaware concerning advancement and indemnification. In 2008 alone, the Delaware Court of Chancery issued 12 decisions addressing advancement and indemnification issues. In 2009, additional cases were issued *and* a new statutory provision became law. These developments address a broad range of issues—relating to who can receive advancement and indemnification, by whom, and under what circumstances—and offer guidance to all who are concerned with advancement and indemnification rights. This article provides a navigable guide, consisting of both summary and analysis, to these developments in Delaware law.¹

By way of background for the uninitiated reader, advancement and indemnification involve a corporation reimbursing its officials for costs resulting from litigation or other proceedings.² Indemnification is a final reimbursement that occurs after the underlying proceeding has concluded. Indemnification is statutorily permitted in certain circumstances and statutorily required in a subset of circumstances.³ Advancement is the payment of potentially indemnifiable expenses as they are incurred (i.e., in advance of the final disposition of the underlying proceeding).⁴ Advancement must be repaid to the corporation in certain circumstances.

For those wondering why one might want to understand the sometimes arcane details of Delaware law on advancement and indemnification, the answer is simple—the dollar

1. This article does not exhaustively address the fact-specific rulings of the recent cases that are unlikely to have broader application, but focuses instead on the aspects of the case law that should be of general interest.

2. For a broader understanding of the role of advancement and indemnification in Delaware law, readers may usefully consult A. Gilchrist Sparks, III et al., *Indemnification, Directors and Officers Liability Insurance and Limitations of Director Liability Pursuant to Statutory Authorization: The Legal Framework Under Delaware Law*, in PROXY CONTESTS, INSTITUTIONAL INVESTOR INITIATIVES, MANAGEMENT RESPONSES 1990, at 941 (PLI Corporate Law and Practice Course Handbook Ser. No. 696, 1990).

3. See DEL. CODE ANN. tit. 8, § 145(a)-(c) (2009).

4. See *id.* § 145(e).

amounts at stake can be staggering. For example, one of the cases discussed in this article involved Sun-Times Media Group, Inc.'s attempt to stop advancing expenses to some former officers—an advancement obligation that had resulted in the payment of more than \$119 million in legal fees to its former officers.⁵ The Sun-Times case is not the only example of the potentially staggering (and difficult to estimate) cost of advancement and indemnification obligations. In the recent KPMG case,⁶ the U.S. Attorney for the Southern District of New York refused to opine on the Court's question of what "a reasonable, privately-funded defense would cost in this case." The U.S. Attorney explained the difficulty in estimating these costs and cited several examples of the litigation expenses incurred in recent high-profile trials—\$70 million for the defense of Jeffrey Skilling in the Enron case; \$25 million for the defense of the Rigases in the Adelphia case; \$21 million for the defense of Richard Scrushy in the HealthSouth case; and \$26 million for the defense of Dennis Kozlowski in two Tyco trials.⁷ To be sure, not all advancement and indemnification cases involve high-profile, costly litigation. But the potential exists and knowledge of the recent developments in Delaware law on advancement and indemnification is important in understanding the contours of advancement and indemnification obligations.

Moreover it was, quite simply, an interesting year in the case law. Among other things, the cases reveal some possible divergences among judges and some areas of analytical uncertainty. They count among their number a case whose result was overturned by the Delaware General Assembly. And they address when outside lawyers representing a company may be entitled to advancement and indemnification.

5. Sun-Times Media Group, Inc., 2008 Annual Report (Form 10-K), at 99 (Apr. 14, 2009).

6. *See* United States v. Stein, 541 F.3d 130, 135 n.1 (2d Cir. 2008) (providing detail of the rulings in the KPMG case).

7. Letter from Michael J. Garcia, U.S. Attorney, S.D.N.Y., to Lewis A. Kaplan, U.S. Dist. J., S.D.N.Y. (June 9, 2007).

I.

THE STATUTORY AND POLICY FRAMEWORK

Section 145 of the Delaware General Corporation Law (the "DGCL") provides the statutory framework for advancement and indemnification rights, and is, of course, a relevant reference point for many of the 2008 cases. Sections 145(a) and (b) give corporations the power to indemnify certain persons against certain legal costs under particular circumstances. Each section provides, in pertinent part, that a "corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party [to legal actions] by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer employee or agent of another corporation"⁸ Section 145(e) empowers corporations to advance expenses to directors and officers.⁹ Section 145(f) provides that Section 145 is non-exclusive, permitting corporations to provide advancement and indemnification rights in bylaws and agreements.¹⁰ Additionally, Section

8. Section 145(a) applies to actions brought by third parties whereas Section 145(b) applies to actions brought "by or in the right of the corporation." Both subsections limit the power to indemnify to situations where the indemnitee "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." Section 145(b) adds the requirement that a person may only be indemnified in matters where the person has been adjudged liable to the corporation if the Court of Chancery or the court handling the underlying litigation determines that "such person is fairly and reasonably entitled to indemnity for such expenses." DEL. CODE ANN. tit. 8, § 145(a)-(b) (2009).

9. Section 145(e) states that: "Expenses (including attorneys' fees) incurred by an officer or director in defending any civil, criminal, administrative or investigative action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this section. Such expenses (including attorneys' fees) incurred by former directors and officers or other employees and agents may be so paid upon such terms and conditions, if any, as the corporation deems appropriate." Tit. 8, § 145(e).

10. Section 145(f) provides that: "The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or oth-

145(k) vests the Court of Chancery with “exclusive jurisdiction to hear and determine all actions for advancement of expenses or indemnification brought under [Section 145] or under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise.”¹¹

Section 145 and advancement and indemnification provisions are interpreted using not only the familiar principles of statutory and contractual interpretation but also by simultaneously applying the “patina of section 145’s policy.”¹² That “invariant policy . . . is 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.”¹³ A closely related policy goal is “encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity.”¹⁴ The resulting interpretive gloss is that Section 145 and advancement and indemnification provisions are “broadly interpreted” to further these underlying policy objectives.¹⁵

erwise, both as to action in such person’s official capacity and as to action in another capacity while holding such office.” Tit. 8, § 145(f).

11. Vice Chancellor Parsons held in *O’Brien v. IAC/Interactive Corp.*, No. 3892-VCP, 2009 Del. Ch. LEXIS 154 (Del. Ch. Aug. 14, 2009) that because Section 145(k) vests exclusive jurisdiction in the Court of Chancery—an equitable court—claims for indemnification may not be “subject to rigid application of a statute of limitations,” but rather may “more appropriately [be] examined under the doctrine of laches,” “especially where there are unusual or mitigating circumstances.” *Id.* at *22-24 & n.39. The Court did acknowledge, however, that in certain prior cases in the area of indemnification and advancement, the Delaware Supreme Court has applied the statute of limitations. *Id.* at *23.

12. *Reinhard & Kreinberg v. Dow Chem. Co.*, No. 3003-CC, 2008 Del. Ch. LEXIS 39, at *5-6 (Del. Ch. Mar. 28, 2008); *see also* *Sun-Times Media Group, Inc. v. Black*, 954 A.2d 380, 404 (Del. Ch. 2008).

13. *Dow*, 2008 Del. Ch. LEXIS 39, at *6 (quoting *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002)).

14. *Sun-Times*, 954 A.2d at 404 (quoting *Von Feldt v. Stifel Fin. Corp.*, 714 A.2d 79, 85 (Del. 1998)).

15. *Dow*, 2008 Del. Ch. LEXIS 39, at *6.

II. THE RECENT CASE LAW

A. *Who Is Entitled to Advancement and Indemnification*

As detailed above, Sections 145(a) and (b) establish general rules regarding whom a corporation may indemnify: that is, a person who has been made a party, or has been threatened to be made a party, to legal actions “by reason of the fact” that the person is or was a “director, officer, employee or agent of the corporation” or “is or was serving at the request of” the corporation, for another corporation in those capacities. Many corporations, of course, reproduce this statutory language when granting advancement and indemnification rights in their charters, bylaws, or agreements. The meaning of this language governing who may be entitled to indemnification and advancement, particularly the terms quoted above, was the subject of three cases in 2008.

1. “By reason of the fact”

In *Bernstein v. TractManager, Inc.*,¹⁶ the Court of Chancery addressed whether an officer and director who also provides legal services to a company and is sued in relation to those legal services is sued “by reason of the fact” that he is an officer and director. Bernstein was an officer and director of the defendant company, TractManager, and also had a separate legal practice at a law firm, through which he provided legal services to TractManager. TractManager brought an action against Bernstein for constructive trust, legal malpractice, and unjust enrichment relating to the legal advice Bernstein had provided to TractManager. Bernstein in turn sought advancement under TractManager’s bylaws¹⁷ of his legal costs in defending these claims. In determining whether TractManager was pursuing the claims against Bernstein “by reason of the fact” that he was a director and officer, the Court applied the Delaware law rule that “if there is a nexus or causal connection between any of the underlying proceedings . . . and one’s offi-

16. 953 A.2d 1003 (Del. Ch. 2007) (Lamb, V.C.).

17. The relevant language in TractManager’s bylaws granting advancement and indemnification rights closely tracked the language of Sections 145(a) and (b). Compare *id.* at 1006 n.3 with DEL. CODE ANN. tit. 8, § 145(a)-(b) (2009).

cial capacity, those proceedings are ‘by reason of the fact’ that one was a corporate officer [or director], without regard to one’s motivation for engaging in that conduct.”¹⁸ The Court determined that the requisite nexus did not exist where there were no allegations that Bernstein relied on information he obtained as a director or officer or on his “corporate powers” either to render legal advice or to compel TractManager to follow his legal advice.¹⁹

18. See *Bernstein*, 953 A.2d at 1011 (quoting *Homestore, Inc. v. Tafteen*, 888 A.2d 204, 215 (Del. 2005)). The Court of Chancery also reiterated this rule in 2008 in *Sassano v. CIBC World Markets Corp.*, 948 A.2d 453 (Del. Ch. 2008) (Lamb, V.C.). There, the defendant corporation, which was resisting an advancement claim by a former officer alleged to have violated securities laws, contended that the former officer was *not* sued “by reason of the fact of” his status as an officer, and therefore was not entitled to advancement, because the former officer “could have engaged in the conduct alleged in the SEC actions without his officer titles.” *Id.* at 469. The Court rejected this argument, pointing back to the rule that there must be a “nexus or causal connection between any of the underlying proceedings . . . and one’s official capacity” and finding that the connection existed in *Sassano*, where the conduct in question related to the former officer’s roles as an officer. *Id.* at 469-70.

19. The Court also rejected a separate argument by Bernstein that TractManager’s bylaws reached his conduct as a lawyer because they provided for indemnification for any director or officer sued by reason of the fact that he is an officer or director “whether the basis of such proceeding is alleged action in an official capacity . . . or any other capacity while serving as a director, officer, employee or agent . . .” *Bernstein*, 953 A.2d at 1012. The Court held that Bernstein’s capacious reading of “any other capacity” as encompassing his separate conduct as a lawyer would render the words “by reason of the fact” meaningless, as any officer or director could invoke those words to cover essentially any action taken while serving as an officer or director (including, according to the Court, a speeding ticket). *Id.* at 1013. Instead, the Court held that the words “any other capacity” are “better read as clarifying the term ‘proceeding by reason of the fact he or she is or was a director or an officer of the corporation’”—which “assures, for example, that a director receives advancement for defending a criminal action brought against him because of something he did as a director—even though such an action is brought against him as an individual . . .” *Id.*

2. "Agent"

In *Jackson Walker L.L.P. v. Spira Footwear, Inc.*,²⁰ *Zaman v. Amedeo Holdings, Inc.*,²¹ and *Bernstein*, the Court of Chancery elucidated the meaning of "agent," specifically in relation to when the term includes a company's outside counsel. All three cases involved application of the holding from the 2003 Court of Chancery case, *Fasciana v. Electronic Data Systems Corp.*,²² that Section 145 should be read "as embracing the more restrictive common law definition of agent, which generally applies only when a person (the agent) acts on behalf of another (the principal) in relations with third parties."²³

Jackson Walker held that when a law firm acts as outside litigation counsel for a company and is sued in connection with its representation of the company to outside parties, the law firm is the company's agent for purposes of the company's advancement bylaw.²⁴ In this case, the company brought an action against a law firm for negligence and breach of fiduciary duty in connection with the law firm's representation of the company to third parties, and the law firm sought advancement from the company for the costs of defending that action. In holding that the law firm was the company's agent, Vice Chancellor Parsons explained that "[t]rial lawyers have the ability to bind their client in dealings with the court and other parties to the litigation" and to "act as an arm of the corporation vis-à-vis the outside world."²⁵

In *Zaman*, a defendant corporation, seeking to fend off an advancement claim by two attorneys in an action by the corporation against the attorneys, argued that they were not the corporation's agents and were simply "outside legal advisors." The argument was contrary to the record in the case, which showed that the corporation and its controlling stockholder had hired the attorneys to perform "diverse managerial, financial, and

20. No. 3150-VCP, 2008 Del. Ch. LEXIS 82 (Del. Ch. June 23, 2008) (Parsons, V.C.).

21. No. 3115-VCS, 2008 Del. Ch. LEXIS 60 (Del. Ch. May 23, 2008) (Strine, V.C.).

22. 829 A.2d 160 (Del. Ch. 2003).

23. *Id.* at 163. In *Fasciana*, the Court of Chancery went on to hold that a lawyer performing corporate transactional work and internal legal advice did not come within that definition of "agent." *Id.* at 171-72.

24. *Jackson Walker*, 2008 Del. Ch. LEXIS 82, at *3.

25. *Id.* at *28 (internal citations omitted).

legal duties” for the corporation and its various subsidiaries, to the point that the attorneys sometimes acted as officers.²⁶ Consistent with the reality before him, Vice Chancellor Strine held, among other things, that the attorneys, who had acted well beyond any narrow role as legal advisors and “were empowered with broad managerial and financial authority,” were agents.²⁷

In *Bernstein*, Vice Chancellor Lamb followed the Court of Chancery’s holding in *Fasciana* that an attorney providing only internal advisory services is not an agent when the corporation sues the attorney for his performance of those services. Without additional analysis, the Court cited *Fasciana* in stating its holding.²⁸ *Jackson Walker*, however, provides some further color on the decision, characterizing *Bernstein* as holding that “a corporation’s attorney who provided advisory services was not an agent for purpose of advancement where the underlying litigation involved a claim of malpractice, among others.”²⁹

3. “At the request of”

In *Zaman*, various companies brought claims against attorneys who, as discussed above, had provided a wide array of managerial and financial services to the companies and their wholly owned subsidiaries. All of the entities were beneficially owned by one person—Jefri, colorfully, the younger brother of the Sultan of Brunei—who ran his corporate empire with a “disregard for corporate formalities.”³⁰ When the attorneys sought advancement in connection with claims relating to their service at the wholly-owned subsidiaries, the question arose whether the attorneys had served at the subsidiaries “at the request of” the parent companies. The issue was critical because some of the subsidiaries’ bylaws did not provide mandatory advancement and indemnification rights, whereas the bylaws of many of the parents did. The defendant companies argued that, in the absence of formal documentation requesting that the attorneys serve at the subsidiaries, the attorneys could not establish that they served the subsidiaries at the

26. *Zaman*, 2008 Del. Ch. LEXIS 60, at *2.

27. *Id.* at *50-51.

28. *Bernstein*, 953 A.2d at 1013.

29. *Jackson Walker*, 2008 Del. Ch. LEXIS 82, at *25 n.60.

30. *Zaman*, 2008 Del. Ch. LEXIS 60, at *56.

request of the parents. The Court rejected this “attempt to turn Jefri’s disregard for corporate formalities into a corporate asset that can be wielded against” the attorneys, instead reasoning that because Jefri exercised “complete dominion” over all of the entities, he was speaking for the parent companies in asking the attorneys to serve at the subsidiaries.³¹

The Court was also careful to note, however, the significance of chains of ownership in this analysis, explaining that wherever the attorneys served at a lower-tier subsidiary, “they were serving at the request of the subsidiaries *above them* in the chain of ownership flowing down from Jefri.”³² Similarly, where neither a subsidiary nor a parent provided mandatory advancement and indemnification rights, even if a sibling company did, the attorneys were not entitled to advancement and indemnification in connection with claims relating to the subsidiary.³³

B. *When An Indemnatee Is Entitled to Indemnification*

Section 145(c) mandates indemnification of a present or former director or officer who has been “successful on the merits or otherwise” in an indemnifiable proceeding.³⁴ One issue dealt with in the last year is whether an indemnatee is “successful” for purposes of Section 145(c) when a proceeding is dismissed without prejudice, such that the proceeding might be revived at a later date.

In *Zaman*, as noted above, Jefri and various companies he controlled brought a series of proceedings against the attorneys who provided services to Jefri’s business empire. The first proceeding was brought in the U.S. District Court for the Southern District of New York and asserted 26 counts against the attorneys (the “Federal Action”). The substance of the various counts was that the attorneys had enriched themselves at

31. *Id.* at *56, *62.

32. *Id.* at *61 (emphasis added).

33. *See id.* at *64.

34. Section 145(c) states: “To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys’ fees) actually and reasonably incurred by such person in connection therewith.” DEL. CODE ANN. tit. 8, § 145(c) (2009).

the expense of Jefri and his companies. The final count in the Federal Action, and the basis for federal jurisdiction, was a claim under the Racketeer Influenced and Corrupt Organizations Act³⁵ (the “RICO Count”). The RICO Count asserted that each of the allegedly improper acts by the attorneys was part of a “master scheme” to defraud Jefri and his companies. The attorneys moved to dismiss the RICO Count. The U.S. District Court found that no “enterprise” existed under the RICO Act, dismissed the RICO Count with prejudice, and dismissed the remaining claims without prejudice for lack of federal jurisdiction. The plaintiffs re-filed the bulk of the remaining claims in New York state court the day after the Federal Action was dismissed.

The attorneys sought indemnification for their expenses in defending the Federal Action under the “successful on the merits or otherwise” standard.³⁶ The companies countered that indemnification was premature because only the RICO Count was dismissed with prejudice and the essence of the other counts in the Federal Action was still being litigated in state court. Vice Chancellor Strine noted that the applicable indemnification provisions placed the burden on the companies to show that the attorneys were not entitled to the requested indemnification and decided that the companies failed to meet that burden. He cited two critical reasons for his decision: (1) the dismissal of the RICO Count was “a big deal”;³⁷ and (2) the Federal Action was over and there were no

35. 18 U.S.C. § 1962(c).

36. Although, as discussed above, the attorneys were “agents” at certain of the companies, Section 145(c)’s successful on the merits or otherwise standard was applied because the indemnification provisions in the companies’ bylaws obligated the companies to indemnify agents serving at their request at another company “to the fullest extent permitted by applicable law.” The Court reasoned that if Delaware law mandates indemnity for success by a director or officer, a company would not be prohibited by law from providing indemnity to a successful agent. Thus, the “to fullest extent permitted by applicable law” language in these indemnification provisions bound the companies to provide indemnification to agents meeting the Section 145(c) standard. *Zaman*, 2008 Del. Ch. LEXIS 60, at *49.

37. The Court observed that RICO Count was not only a very serious count but also that it was closely tied to the other allegations because it was “premised on the notion that each of the specific instances of alleged wrongdoing was in aid of an overall conspiracy among several legal persons comprising an illegal racketeering enterprise prohibited by RICO.” *Id.* at *69-70.

claims pending against the attorneys anywhere at the time of dismissal.³⁸ The absence of concurrent litigation at dismissal distinguished the case from precedent addressing the situation where similar claims were pending in two different forums and holding that the dismissal of one case so that the other case could proceed was not success for the purposes of Section 145(c).³⁹

In a broader sense, Vice Chancellor Strine reasoned that it was more efficient and consistent with the purpose of Section 145 to view the Federal Action as concluded and to determine whether the attorneys were successful notwithstanding the pending claims in state court. He observed that Section 145(c)'s successful on the merits or otherwise standard "grants indemnification to corporate officials even when they have not been adjudged innocent in some ethical or moral sense."⁴⁰ Moreover, Vice Chancellor Strine expressed practical concerns about delaying the Court's decision. Among other things, he questioned how long the attorneys would have to wait for indemnification on the RICO Count and whether delaying the decision regarding indemnification for the dismissed Federal Action would "create an incentive" for plaintiffs that owe advancement and indemnification obligations to potential defendants "to engage in questionable forum selection tactics, safe in the recognition that a loss that results in a dismissal on jurisdictional or forum non conveniens grounds will not result in a ripe claim for indemnification."⁴¹

The Court of Chancery revisited the issue of whether a dismissal without prejudice requires mandatory indemnification under Section 145(c) in *Stockman v. Heartland Industrial Partners, L.P.*,⁴² in which the Court applied inelegantly drafted indemnification language in a limited partnership agreement to a dismissal of criminal charges without prejudice. The Court considered the result under Section 145(c) in dicta and observed that the indemnitees would be entitled to mandatory indemnification under Section 145(c) as a result of the dismissal.

38. *Id.* at *70-71.

39. *Id.* at *71-72 (distinguishing *Galdi v. Berg*, 359 F. Supp. 698, 702 (D. Del. 1973)).

40. *Id.* at *72.

41. *Id.* at *74.

42. No. 4227-VCS, 2009 Del. Ch. LEXIS 131 (Del. Ch. July 14, 2009).

sal without prejudice. Vice Chancellor Strine explained that “two recent decisions of this court [*Zaman* and *Levy v. Hayes Lemmerz International, Inc.*]⁴³ support awarding indemnification after a dismissal without prejudice on the basis that indemnification decisions should be made on a case-by-case basis, especially where the governing bylaw or organizational document provides broad, mandatory indemnification rights.”⁴⁴ The Court’s conclusion was influenced strongly by the concern that requiring an indemnitee to wait for all the relevant statutes of limitations to expire before awarding mandatory indemnification would “eviscerat[e]. . . important indemnification rights.”⁴⁵

C. Who Must Provide Advancement and Indemnification

The issue of contribution among indemnitors also arose in 2008. Two questions were addressed: (a) who bears responsibility for actually advancing expenses to or indemnifying an individual when more than one entity agrees to provide advancement and indemnification to that individual, and (b)

43. No. 1395-N, 2006 Del. Ch. LEXIS 68 (Del. Ch. Apr. 5, 2006). In *Levy*, several outside directors of a company sought indemnification for the settlement of a class action alleging various statutory violations and breaches of fiduciary duty in connection with accounting irregularities. The company argued that the directors’ indemnification claim was not ripe because an SEC investigation was still pending. Although the SEC had not issued letters to the outside directors stating it planned to bring an enforcement action against them, the company contended that it needed to wait until the statute of limitations for bringing claims against the directors had run or risk violating its statutory and fiduciary duties with respect to determining whether the directors had met the “good faith” and in the “best interests” of the company requirements embodied in Section 145(a) & (d). Vice Chancellor Lamb recognized the company’s concerns but concluded that the company had the responsibility to make a decision regarding indemnification for the concluded class action. The Court viewed the indemnification language promising indemnification for any action, “whether civil, criminal, administrative, or investigative” as “impl[y]ing” that indemnification is to be treated on a case-by-case basis.” *Id.* at *34. The Court further explained that reading that “language to mean that in any case where multiple causes of action could be raised the indemnified party must wait for all relevant statutes of limitations to run, or for all other possible causes of action to be disposed of, is to eviscerate the important right of indemnification on which Delaware corporations rely to secure qualified people to serve on their boards.” *Id.* at *34-35.

44. *Stockman*, 2009 Del. Ch. LEXIS 131, at *43.

45. *Id.* at *46.

which party has standing to seek recourse against a co-indemnitor who fails to provide advancement or indemnification as promised?

The 2008 contribution cases built on the foundation previously laid by the Court of Chancery in *Levy v. HLI Operating Co.* in 2007.⁴⁶ In *Levy*, two entities—a corporation and an investment fund that had placed representatives on the corporation's board—separately contracted to indemnify the director representatives. After the directors became involved in legal proceedings, however, only the fund reimbursed the directors for expenses. The Court held that, in such a situation, the following landscape of rights results: first, once an indemnitee has been paid in full by one of the indemnitors and has no out-of-pocket losses, the indemnitee no longer has standing to seek reimbursement from the other indemnitors;⁴⁷ second, the indemnitor who provided indemnification may seek payment from the other indemnitors under the theory of contribution (which divides responsibility equally), but not subrogation (which permits full fee shifting).⁴⁸

In the 2008 case, *Schoon v. Troy Corp.*, the Court of Chancery was confronted with a different set of facts demonstrating when it *would* be logical for an indemnitee to have standing to sue a co-indemnitor in the indemnitee's own name.⁴⁹ In *Schoon*, one company (Steel Investment Company, or "Steel") was a major stockholder of another company (Troy Corpora-

46. 924 A.2d 210 (Del. Ch. 2007) (Lamb, V.C.).

47. *Id.* at 223. The premise for this holding was that Section 145 provides that a corporation may only grant indemnification for amounts "actually . . . incurred by the person" and once that person will no longer incur expenses, his or her claims fall away. *Id.* at 222-23.

48. *Id.* at 222-23. In reaching this holding, the Court held that *Chamison v. Healthtrust, Inc.—The Hospital Co.*, 735 A.2d 912 (Del. Ch. 1999) (Chandler, C.), which permitted co-indemnitors to pursue a subrogation theory against each other, was "no longer persuasive" in that respect. *Levy* reasoned that, as a legal theory, "subrogation necessarily contemplates full recovery by the party invoking it, as well as a primary-secondary ordering of liability between the indemnitors," whereas contribution more properly contemplates an equal division of responsibility between indemnitors. *Levy*, 924 A.2d at 223. The linchpin to this analysis is contained in *Chamison* itself, which stated that "[t]he Legislature created no primary-secondary hierarchy among § 145 indemnitors" and co-indemnitors should, absent a specific arrangement to the contrary, therefore divide costs equally. *Chamison*, 735 A.2d at 924.

49. 948 A.2d 1157 (Del. Ch. 2008) (Lamb, V.C.). This was one of four issues addressed in *Schoon*, all of which are covered in this article.

tion, or “Troy”), which enabled it to designate a director on the Troy board of directors. Eventually, two of Steel’s designees became enmeshed in litigation with Troy. Steel voluntarily advanced expenses for the litigation to the designees, even though it had no contractual obligation to do so. When a designee pressed a claim seeking to shift advancement obligations to Troy, Troy argued that under *Levy*, the designee had no standing against Troy because he was already receiving advancement from Steel. Troy also argued that Steel could have no contribution claim against Troy, because Steel was voluntarily advancing expenses, and only *contractual* co-indemnitors have a claim of contribution against each other. Without engaging the second argument, the Court held that the designee did have standing against Troy. Because Steel was only voluntarily providing advancement, the designee had “no assurance that Steel [would] continue advancing his costs and [was] obliged to repay those amounts to the extent he recover[ed] them from Troy,” and therefore it “cannot be said . . . that [the designee] ‘[would] not sustain any actual out-of-pocket loss.’”⁵⁰ The Court also pointed out that a contrary holding would encourage companies to shirk their advancement obligations or delay providing advancement in the hope that an “affluent aunt, cousin, best friend” would come along.⁵¹

In *Sodano v. American Stock Exchange LLC*,⁵² which was affirmed by the Delaware Supreme Court by summary order, the Court of Chancery examined when two indemnitors have successfully created a hierarchy of advancement and indemnification obligations between each other, such that they avoid the default rule from *Chamison* and *Levy* that fellow indemnitors divide costs equally. In *Sodano*, the plaintiff, Sodano, was an officer of the National Association of Securities Dealers, Inc. (the “NASD”), as well as of the American Stock Exchange (the “Amex”), a subsidiary of the NASD at which he served at the request of the NASD. The Amex came under investigation by

50. *Id.* at 1175 (quoting *Levy*, 924 A.2d at 222).

51. *Id.* (citing *DeLucca v. KKAT Mgmt, L.L.C.*, C.A. No. 1384-N, 2006 Del. Ch. LEXIS 19, at *32 (Del. Ch. Jan. 30, 2006) (similarly holding that an indemnitee still had standing to pursue advancement from one entity when another entity had voluntarily provided advancement)).

52. 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008) (Strine, V.C.), *aff’d sub nom.* *Am. Stock Exch. LLC v. Fin. Indus. Regulatory Auth., Inc.*, No. 3418-VCS, 2009 Del. Ch. LEXIS 141 (Del. Mar. 17, 2009).

the Securities and Exchange Commission (the “SEC”), and the question arose whether the NASD or the Amex was primarily responsible for advancing Sodano’s expenses relating to the investigation. The NASD charter granted Sodano advancement and indemnification rights, but also provided that when a director or officer served another entity “at the request of” the NASD, the NASD’s obligations would be reduced by any indemnification or advancement received from that entity. Specifically, Article Fifth(h) of the NASD charter provided that:

The NASD’s obligation, if any, to indemnify or advance expenses to any person who is or was serving at its request as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, enterprise, or non-profit entity shall be reduced by any amount such person may collect as indemnification or advancement from such other corporation, partnership, joint venture, trust, enterprise, or non-profit entity.⁵³

The Amex, meanwhile, had also previously bound itself in its LLC agreement to provide advancement and indemnification to Sodano. The NASD read Article Fifth as providing a “back-stop,” whereby NASD would only be responsible for providing advancement when an entity at which one of its officers was serving at the request of the NASD was itself unable to provide advancement. The Amex, by contrast, argued that it and the NASD were “equal co-indemnitors” who should each pay 50% of Sodano’s advancement costs and “that the only purpose and effect of Article Fifth(h) [was] to prevent a double recovery of advancement or ultimate indemnification.”⁵⁴ The Amex’s argument was based on the default rule from *Chamison and Levy*—that co-indemnitors generally divide costs equally—rather than the language of Article Fifth(h).

Presented with language that had the effect and intent of contracting around the default rule, the Court of Chancery

53. *Id.* at *13. Contemporaneously with the SEC investigation, the NASD sold the Amex, and the NASD and Sodano entered into a general release, which, in a separate holding addressed later in this article, the Court determined left the NASD’s advancement and indemnification obligations untouched.

54. *Id.* at *53.

agreed with the NASD, holding that Article Fifth(h) created a hierarchy of obligations in which the Amex was primarily responsible for providing advancement. The Court reasoned that Article Fifth(h) was “only implicated in situations, such as this one, where the obligation to advance expenses arises in the first instance from the individual’s service at another entity” and that “the hierarchical nature of the obligation mirrors the nature of the individual’s service.”⁵⁵ The Court also pointed to “business realities,” noting that such a reading is “consistent with one of the primary purposes for forming subsidiary corporations—confining the costs and liabilities of a particular line of business” but also assuring the subsidiary that “the parent corporation has his back.”⁵⁶

D. *What Types of Actions and Expenses Are Covered*

1. *Counterclaims*

Section 145(e) of the DGCL, which enables corporations to provide advancement to officers and directors, provides that “[e]xpenses (including attorneys’ fees) incurred by an officer or director *in defending* any civil, criminal, administrative or investigative action, suit or proceeding may be paid by the corporation in advance . . .” (emphasis added). Corporate documents granting advancement rights often track this language, stating that a corporation will advance expenses that an indemnitee incurs “in defending” or “in the defense” of a proceeding. Three decisions in 2008 grappled with exactly how broad the concept of “in defending” is—specifically whether it

55. *Id.* at *54. In reaching this holding, the Court also rejected an argument by the Amex that finding a hierarchy of obligations would encourage entities such as Amex to refuse to honor their primary advancement and indemnification obligations. The Court reasoned that a provision such as Article Fifth(h) contractually protects the secondary obligor, and that a secondary obligor forced to file suit against a primary obligor under such circumstances “would also have a plausible claim for automatic ‘fees on fees’”—i.e., reimbursement for the costs associated with the suit. *Id.* at *59.

56. *Id.* at *55-56, *61. By contrasting the business realities of the facts at hand with the use of contractual language to “offload . . . advancement and ultimate indemnification obligations on an unrelated entity who happened to provide advancement and ultimate indemnification rights to the same official,” the Court implicitly suggested that creating a hierarchy of advancement and indemnification obligations would only be respected where it was a “common sense, measured use of the freedom of contract.” *Id.* at *61.

includes counterclaims raised by an indemnitee who has become embroiled in a proceeding. All three of the decisions—the first by Chancellor Chandler, the second by Vice Chancellor Strine, and the third by Vice Chancellor Noble—answer that question differently.

A 1992 Delaware Supreme Court case, *Citadel Holding Corp. v. Roven*,⁵⁷ is foundational to these 2008 cases. In *Roven*, the Court held that the term “in defending”—as used in an indemnification agreement granting a former director advancement rights—encompassed the former director’s affirmative defenses and counterclaims raised in response to a federal action that the company had brought against him. The Court first noted that the notion of “defense” has a “broad meaning,” citing to the *Black’s Law Dictionary* definition of “defense” as “[t]hat which is offered and alleged by the party proceeded against in an action or suit, as a reason in law or fact why the plaintiff should not recover or establish what he seeks” and “[t]hat which is put forward to diminish plaintiff’s cause of action or defeat recovery.”⁵⁸ The Court also noted evidence from the record indicating that the parties did not intend a restrictive meaning of the term “in defending.”⁵⁹ From there, the Court concluded that the term encompassed affirmative defenses. The Court noted, however, that “counterclaims present a more difficult problem.” Although acknowledging that “[t]echnically, of course, they represent separate causes of action,” the Court reasoned that “under the Federal Rules of Civil Procedure, certain claims must be asserted by a defendant in the same action and others are permissive” and that “[c]ounterclaims arising from the same transaction as the original complaint must be asserted or be thereafter barred.”⁶⁰ Thus, the Court concluded, “any counterclaims asserted by [the former director] are necessarily part of the same dispute and were advanced to defeat, or offset, [the company’s] claim”—and therefore came within the scope of “in defending.”⁶¹

57. 603 A.2d 818 (Del. 1992).

58. *Id.* at 824 (quoting BLACK’S LAW DICTIONARY 377 (5th Ed. 1979)).

59. *Id.*

60. *Id.*

61. *Id.*

The Supreme Court's holding in *Roven* is curious, and in a way that is significant for the 2008 cases. The Court did not expressly note that the counterclaims at issue were compulsory rather than permissive—although its commentary would suggest that they were. The Court also did not expressly hold that only compulsory, rather than permissive, counterclaims would come within the term “in defending.” And, yet, the Court's conclusion that the former director was entitled to advancement for his counterclaims seemed to be staked on the nature of compulsory counterclaims.

This possible opacity in *Roven* may help explain the split in the case law that emerged in 2008. In *Reinhard & Kreinberg v. The Dow Chemical Co.*,⁶² Chancellor Chandler held that the term “defense”—in that case, as used in a stipulated agreement between Dow and its former executives, reached in the context of litigation by Dow against the former executives—includes only *compulsory* counterclaims. Describing *Roven* as “perfectly on point,” Chancellor Chandler construed *Roven* as having “naturally” concluded that the term “defense” includes affirmative defenses and *compulsory* counterclaims because the latter “are necessarily part of the same dispute.”⁶³ By contrast, Chancellor Chandler stated that legal fees incurred in connection with permissive counterclaims “cannot justifiably be construed as part of a director's ‘defense’ of claims brought against her by a corporation” because *permissive* counterclaims “do ‘not aris[e] out of the transaction or occurrence that is the subject matter of the opposing party's claim.’”⁶⁴ Chancellor Chandler clearly perceived the *Roven* Court as having drawn the same line regarding compulsory and permissive counterclaims, noting that the *Roven* Court acknowledged that counterclaims “present a . . . difficult problem” but that the *Roven* Court's concern was “assuaged because compulsory counterclaims ‘must be asserted or be thereafter barred,’” whereas “permissive counterclaims do not face the same fate.”⁶⁵

In *Zaman*, issued two months after *Dow*, Vice Chancellor Strine rejected an interpretation of “in defending”—which

62. No. 3003-CC, 2008 Del. Ch. LEXIS 39 (Del. Ch. Mar. 28, 2008).

63. *Id.* at *8.

64. *Id.* at *9.

65. *Id.* at *9-10 (quoting *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 824 (Del. 1992)).

term, in *Zaman*, appeared in advancement bylaws—that would turn on a distinction between compulsory and non-compulsory counterclaims. Vice Chancellor Strine emphasized that the facts before him demonstrated the difficulties with *Dow*'s bright-line rule: in *Zaman*, the counterclaims at issue were governed by New York law, under which *all* counterclaims are permissive and no distinction is made between permissive and compulsory counterclaims.⁶⁶ Moreover, Vice Chancellor Strine pointed out that “16 states either have no compulsory counterclaim requirement or have material carveouts from the traditional compulsory counterclaim test.”⁶⁷ Reasoning, among other things, that the term “in defending” should not have “an accordion-like nature that varies because of the forum chosen by the party suing the corporate official owed advancement rights,” Vice Chancellor Strine posited a modified test for when a counterclaim comes within the term: “[I]f 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 that success on the counterclaim would operate to defeat the affirmative claims against the corporate official” then the counterclaim would come within the term “in defending.”⁶⁸

Vice Chancellor Strine also addressed the tensions between his decision in *Zaman* and Chancellor Chandler's decision in *Dow*. Acknowledging *Dow*'s treatment of *Roven*, Vice Chancellor Strine explained that he did not view the holding in *Roven* as being “dependent on defining the counterclaims as compulsory counterclaims,” but instead as having as its “primary rationale” that counterclaims be “substantively defensive” and be “advanced to defeat, or offset” the initial claim.⁶⁹ Vice Chancellor Strine noted that he found it “impossible to read the holding of *Roven* as driven by the idea that a corporate official should have his cost of playing offense paid simply because the company sued him first and he is now forced to play offense in the corporation's chosen forum or give up the right

66. *Zaman v. Amedeo Holdings, Inc.*, No. 3115-VCS, 2008 Del. Ch. LEXIS 60, at *116 (Del. Ch. May 23, 2008).

67. *Id.* at *123.

68. *Id.* at *122-25 (emphasis in original).

69. *Id.* at *115 (quoting *Roven*, 603 A.2d at 824).

to do so later.”⁷⁰ Nonetheless, Vice Chancellor Strine acknowledged that *Roven* could be read literally and that “our Supreme Court must answer the question of how to read *Roven*, as the text of that decision can plausibly lead to different interpretations.”⁷¹

Nevertheless, although *Dow* and *Zaman* clearly depart from each other facially, the conflict between the two cases may not be very deep as a practical matter. Although *Zaman*, unlike *Dow*, would not require that counterclaims be “compulsory” to come within the term “in defending,” *Zaman* would nonetheless require that counterclaims satisfy the traditional compulsory counterclaim test used by both the Delaware and federal rules. The two cases therefore seem very likely to lead to the same result and to have been driven by the same intent, with Vice Chancellor Strine simply modifying *Dow*’s rule because of the possible issues with that ruling that the procedural considerations before him pointed out.⁷²

As for which case gets the Supreme Court precedent “right,” the question is, obviously, contestable. One sentence in *Roven*, quoted above, encapsulates the different interpretations that can be drawn from the case: “Thus, in the federal action at least, any counterclaims asserted by [the former director] are necessarily part of the same dispute and were advanced to defeat, or offset, [the company’s] claim.”⁷³ The question is which half of that logic should be determinative: the first half, which focuses on counterclaims “necessarily” be-

70. *Id.* at *117.

71. *Id.* at *128 n.155. Should the Supreme Court revisit *Roven*, Vice Chancellor Strine intimated that the analysis should begin with the question of whether counterclaims, regardless of whether they are compulsory or permissive, should be subject to advancement under a contractual right for “defending” an action rather than one that affirmatively covers suits brought by the corporate official. *Id.* at *118 (noting that “one can argue that it would have been most sound for *Roven* to have simply held” that counterclaims are only covered if the advancement bylaw covers suits brought by the corporate official), *127 (qualifying the counterclaim holding with “if *Roven* is good law”).

72. Although it is unclear whether, as a practical matter, the distinction makes a difference, *Zaman*’s interpretation of *Roven* as requiring that a counterclaim must defeat or offset the company’s claim to be “defending” appears to apply equally to compulsory counterclaims, thus adding another layer to the analysis for compulsory counterclaims. *See id.* at *122.

73. 603 A.2d at 824.

ing “part of the same dispute” and therefore suggests that counterclaims must be compulsory, or the second half, which focuses on whether a counterclaim would “defeat” or “offset” a claim and therefore leaves the door open to the inclusion of non-compulsory counterclaims that would serve such a function. As Chancellor Chandler decided and Vice Chancellor Strine conceded, it is indeed possible that the Supreme Court’s reliance in *Roven* on the nature of compulsory counterclaims means that the Supreme Court intended the *Dow* rule. It also seems quite possible, however, that the Supreme Court simply recognized that “certain claims must be asserted by a defendant in the same action” under federal rules and that that possibility alone would militate in favor of holding that, as a general rule, counterclaims should come within “in defending” language (without parsing further whether they are compulsory or permissive).⁷⁴

Any focus on the not-so-radical “split” between *Dow* and *Zaman* may unduly overshadow the more radical case from 2008—*Duthie v. CorSolutions Medical, Inc.*,⁷⁵ in which Vice Chancellor Noble held that a *separate* defamation claim was part of an indemnitee’s defense and was therefore entitled to advancement. In *Duthie*, the defendant corporation had brought claims of fraud and breach of contract against the plaintiff indemnitees, for which the plaintiffs were entitled to advancement. According to plaintiffs, the company “repeated its claims publicly” and “with the intent to embarrass them and

74. In *Sun-Times*—a decision published one month after *Zaman*—Vice Chancellor Strine explicitly addressed the two strains of logic in *Roven* and the different import of each. In *Sun-Times*, Vice Chancellor Strine held that, in the criminal context, an appeal by an indemnitee, following sentencing at the trial court level, would come within the term “in defending,” as used in Section 145(e) of the DGCL and bylaws, and would therefore be entitled to advancement. He reasoned that appeals “are clearly designed to ‘defeat or offset’ the prosecutor’s claims against the defendant” and that they are also “necessarily part of the same dispute” because an “appeal must arise from the trial court dispute and generally involves the same facts and legal arguments as the trial court dispute.” *Sun-Times Media Group, Inc. v. Black*, 954 A.2d 300, 397-98 (Del. Ch. 2008). He further noted that “to the extent that *Roven* hinges on the ‘use it or lose it’ nature of compulsory counterclaims, appeals must similarly be filed in a timely manner”—although he confirmed in a footnote that he did not view *Roven* as hinging on that rationale. *Id.* at 398.

75. No. 3048-VCN, 2008 Del. Ch. LEXIS 128 (Del. Ch. Sept. 10, 2008), *modified*, No. 3048-VCN, 2009 LEXIS 112 (Del. Ch. June 16, 2009).

ruin their reputations.”⁷⁶ The plaintiffs therefore brought a defamation claim against the company, which led to the question: “Were plaintiffs entitled to advancement for the defamation claim?” Vice Chancellor Noble answered that question affirmatively, writing that “[a]lthough advancement is generally associated with the defense of claims, there are instances in which affirmative claims, asserted as part of a defensive strategy involving the same dispute, may be funded through advancement.”⁷⁷ Vice Chancellor Noble first noted that the company’s charter broadly allowed advancement and “cannot be read to preclude advancement for asserting affirmative claims.”⁷⁸ He also took an expansive view of the notion of defense, stating that “[b]ecause the alleged defamatory attacks reprise the same charges as advanced in the litigation and because the adverse party has already brought litigation involving the same allegations, it is neither practicable nor reasonable to attempt to draw some line defining which defensive strategy, even though it may involve an assertion of affirmative claims, is appropriate.”⁷⁹ Sidestepping the focus in *Dow* and *Zaman* on whether a claim is compulsory, Vice Chancellor Noble rea-

76. *Id.* at *2.

77. *Id.*

78. *Id.* Although the Court in *Duthie* did not quote the specific language of the charter, the charter (as publicly filed with the Secretary of State of Delaware) provides, in pertinent part, that:

Each person who was or is a director of [sic] officer of the Company and who was or is made a party or is threatened to be made a party to or is otherwise involved . . . in any . . . proceeding . . . (hereinafter an “Indemnified Person”), shall be indemnified . . . to the fullest extent permitted by the General Corporation Law of Delaware . . . against all liability, all reasonable expenses and all loss . . . incurred or suffered by such Indemnified Person in connection therewith Notwithstanding the foregoing . . . the Company shall indemnify any Indemnified Person in connection with a proceeding (or part thereof) initiated by such Indemnified Person only if such proceeding (or part thereof) was authorized by the Board of Directors of the Company The right to indemnification conferred in this Article . . . shall include the right to be paid by the Company the expenses incurred in defending any such proceeding in advance of its final disposition

CorSolutions Med., Inc., Certificate of Incorporation (filed as Exhibit to Certificate of Merger of Coral Acquisition Corp. With And Into CorSolutions Medical, Inc. (Jan. 19, 2006)).

79. *Duthie*, 2008 Del. Ch. LEXIS 128, at *2-3.

soned that the defamation claim “arises as an outgrowth of [the company’s] litigation strategy and is a ‘necessary part of the same dispute.’”⁸⁰ In short, *Dow* and *Zaman* parsed *Roven* to determine whether non-compulsory counterclaims could come within the concept of defense—but *Duthie* blew *Roven* open, citing language from that case to hold that affirmative claims came within the concept.

In 2009, Vice Chancellor Noble issued a second decision in *Duthie*, this time in response to a request by the defendant corporation to stop advancing expenses to the indemnitees for their defamation claim (and other affirmative claims the indemnitees had brought).⁸¹ The defendant corporation contended that circumstances had changed since the Court’s last order: the corporation was no longer pursuing any charges or claims against the indemnitees, and therefore the indemnitees were no longer “defending” against any claims. The Court agreed, holding that “[b]ecause no threat now exists . . . [t]hese defamation claims are no longer defensive, but rather, are solely offensive in nature.”⁸² In reaching this decision, the Court reaffirmed its prior expansive interpretation of “defending,” noting that an “affirmative claim is defensive in nature

80. *Id.* at *3 (citing *Roven*, 603 A.2d at 824; *Pearson v. Exide Corp.*, 157 F. Supp. 2d 429, 439-40 (E.D. Pa. 2001)). *Pearson*, which applied Delaware law, read *Roven* as having “broadly interpreted” the term “in defending,” but as holding only that actions “which could have been asserted as compulsory counterclaims to previously-filed claims” would come within the term. *Pearson*, 157 F. Supp. 2d at 439-40. In *Pearson*, former officers of Exide Corporation (“Exide”) became involved in a series of legal proceedings. In the first proceeding (filed in Michigan), a third party brought an action against Exide, and Exide filed a counterclaim and joined the former officers. In the second proceeding (filed in Pennsylvania), the former officers affirmatively brought a claim against the Exide, relating to matters Exide had put at issue in Michigan. The question arose whether the former officers were entitled to advancement for the Pennsylvania action. Exide’s bylaws provided, among other things, that the former officers were entitled to expenses incurred “in defending” legal proceedings. The Court held that the Pennsylvania action came within the term “in defending,” both because it was filed in response to the litigation begun by Exide in Michigan and was therefore “equally defensive in nature as the counterclaims asserted by plaintiff in *Citadel [v. Roven]*” and because the Pennsylvania claim, if asserted in Michigan, would have qualified as a compulsory counterclaim under the federal rules. *Id.* at 439.

81. *Duthie v. CorSolutions Med., Inc.*, C.A. No. 3048-VCN 2009 Del. Ch. LEXIS 112 (Del. Ch. June 16, 2009) (“*Duthie II*”).

82. *Id.* at *8.

where it defends the corporate official by directly responding to and negating the affirmative claims brought against that corporate official.”⁸³ Although the Court cited *Zaman* as support for that proposition, the Court, as in its earlier decision, did not acknowledge the discussion in *Zaman* and *Dow* as to whether a claim must also be compulsory to qualify as defensive—maintaining *Duthie*’s status as the most expansive decision of the three cases.⁸⁴

One remaining question is whether the issues from *Dow*, *Zaman*, and *Duthie* can be avoided or answered in the drafting of advancement provisions. As Vice Chancellor Strine wrote in *Zaman*, “corporations retain the contractual freedom to explicitly carve-out all counterclaims or offensive claims from advancement.”⁸⁵ On the other hand, because “in defending” is a statutory term, lawyers may have limited flexibility in their drafting, depending on how the Delaware courts ultimately resolve the meaning of that term. That is, because Section 145(e) of the DGCL enables corporations to provide advancement to officers or directors for expenses incurred “in defending” various actions, if the Delaware courts ultimately adopt

83. *Id.* at *7.

84. The *Duthie II* decision raises another conceptual question: once a corporation drops all claims against an indemnitee—and represents, as in *Duthie II*, that it will not pursue any claims in the future, see *id.* at *8 n.17—should the indemnitee’s entitlement to advancement for pending, previously “defensive,” claims immediately cease? On one hand, it is true that the claims are no longer technically defensive, and the *Duthie II* rule would prevent corporations from advancing expenses to indemnitees *ad infinitum*. As Vice Chancellor Noble noted in *Duthie II*, where the limiting “in defending” language is present, it may be an “unwarranted expansion of . . . plain language . . . to order the continued advancement of fees and expenses” after there is no threat against which to defend. *Id.* at *10. On the other hand, as noted previously, one public policy goal of Delaware law on advancement is “encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity.” See *Sun-Times Media Group, Inc. v. Black*, 954 A.2d 380, 404 (Del. Ch. 2008) (quoting *VonFeldt v. Stifel Fin. Corp.* 714 A.2d 79, 84 (Del. 1998)). In light of this goal, and if one accepts the broad reading of “defending” embraced in the first *Duthie* case, it is arguably problematic, once a director or officer begins “defending” her name against attacks that have already occurred (as in the defamation claim in *Duthie*), to permit the corporation to cut off that defensive effort through its own tactical decisions in litigation.

85. *Zaman v. Amedeo Holdings, Inc.*, No. 3115-VCS, 2008 Del. Ch. LEXIS 60, at *127 (Del. Ch. May 23, 2008).

Chancellor Chandler's narrow interpretation of the term, corporations may, under that enabling statutory provision, be limited in the types of affirmative actions by directors and officers for which they are allowed to provide advancement. To be sure, Section 145(f) allows corporations to supplement the statute and provide additional advancement and indemnification rights through bylaws and agreements⁸⁶—and, therefore, corporations could likely use Section 145(f) to broaden the types of affirmative actions by a corporate official that would be entitled to advancement. At the same time, Section 145(f) may not be used to circumvent the statute,⁸⁷ which renders the bounds of 145(f)—and the extent to which it may be used creatively—unclear.

86. Section 145(f) currently provides in full as follows:

The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to such action in another capacity while holding such office. A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to such provision after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.

87. See *Sun-Times*, 954 A.2d at 404 n.93 (quoting *Cochran v. Stifel Fin. Corp.*, 2000 Del. Ch. LEXIS 58, at *18 (Del. Ch. Mar. 8, 2000), *rev'd on other grounds*, 809 A.2d 555 (Del. 2002)) (suggesting that Section 145(f) cannot authorize advancement or indemnification rights by contract that are "contrary to the limitations or prohibitions set forth in the other section 145 subsections, other statutes, court decisions, or public policy"); *Levy v. HLI Operating Co.*, 924 A.2d 210, 226 n.59 (quoting *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87, 91 (2d Cir. 1996)) ("Under [Section] 145(f), a corporation may provide indemnification rights that go 'beyond' the rights provided by . . . the other substantive subsections of [Section] 145. At the same time, such indemnification rights must be 'consistent with' the substantive provisions of [Section] 145 . . .").

2. *Actions brought by the indemnitee as a plaintiff*

In *Donohue v. Corning*, Vice Chancellor Strine faced the issue of when an indemnitee is entitled to receive advancement for actions brought by the indemnitee as a plaintiff in the context of what the company termed “a game of chess . . . on the issue of advancement.”⁸⁸ The LLC Agreement of Expansion Capital Partners, LLC (“Expansion”) contained an advancement provision that provided advancement to, *inter alia*, its Managing Members for expenses “incurred in connection with the defense or disposition” of any proceeding in which a Managing Member is “involved, as a party or otherwise, or with which [a Managing Member] may be threatened” by reason of having been a Managing Member.⁸⁹ Expansion’s board removed Donohue, a Managing Member and Board Chairman, for cause pursuant to a removal provision in the LLC Agreement. In the period leading up to Donohue’s removal, he threatened an adversarial proceeding if the board removed him. The board responded by stating that although they were removing Donohue for cause, they did not intend to bring a proceeding against him for the actions underlying his for cause removal. Donohue filed suit challenging his removal and argued that he was pursuing the action to remedy his wrongful removal on behalf of Expansion and its investors. Donohue sought advancement for his suit, arguing that the board had threatened to remove him for cause and accused him of breaching his duties to Expansion and that he was “disposing” of the threatened proceeding by challenging his for cause removal.

Vice Chancellor Strine found that Donohue was not entitled to advancement because Expansion’s advancement provision only applied to actions that “although not strictly limited to defending a suit, [are] defensive or responsive in nature.”⁹⁰ The Vice Chancellor’s analysis was straightforward—the for cause removal was not a proceeding contemplated by the advancement provision and Donohue was not “threatened” with a proceeding because the board had made clear that they

88. 949 A.2d 574, 580 n.26 (Del. Ch. 2008).

89. *Id.* at 576.

90. *Id.* at 578-79.

would not take further action against Donohue.⁹¹ Vice Chancellor Strine was careful to note that there was color to Donohue's claim that he was challenging his removal on behalf of Expansion and its investors, that bringing such an action was consistent with the policy behind allowing companies to advance funds to and indemnify their directors and officers, and that such a policy had supported indemnification of corporate officials for litigation brought in "somewhat analogous intra-corporate disputes," such as *Hibbert v. Hollywood Park, Inc.*⁹² Nevertheless, the language of the advancement provision controlled whether Donohue was entitled to advancement and the Court observed that the critical "in connection with the defense or disposition of" language appeared to have been added to the advancement provision to contract around the result in *Hibbert*.⁹³

Schoon v. Troy Corp. is an example of a situation in which a corporation's bylaws limit a director's right to advancement when acting as a plaintiff, but the corporation's actions in a litigation neutralize that language. In that case, Schoon, a director of Troy Corporation ("Troy"), brought an action under Section 220 of the DGCL against Troy seeking access to some books and records of Troy. Under Troy's bylaws (the "Bylaws"), Schoon was not entitled to advancement for the Section 220 action because the Bylaws provided that "the Corporation shall not . . . make advance payments . . . in connection with any Proceeding . . . initiated against the Corporation . . .

91. Vice Chancellor Strine expressly noted that the board's assertions in the advancement litigation judicially estopped them "from later initiating any proceeding against Donohue for the actions at dispute in this action." *Id.* at 580 n.26.

92. *Id.* at 578 (referencing *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339 (Del. 1983) and *Shearin v. E.F. Hutton Group, Inc.*, 652 A.2d 578 (Del. Ch. 1994)). In *Hibbert*, the company's board of directors split into two factions and one faction initiated litigation against the other faction in the midst of a proxy contest. The Delaware Supreme Court found that the board faction initiating litigation was entitled to indemnification because the indemnification provision was not limited to defensive applications and the Court could not conclude that the litigation "was entirely initiated without regard to any duty the plaintiffs might have had as directors." *Hibbert*, 457 A.2d at 344; see also *Shearin*, 652 A.2d at 594 (interpreting *Hibbert* as "recogniz[ing] that permissible indemnification claims will include those deriving from lawsuits brought by directors, officers, agents, etc., only insofar as the suit was brought as part of the employee's duties to the corporation and its shareholders.").

93. *Donohue*, 949 A.2d at 579.

⁹⁴ The Bylaws also provided, however, that Troy *would* make advance payments for “[l]osses reasonably incurred . . . in *defending* a *threatened* or pending Proceeding . . .”⁹⁵—that is, a proceeding not initiated by the indemnitee. Shortly after Schoon filed his Section220 action, Troy filed its answer and affirmative defenses in that action, which included allegations that Schoon had breached his fiduciary duties. Approximately three months later, Troy moved in the Section220 action for leave to file an amended and supplemental answer, verified counterclaims, and a third-party complaint. At this point, Schoon sought advancement for the claims Troy sought to raise in that motion. One week later, the Court denied Troy’s motion, and, two weeks after that, Troy filed a separate plenary action bringing the claims it had attempted to raise through the amended filings.

The question remained whether Schoon was entitled to advancement for any of the stages of the Section220 action. Prior to Troy’s motion to amend, the Section220 was a proceeding “initiated” by Schoon and therefore not subject to advancement.⁹⁶ The Court stated, however, that Schoon was entitled to “advancement in defending Troy’s motion to amend in the 220 action”⁹⁷—and although the Court did not explain why, presumably it was because, in connection with the motion to amend, Schoon was “defending” a claim under the Bylaws. After the *denial* of the motion to amend, the Court held that Schoon was still entitled to advancement—because, significantly, the record showed that Troy, in connection with the Section220 action, had continued to investigate (for example, in depositions) the claims that would form its separate plenary action after the denial. As such, according to the Court, Schoon was defending against a “threatened” proceeding.⁹⁸ Of course, the Court also pointed out that if Schoon was unsuccessful in defending the claims in the separate plenary action, he would have to repay the advanced amounts.⁹⁹

94. *Schoon v. Troy Corp.*, 948 A.2d 1157, 1168 (Del. Ch. 2008).

95. *Id.* at 1169 (emphasis added).

96. *See id.* at 1171 & n.66.

97. *Id.* at 1169.

98. *Id.* at 1170.

99. *Id.* As the *Schoon* Court explained, this rule flows from § 145(e) of the DGCL, which “authorizes advancement of the expenses a director incurs in defending a lawsuit so long as the director undertakes to ‘repay such

3. *When a right to “indemnification” also includes a right to “advancement”*

As a general rule, Delaware law views indemnification and advancement as distinct concepts. Therefore, where a provision in a corporate instrument grants “indemnification” rights, that provision will not necessarily be read as granting “advancement” rights (and vice versa).¹⁰⁰ In some cases, however, Delaware courts have concluded that, under the circumstances at bar, the parties to a corporate instrument intended the term “indemnify” to operate broadly, to impart both advancement and indemnification rights.¹⁰¹ In 2008, Vice Chancellor Strine issued another such decision in *Sodano*.

In *Sodano* (which is discussed above on another point),¹⁰² the plaintiff, Sodano, had served as an officer at both the NASD and Amex, which the NASD owned. Following a decision by the NASD to sell Amex and the initiation of an SEC investigation of Amex, Sodano’s employment at each entity ended. In connection with Sodano’s separation, the three parties entered into a settlement agreement and release. Under the NASD’s charter, Sodano had been explicitly entitled to advancement and indemnification rights. By contrast, under the settlement agreement that the three parties negotiated and which supplanted Sodano’s preexisting rights, the NASD agreed only to “indemnify” Sodano, without any reference to the advancement of expenses.¹⁰³ Once Sodano became the

amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation.’ *Id.* at 1165 (quoting DEL. CODE ANN. tit. 8, § 145(e)).

100. See, e.g., *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 589 (Del. Ch. 2006).

101. See *Weinstock v. Lazard Debt Recovery GP, LLC*, No. 20048, 2003 Del. Ch. LEXIS 83, at *11-13 (Del. Ch. Aug. 1, 2003); *Greco v. Columbia/HCA Healthcare Corp.*, No. 16801, 1999 Del. Ch. LEXIS 24, at *38-39 (Del. Ch. Feb. 11, 1999).

102. See *supra* notes 52-56 and accompanying text.

103. The indemnification provision in the settlement agreement provided in full as follows:

Indemnification/D&O Insurance. [NASD] will indemnify you for any liability (including but not limited to, all reasonable legal fees and out-of-pocket expenses) you incur arising from your actions or omissions prior to the closing of the [Sale] Transaction as an employee, officer, director, governor or other service provider of NASD or Amex to the fullest extent permitted by law and NASD’s

subject of lawsuits following his separation, a dispute arose over whether the NASD was required to advance him expenses.

Vice Chancellor Strine concluded that notwithstanding the settlement agreement's use of only the term "indemnify," the clear intention of the parties was for that term to encompass both indemnification and advancement rights. His reasons were many: (1) the NASD charter used "indemnify" both narrowly and broadly (respectively, to exclude and include advancement rights), and the settlement agreement provided that Sodano would be indemnified to the "fullest extent permitted by law and NASD's organizational documents," suggesting the broader meaning; (2) all parties to the settlement agreement knew Sodano was likely to be sued following his separation, and "Sodano would have had to have fallen off the proverbial turnip truck to have given up his right to advancement from the NASD"; (3) relatedly, such a development would have been a "momentous event," but there was nothing in the record to suggest that either side believed that such a momentous event had occurred; (4) the lawyers involved in negotiating the settlement agreement did not understand the difference between advancement and indemnification, but the record indicated that both sides believed Sodano was broadly retaining his rights under the NASD charter; and (5) the businesspeople and lawyers involved in the negotiations consistently used "indemnification" to refer to both indemnification and advancement rights.¹⁰⁴

organizational documents. While any potential liability exists (but no less than six years) following closing of the [Sale] Transaction, NASD will maintain a director's and officer's liability insurance policy covering you in the same amount and to the same extent as NASD's officers, directors and governors.

Sodano v. Am. Stock Exch. LLC, No. 3418-VCS, 2008 Del. Ch. LEXIS 92, at *13-14 (Del. Ch. July 15, 2008).

104. *See id.* at *39-47. The settlement agreement at issue in *Sodano* was governed by New York law and Vice Chancellor Strine therefore applied New York law principles in interpreting the agreement generally. As to whether "indemnify" encompassed both advancement and indemnification rights, however, Vice Chancellor Strine looked to Delaware case law—and thus the decision should be relevant to practitioners and courts applying either body of law.

4. *Fees on fees*

Corporate instruments often provide that corporate officials are not only entitled to advancement and indemnification for proceedings with which they become involved, but also for attorneys' fees incurred in enforcing the right to advancement or indemnification if it is disputed—commonly referred to as “fees on fees.” In addition, the Delaware Supreme Court has held that under Section 145, where an indemnitee is entitled to indemnification, that right also includes a right to fees on fees.¹⁰⁵

But certain policies limit entitlement to fees on fees. In 2003, in a second decision in *Fasciana*, the Court of Chancery held that indemnitees could only be indemnified for fees on fees in proportion to the indemnitee's success in the enforcement action.¹⁰⁶ The *Fasciana* Court reasoned that, absent such a rule, “parties seeking advancement [would] raise any conceivable argument that can pass Rule 11 muster knowing that any level of ultimate success would warrant a full fees on fees award,” and that, with such a rule, indemnitees would raise only “substantial claims” and corporations can “resist less meritorious claims.”¹⁰⁷ In 2008, the Court of Chancery stated in *Schoon* that a corporation cannot contract around the policies underlying *Fasciana*.

In *Schoon*, the bylaws of Troy Corporation provided that an indemnitee who has brought suit to enforce advancement and indemnification rights “if successful in whole or in part, shall be entitled to be paid the expense of prosecuting such claim.”¹⁰⁸ The indemnitees argued that the “in whole or in part” language distinguished *Fasciana* and entitled them to full fees on fees regardless of success. The Court rejected this argument, citing the policies identified in *Fasciana*. This decision, of course, was not surprising, in light of the Court of Chancery's 2007 decision in *Levy*, in which the Court held that the rule of *Fasciana* could not be avoided by language in indemni-

105. See *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 560-62 (Del. 2002).

106. 829 A.2d 178, 179 (Del. Ch. 2003).

107. *Id.* at 184. In *Fasciana*, the bylaws at issue provided for advancement and indemnification “to the fullest extent permitted by § 145”—but the Court held that such language could not prevent the policy-based imposition of a proportionality requirement. *Id.* at 182.

108. 948 A.2d 1157, 1176 (Del. Ch. 2008).

fication agreements allowing for fees on fees “regardless of whether [the party] is ultimately determined to be entitled to . . . indemnification.”¹⁰⁹

5. *Elimination or impairment after the pertinent act or omission*

In *Schoon*, the Court of Chancery also addressed when a corporate official’s right to advancement (and likely indemnification) vests—but that portion of the decision was promptly overturned by the Delaware General Assembly approximately one year later.

In *Schoon*, the Court of Chancery held that a former director’s right to advancement as set forth in bylaws did not vest until some type of litigation was contemplated or pursued against the director. One of Troy Corporation’s former directors (Bohnen) sought advancement from Troy after Troy sued Bohnen for breach of his fiduciary duties. At the time Bohnen served as a director, Troy’s bylaws provided advancement rights for former directors. Subsequent to Bohnen’s leaving office, Troy amended its bylaws to eliminate former directors from the universe of officials entitled to advancement. Approximately two months later, Troy brought an action against Bohnen for breach of fiduciary duty. Bohnen sought advancement for the action, arguing that he was entitled to advancement because “his right to advancement in the pre-amendment bylaws vested when he took office,”¹¹⁰ regardless of the subsequent amendment. The *Schoon* Court disagreed, holding that Bohnen’s rights had not vested because, at the time Troy amended the bylaws, Troy had not named Bohnen in any action, had not conducted discovery against him, and was not “even contemplating claims against Bohnen.”¹¹¹ In other words, the right to advancement contained in the bylaws did not vest simply by virtue of Bohnen’s becoming an officer.¹¹²

109. 924 A.2d 210, 225 (Del. Ch. 2006).

110. 948 A.2d at 1166.

111. *Id.*

112. In reaching this decision, the Court rejected Bohnen’s argument that an earlier decision, *Salaman v. National Media Corp.*, C.A. 92C-01-161, 1992 Del. Super. LEXIS 564 (Del. Super. Ct. Oct. 8, 1992), supported the conclusion that Bohnen’s right to advancement had already vested. In *Salaman*, the defendant corporation amended its bylaws after litigation had already arisen against a former director and after the corporation had begun advancing expenses to the former director. The *Salaman* Court held that the amend-

The decision quickly became a subject of discussion among practitioners, many of whom rightly saw it as calling into question the security of corporate officials' advancement and indemnification rights.¹¹³ In response, the Delaware General Assembly enacted legislation, which was signed into law by Governor Jack Markell on April 10, 2009, to reverse this aspect of *Schoon*.¹¹⁴ The new law, which became effective on August 1, 2009, addresses both advancement and indemnification and provides that once the act or omission that is the subject of the action for which a corporate official seeks advancement or indemnification has occurred, the right to advancement or indemnification cannot be eliminated or "impaired," unless the provision granting the right explicitly permitted otherwise.¹¹⁵

ment did not permit the corporation to discontinue advancing expenses and stated that that the company could not "unilaterally rescind a vested contract right upon which [the former director] relied." *Salaman*, 1992 Del. Super. LEXIS 564, at *17. The *Schoon* Court interpreted *Salaman* narrowly, stating that the *Salaman* Court only "upheld [the former director's] right to advancement because he was named as a defendant before the bylaw was amended." *Schoon*, 948 A.2d at 1166 (emphasis added).

113. See, e.g., Ropes & Gray LLP, *Delaware Court Allows Retroactive Repeal of Director Advancement Rights*, (May 8, 2008), <http://www.ropesgray.com/news/pubs/detail.aspx?publication=919> (stating about *Schoon* that a "recent decision from the Delaware Chancery Court has called into question the reliability of advancement and indemnification rights for directors of Delaware corporations"); Dorsey & Whitney LLP, *Time to Review Director and Officer Indemnification and Advancement Arrangements*, (July 2008), http://www.dorsey.com/cu_071708_officer_indem_advance_arrange/ (stating about *Schoon* that: "Corporate boards should review and update the arrangements with the corporation for indemnification and advancement of expenses of directors and officers in light of a disturbing decision earlier this year in which the Delaware Chancery Court upheld a bylaw amendment retroactively eliminating a former director's rights."); Wachtell, Lipton, Rosen & Katz, *Corporate Governance Update: Delaware Decision Highlights Need for Director Protection*, (July 24, 2008), <http://blogs.law.harvard.edu/corpgov/files/2008/08/delaware-decision-highlights-need-for-director-protection.pdf> ("In the wake of *Schoon v. Troy*, directors will want to be certain that they understand the extent of their rights to indemnification and advancement of expenses and that those rights are secure.").

114. See H.B. 19, 145th Del. Gen. Assem. (2009).

115. Specifically, the following sentence was added to § 145(f) of the DGCL:

A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to such provision after the occurrence of the act or omission that is the subject of the

E. *Which Standard of Review Applies to the Implementation of Advancement Right*

In *Underbrink v. Warrior Energy Services Corp.*, Vice Chancellor Parsons addressed the standard of review that applies to a board of directors' adoption of a mandatory advancement bylaw (*i.e.*, a bylaw requiring a corporation to advance expenses to indemnitees).¹¹⁶ The Court's analysis focused on whether the adoption of the mandatory advancement bylaw was intended to provide for the advancement of litigation expenses for a particular proceeding as opposed to the adoption of a bylaw requiring the corporation to advance litigation costs sometime in the future.

In *Underbrink*, the board of directors of Warrior Energy Services ("Warrior") adopted a mandatory advancement provision as part of an amended set of "2006 Bylaws" implemented shortly before a secondary public offering by Warrior (the "SPO"). Underbrink and Harrison, two of Warrior's four directors at the time, resigned in connection with the SPO. At the time the Warrior board adopted the 2006 Bylaws, a lawsuit had been filed against the company by unhappy stockholders. The plaintiff stockholders, however, did not name the directors as defendants until seven months later. Once they were added, Underbrink and Harrison sought advancement of legal expenses incurred in the lawsuit pursuant to Warrior's mandatory advancement provision. Warrior, which had since been acquired by another company, denied the advancement request and counterclaimed that the bylaw provisions granting advancement were void *ab initio* because the directors had breached their fiduciary duties in adopting them. Warrior argued that Underbrink and Harrison were interested in the implementation of bylaws because they benefited directly from

civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.

DEL. CODE ANN. tit. 8, § 145(f) (2009). For a theoretical elucidation of the Delaware legislature's responsiveness to case law developments—and the implications of such responsiveness for federalism generally—see Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209 (2006).

116. No. 2982-VCP, 2008 Del. Ch. LEXIS 65 (Del. Ch. May 30, 2008).

the mandatory advancement provision and because the bylaws were not fair to Warrior. As a result, according to Warrior, the 2006 Bylaws were the product of self-dealing and should be subject to entire fairness review. Underbrink and Harrison countered that the more deferential business judgment review was appropriate.¹¹⁷

The Court sided with Underbrink and Harrison, holding that the mandatory advancement bylaw was valid because Underbrink and Harrison faced “nothing more than an imminent threat of litigation” at the time the board adopted the bylaw and because the bylaw only “requires the corporation to advance litigation costs sometime in the future.”¹¹⁸ In reaching this conclusion, the Court identified the two relevant Delaware precedents—*Havens v. Attar*¹¹⁹ and *Orloff v. Shulman*¹²⁰—and explicitly cast those cases as the two poles guiding its decision. Specifically, the Court stated that the “issue presented in this case is whether *Orloff* or *Havens* is more apposite in determining the appropriate standard of review to apply”¹²¹ Given the significance of those cases, we review them here.

In *Havens*, a family holding a minority stake in a company, as well as one of four seats on the company’s board of directors, challenged an interrelated set of transactions approved by the other directors—*i.e.*, the majority directors—as consti-

117. The business judgment rule has both a procedural and substantive function. “Procedurally, the initial burden is on the . . . plaintiff to rebut the presumption of the business judgment rule”—which the plaintiff does by showing by a preponderance of evidence that directors breached the fiduciary duty of care or loyalty. *McMullin v. Beran*, 765 A.2d 910, 917 (Del. 2000). “Substantively, if the . . . plaintiff fails to meet that evidentiary burden, the business judgment rule attaches and operates to protect the individual director-defendants from personal liability for making the board decision at issue.” *Id.* (internal citations omitted). The purpose of the business judgment rule is to ensure that a court will not “second guess” the business judgments of corporate fiduciaries unless a plaintiff makes sufficient allegations. *See Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993). When a plaintiff so rebuts the application of the business judgment rule, the burden shifts to the defendant fiduciaries to show the “entire fairness” of the challenged decision or transaction—which is a two-pronged test requiring fair dealing and a fair price (or terms). *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983).

118. *Underbrink*, at *50, *54.

119. No. 15134, 1997 Del. Ch. LEXIS 12 (Del. Ch. Jan. 30, 1997).

120. No. 852-N, 2005 Del. Ch. LEXIS 184 (Del. Ch. Nov. 23, 2005).

121. *Underbrink*, 2008 Del. Ch. LEXIS 65, at *49.

tuting self-dealing, waste, and usurpation of a corporate opportunity. After the minority stockholders filed the litigation, the majority directors voted to advance themselves expenses in connection with the litigation. The company did not have a mandatory advancement provision in place, and the majority directors took turns approving advancement of expenses for each other, with each majority director abstaining from the vote relating to his or her own advancement. The plaintiffs, seeking a preliminary injunction of the advancement, challenged these votes as a breach of the duties of care and loyalty, arguing on the latter point that “each of the three separate votes, taken to approve the advancement of expenses for the individual directors, was invalid, having been approved by a majority consisting solely of interested directors.”¹²² The Court first noted that a decision by directors to advance themselves expenses absent a contractual provision is subject to the presumption of the business judgment rule, unless a plaintiff successfully rebuts that presumption.¹²³ The Court next concluded that the plaintiffs in *Havens* were likely to succeed on their claim that the advancement approvals violated the majority directors’ duty of care and was not entirely fair, and that an injunction was therefore appropriate.¹²⁴ The Court’s duty of care determination was based on the directors’ failure to provide any evidence suggesting that they “consider[ed] the potential magnitude of expenses or damages or the ability of the defendant directors to repay any funds ultimately advanced.”¹²⁵ The Court did not reach, however, the minority stockholders’ loyalty claim.¹²⁶

122. *Havens*, 1997 Del. Ch. LEXIS 12, at *44-45.

123. *Id.* at *43, *46.

124. *Id.* at *46-47. In reaching this conclusion as to the directors’ care, the Court agreed with the plaintiffs’ argument that under *Advanced Mining Systems v. Fricke*, 623 A.2d 82 (Del. Ch. 1992), directors must, when advancing expenses in the absence of a mandatory advancement provision and in order to comply with their duty of care, “evaluate (1) the potential damages to be paid in the event that the directors are found not to ultimately be entitled to indemnification, (2) an estimate of attorneys’ fees and (3) the assets of each director to determine whether the directors could pay potential damages and repay litigation expenses”—and that the majority directors had not done so in *Havens*. See *Havens*, 1997 Del. Ch. LEXIS 12, at *41-42 (internal citations omitted).

125. *Id.* at *46.

126. For more discussion on this point, see *infra* note 136.

Orloff arose in a factual context somewhat similar to the one in *Havens*: the minority stockholders of a closely held company brought an action against the majority stockholders and their affiliated directors challenging a series of corporate transactions. As the Court described, the parties had a “long and acrimonious history of litigation”: from 1992 to 1998, the parties were enmeshed in litigation in New York; in January 2004, the minority stockholders filed an action in the Delaware Court of Chancery under Section 220 of the DGCL to obtain information from the company; in August 2004, the majority stockholders filed an action against the minority stockholders in New York; and in November 2004, the minority stockholder plaintiffs filed the Delaware action leading to the *Orloff* decision.¹²⁷ In March 2004, while the plaintiffs’ Section 220 action was pending, the majority directors adopted an amended set of bylaws giving the company’s directors a right to advancement. The plaintiffs challenged the validity of these bylaws, arguing that “the defendants approved each of these provisions under the threat of imminent litigation, and breached their fiduciary duties by self-interestedly protecting themselves against litigation that they knew would soon name them as defendants.”¹²⁸ The Court rejected this claim, reasoning that “the law of Delaware is clear on the permissibility of advancing legal fees” and that “[t]his is especially true when, as here, the plaintiffs challenge the adoption of a bylaw that requires the corporation to advance litigation costs sometime in the future rather than challenging the directors’ decision to advance particular litigation expenses.”¹²⁹ The Court went on to explain that “bylaw amendments are presumed to be valid unless they are unreasonable,” that the “plaintiffs have pleaded no facts which suggest that the bylaw amendment at issue is unreasonable in this case,” and “further scrutiny” was therefore not warranted.¹³⁰

As described above, Vice Chancellor Parsons noted that the issue in *Underbrink* was which of *Havens* or *Orloff* was “more apposite.” He concluded that “[t]he facts of this case more

127. *Orloff v. Shulman*, No. 852-N, 2005 Del. Ch. LEXIS 184, at *4-5 (Del. Ch. Nov. 23, 2005).

128. *Id.* at *21.

129. *Id.* at *49.

130. *Id.* at *50.

closely resemble the situation in *Orloff*, [therefore,] *Orloff* provides the applicable standard.”¹³¹ Vice Chancellor Parsons explained that none of the findings before him served to “show Underbrink and Harrison faced something more than an ‘imminent threat of litigation’ . . . such that the Board, when it enacted the 2006 Bylaws, was in fact advancing expenses for a particular proceeding.”¹³² In the ensuing discussion, the Court emphasized no less than six times that Harrison and Underbrink had faced only “an imminent threat” of litigation when implementing the 2006 Bylaws—ending with the conclusion that “[t]hus, as in *Orloff*, . . . Warrior is ‘challeng[ing] the adoption of a bylaw that requires the corporation to advance litigation costs sometime in the future rather than challenging the directors’ decision to advance particular litigation expenses.”¹³³ The Court ended its analysis by observing that under *Orloff*, the advancement bylaw would be valid unless unreasonable and that “[t]he mandatory advancement provision was passed as part of updating Warrior’s bylaws in preparation for the SPO . . . and there is no suggestion the provision is otherwise unreasonable.”¹³⁴

The result in *Underbrink* is arguably correct, on the rationale that the plaintiffs alleged no facts sufficiently rebutting the application of the business judgment rule. Unfortunately, the Court’s abridged reasoning—characterizing *Orloff* and *Havens* as antipodes and choosing *Orloff* as “provid[ing] the applicable standard”—creates some ambiguity about the essence of its analysis. To our minds, the Court was addressing two distinct issues that would determine which standard of review would apply, both of which turned on the factual determination of whether there was more than an imminent threat of litigation. First, in *Havens*, a critical issue was whether an advancement of particular litigation expenses was occurring because the duty of care analysis would be materially different if that were the case. If directors have advanced particular litigation expenses, then, under *Havens*, the business judgment presumption would be rebutted if the directors who approved the

131. *Underbrink v. Warrior Energy Servs. Corp.*, No. 2982-VCP, 2008 Del. Ch. LEXIS 65, at *49-50 (Del. Ch. May 30, 2008).

132. *Id.* at *50.

133. *Id.* at *54 (citing *Orloff*, 2005 Del. Ch. LEXIS 184, at *49).

134. *Underbrink*, 2008 Del. Ch. LEXIS 65, at *54.

advancement failed to consider the magnitude of the advanced expenses and the defendant directors' ability to repay. In *Underbrink*, however, a duty of care allegation was not made and expenses were *not* being advanced for a particular proceeding. We view this as the basis for the Court's determination that *Havens* did not apply. Second, under *Orloff*, allegations that a mandatory advancement bylaw was adopted under a threat of imminent litigation without more are insufficient to invoke the entire fairness standard of review. In *Underbrink*, as in *Orloff*, nothing more than this type of threat was alleged; thus *Orloff* was directly on point and militated against applying the entire fairness standard. We view this as the import of the Court's statement that *Orloff* provided the applicable standard. Interpreted in this way, the Court's statement that *Orloff* "provides the applicable standard" because the "facts of this case more closely resemble the situation in *Orloff*" makes sense.

The Court's condensed reasoning, however, and particularly its emphasis that only an imminent threat of litigation existed, leaves *Underbrink* open to another interpretation. That is, *Underbrink* could be interpreted as reading *Havens* and *Orloff* together to create a temporal rule for when entire fairness review will apply to a decision by directors to grant themselves expenses: if litigation against the directors is only imminent when they implement an advancement bylaw, entire fairness will not apply, but if directors are advancing themselves expenses for a particular ongoing proceeding, entire fairness review may apply.

Interpreting *Underbrink* to create this temporal rule would be inconsistent with precedent. The holdings in *Havens* and *Orloff* quite arguably had much less to do with the timing of when the directors in those cases acted than with the quality of the facts alleged in support of the self-dealing claims. In *Havens*, the Court, although it applied entire fairness on duty of care grounds, never reached the self-dealing claim. But the self-dealing claim nonetheless there seemed to have some color, and in a manner not contingent upon the timing of when the directors acted: according to the plaintiff, after the directors had embarked on a course of self-dealing and waste and the diversion of a corporate opportunity to a related company, the directors, who did not otherwise enjoy a mandatory right to advancement, proceeded to advance each other expenses. In *Orloff*, by contrast, the majority directors appeared

simply to be the target of protracted litigation pursued by a disgruntled stockholder, who had stated nothing more than conclusory allegations about the bylaw in that case. As the Court there said, the “plaintiffs had pleaded *no facts* which suggest that the bylaw amendment at issue is unreasonable.”¹³⁵ In short, the lesson from *Orloff* and *Havens* (to the extent a lesson can even be drawn from *Havens*¹³⁶) seems to be that entire fairness will be triggered not based particularly on when direc-

135. *Orloff*, 2005 Del. Ch. LEXIS 184, at *50. For this reason, we disagree with the Court’s statement in *Underbrink* that the *Orloff* “court limited its holding . . . to situations in which ‘plaintiffs challenge the adoption of a bylaw that requires the corporation to advance litigation costs sometime in the future rather than challenging the directors’ decision to advance particular expenses’—a statement that seems to overlook the *Orloff* Court’s references to the quality of the facts alleged. See *Underbrink*, 2008 Del. Ch. LEXIS 65, at *47.

136. To be sure, in a later decision in *Havens* denying a motion for reargument by the defendants, Chancellor Chandler occasionally cast the first *Havens* decision as a duty of loyalty decision. See *Havens v. Attar*, No. 15134, 1997 Del. Ch. LEXIS 147, at *5 (Del. Ch. Nov. 5, 1997) (“I found preliminarily that plaintiffs, by alleging that defendants were interested in the decision to advance funds, would be likely to rebut the presumptions of the business judgment rule.”); *id.* at *11, *12 (referring to the board members as “interested”); *id.* at *12 n.18 (“Interested directors. . . are not provided with absolute authority to advance expenses to themselves pursuant to a vote taken after their interest is established”). Of course, in other portions of the decision, the Chancellor also cast the case as having been a duty of care case. See *id.* at *1 (stating that the directors previously had not shown “that their decision to advance litigation expenses to themselves was the product of informed business judgment”); *id.* at *3 (stating that, previously, the “directors were unable to show any evidence that they considered any details of the decision they were about to make”) (internal citations omitted). In our view, the first decision hinged on the defendants’ duty of care. Indeed, the critical paragraph in that decision setting forth the Court’s holding read as follows:

Plaintiffs have alleged that the defendants breached their fiduciary duty of care by failing to consider the potential magnitude of expenses or damages or the ability of the defendant directors to repay any funds ultimately advanced. While the standard of care applicable to the fiduciary duty of care is gross negligence, defendants have not pointed to any evidence that would allow me to conclude, on the basis of the facts before me, that plaintiffs would face even a remote chance of failing on the merits. For this reason, I conclude that plaintiffs have demonstrated they will be likely to rebut the presumptions of the business judgment rule and that defendants, unable to provide evidence that they considered any details of the decision they were about to make, will be unable to show that the decision was entirely fair.

tors implement advancement rights, but when plaintiffs sufficiently plead facts signaling that the implementation of advancement rights was, based on the broader context, an act of self-dealing.¹³⁷ Fundamentally, then, *Underbrink* stands for the proposition that the plaintiffs needed to allege something more than the threat of imminent litigation to rebut the business judgment presumption with respect to the adoption of a mandatory advancement bylaw—and that pending litigation, although not necessary, *might* have been sufficient to create that “something more.”¹³⁸

See Havens v. Attar, No. 15134, 1997 Del. Ch. LEXIS 12, at *46 (Del. Ch. Jan. 30, 1997). Even if, however, the portion of the *Havens* case concerning advancement could be said to have been based on the duty of loyalty rather than care, we believe that it is still factually distinguishable from *Underbrink* on a basis other than whether litigation had been filed when the directors acted—including relating to the Court’s refusal to dismiss the other fiduciary duty claims in that case.

137. Indeed, as a normative matter, it is debatable whether the application of entire fairness *should* turn on whether litigation has been filed at the time directors implement a mandatory advancement bylaw. One can easily imagine a “worse” set of facts than existed in *Orloff*, and which would permit a plaintiff to make more than a conclusory set of allegations: for example, if directors engage in a series of self-dealing actions and preliminarily implement a mandatory advancement bylaw to protect themselves from litigation that will ensue, it seems the bylaw should be subject to challenge. A temporal test would seem to make it impossible for a plaintiff to challenge the directors’ provision of advancement rights for themselves until the directors actually advance expenses in the face of a pending litigation—a seemingly arbitrary result, untethered to what makes the advancement bylaw most objectionable.

138. In *Havens*, the Court reviewed the defendant directors’ decision to advance each other expenses—in the absence of a mandatory advancement bylaw or provision—based on a business judgment rule/entire fairness analysis. In *Underbrink* and *Orloff*, however, the Courts noted that the bylaws were not “unreasonable,” even though the plaintiffs had challenged the bylaws on entire fairness, rather than reasonableness, grounds. *See Underbrink*, 2008 Del. Ch. LEXIS 65, at *54 (stating that “there is no suggestion the provision is . . . unreasonable” and that the plaintiff “has not shown any basis for me to conclude the passage of the 2006 Bylaws . . . would not be fair to the corporation”); *Orloff*, 2005 Del. Ch. LEXIS 184, at *50 (“The plaintiffs have pleaded no facts which suggest that the bylaw amendment at issue is unreasonable in this case”). Both cases, in mentioning the reasonableness of the bylaws at issue, cite to *Frantz Manufacturing Co. v. EAC Industries*, 501 A.2d 401, 407 (Del. 1985), which noted that “bylaws must be reasonable in their application.” These statements in *Underbrink* and *Orloff* could be seen as raising a question as to whether courts will fundamentally review *bylaws* (as opposed to simply a decision to advance expenses, as occurred in *Havens*) on a

Of course, it is also entirely possible that a temporal test is precisely what Vice Chancellor Parsons had in mind and what Delaware law could definitively embrace. After all, such a rule is more protective of directors and may promote Delaware's policy in favor of advancement and indemnification rights. Until further guidance is provided, uncertainty may persist as to how *Havens*, *Orloff*, and *Underbrink* should be most properly interpreted.

F. *Direct Warnings from the Delaware Courts on Advancement and Indemnification*

In many ways, the recent advancement and indemnification cases are a collection of implicit tips and warnings to drafters, litigators, and directors. The bulk of this article extracts their holdings and logic, which should be taken into account in drafting and litigation tactics. The following cases, however, do not need to be scrutinized to understand the court's message—the court issued direct warnings to the applicable parties.

In *Gary v. Beazer*,¹³⁹ Vice Chancellor Strine warned drafters about the dangers of using boilerplate language. At dispute was whether the language “pay as incurred” in an attorneys’ fees clause in an employment contract granted the right to advancement. It was unclear whether the phrase meant the indemnitee was entitled to payment as costs were incurred (i.e., advancement) or whether the indemnitee was simply entitled after litigation ended to costs that had been incurred (i.e., indemnification).¹⁴⁰ Vice Chancellor Strine avoided the “inter-

reasonableness, rather than fairness, basis. But the fairness of the circumstances surrounding a decision to *adopt or amend* bylaws is arguably a different question from the reasonableness of bylaws *in their application*. Cf. *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) (invalidating the adoption of a bylaw under the heightened standards of *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) and *Blasius Industries v. Atlas Corp.*, 564 A.2d 951 (Del. 1988), as opposed to invalidating the adoption under a reasonableness standard).

139. 2008 Del. Ch. LEXIS 72 (Del. Ch. June 11, 2008) (Strine, V.C.).

140. The U.S. District Court for the District of Maryland had previously interpreted “as incurred” in the form employment agreement as creating a right to advancement, but in *Gary v. Beazer* the parties had modified the form language, which clouded the intended meaning of “as incurred.” *Id.* at *11 n.10 (discussing *Miller v. U.S. Foodservice, Inc.*, 405 F. Supp. 2d 607, 614 (D. Md. 2005)).

pretive quagmire” because he found that the relevant provision in the employment contract had terminated after the employee had been fired for cause. Nevertheless, the Vice Chancellor commented on the disputed language, which he noted had been “adapted from a form appearing in hundreds of employment contracts filed with the SEC.”¹⁴¹ He warned drafters that “the attorneys’ fees clause is a good example of the unclear contractual language that can be created by starting with murky form language (a.k.a., “bad boilerplate”) and making ill-chosen modifications that further muck up the already unclear form language.”¹⁴²

In *Barrett v. American Country Holdings, Inc.*,¹⁴³ Vice Chancellor Strine fired another warning shot to directors who baselessly resist advancement and indemnification obligations: doing so may expose them to a claim for corporate waste. In *Barrett*, the defendant corporation, Kingsway, accused its former directors of intentional fraud. Kingsway’s charter clearly provided the former directors advancement rights in defending this claim. Kingsway’s board refused to advance expenses, however, instead urging the former directors to join Kingsway in a scheme under which the former directors would settle with Kingsway, which would, in turn, allow Kingsway to pursue a large recovery from its D&O insurance carrier. Critically, Kingsway knew that agreeing to this settlement would cause the former directors to breach their contracts with the D&O insurer.

Confronted with this “outlandish” scheme,¹⁴⁴ the Court held that Kingsway had a clear obligation to advance expenses. The Court’s language was unequivocal:

Sadly, Kingsway’s stockholders will end up paying for this time- and resource-wasting litigation. In accord with the Supreme Court jurisprudence mandating “fees on fees” in ad-

141. *Id.* at *11.

142. *Id.* at *2.

143. 951 A.2d 735 (Del. Ch. 2008).

144. Vice Chancellor Strine was critical of Kingsway’s outside counsel, who devised the underlying strategem and litigated the advancement suit. For example, he consistently referred to Kingsway’s outside counsel by name and made a “sting[ing]” analogy between Kingsway’s scheme and Kingsway’s counsel agreeing to “such voluntary and public judgments in malpractice cases as a basis for permitting plaintiffs to go after their firms’ malpractice carriers.” *Id.* at 744.

vancement actions, Kingsway must pay all the fees and expenses of the [f]ormer [d]irectors' counsel. And, an all too often ignored factor in these kind of cases is that the stockholders will also end up footing the bill for the company's own counsel. The accumulation of cases like this, where the stockholders get it coming and going because of the corporation's refusal to honor mandatory advancement contracts, is regrettable, and at some point, a case of sufficient dollar value will arise such that a board is sued for wasting the corporation's resources by putting up a clearly frivolous defense.¹⁴⁵

The Court added that there is a simple answer for corporate boards who regret having to advance expenses to officials believed to have engaged in serious wrongdoing: "fix what they can by revising the corporation's advancement obligations on a going-forward basis."¹⁴⁶ The solution is not to "breach a contract because you do not like its terms."¹⁴⁷

145. *Id.* at 746-47. Vice Chancellor Strine is not alone in his frustration on this issue—Vice Chancellor Lamb expressed a similar sentiment in the 2006 case *Radiancy, Inc. v. Azar*: "To decide . . . [not to grant fees on fees] when the plaintiff has so clearly violated its contractual duty to provide advancement would be to weaken *Section 145* of the Delaware corporate law, and to encourage the very kind of reflexive challenges to advancement claims that have proliferated in such number before this court recently." No. 1547-N, 2006 Del. Ch. LEXIS 13, at *14-15 (Del. Ch. Jan. 23, 2006).

146. *Barrett*, at 747 n.39.

147. *Id.* Vice Chancellor Parsons issued a similar reminder in *Martinez v. Regions Fin. Corp.*, 2009 Del. Ch. LEXIS 143 (Del. Ch. Aug. 6, 2009), by invoking the principle that "[T]here is no requirement that advancement provisions be written broadly or in a mandatory fashion. But when an advancement provision is, by its plain terms, expansively written and mandatory, it will be enforced as written." *Id.* at *50 (quoting *Lillis v. AT&T Corp.*, 904 A.2d 325, 331-32 (Del. Ch. 2006)). In *Martinez*, the plaintiff, Martinez, a former executive of the defendant corporation, alleged that the defendant had breached her employment agreement by not providing certain compensation when her employment terminated. She also sought advancement of her legal fees and expenses for her claims under the employment agreement, which provided that the defendant corporation would "pay as incurred, to the fullest extent permitted by law, all legal fees and expenses which the Executive may reasonably incur. . . ." in connection with certain legal actions. *Id.* at *13-14. The defendant corporation argued that Martinez's fees and expenses for the underlying claims on the employment agreement were not "reasonably" incurred because the Seventh Circuit Court of Appeals had recently rejected a similar claim. *Id.* at *26-27. Vice Chancellor Parsons rejected this argument, reasoning not only that the issue raised by Martinez had not been decided by a Delaware court and that the agreements involved in the two cases were different in some respects, *id.* at *51 n.65, but also that

Although certain areas of the case law will require further clarification, the recent cases go a long way in illuminating for corporations how to avoid such undesirable results.

certain provisions of Martinez's employment agreement—such as language that she was entitled to advancement “regardless of the outcome” and for “all” legal expenses—rendered the defendant's position untenable, *id.* at *48. In short, according to the Court, the defendant could have contracted for the narrower interpretation it advocated in litigation—but had not.