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Fee Advancement Considerations Arise From Recent Delaware and Third Circuit Decisions

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Recent decisions by the US Court of Appeals for the Third Circuit and the Delaware Court of Chancery have raised important issues regarding fee advancement bylaws or policies of Delaware corporations.

Indemnification refers to the right of officers and directors of a corporation to be reimbursed by the corporation for losses, including legal fees, incurred in legal proceedings related to their employment by that corporation. Advancement refers to the right of those officers and directors to receive immediate funds from the corporation to pay for legal fees and expenses prior to indemnification, conditioned on the return of the funds if the officer or director is ultimately determined to be ineligible for indemnification.

Under 8 Del. C. § 145(c), Delaware corporations are obligated to have policies indemnifying officers and directors for reasonable expenses, including attorneys' fees, incurred in legal proceedings arising out of those roles where they are successful on the merits of their defense of those proceedings. In contrast to the mandatory indemnification obligation under § 145(c), fee advancement is not mandatory, but permitted under § 145(e), which states that corporations "may" advance fees for officers and directors "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 noted, mandatory indemnification obligations under § 145(c) attach only to an "officer or director" of a corporation. Many corporations nevertheless have policies that exceed Delaware statutory requirements for indemnification and cover additional persons. Delaware corporations may permit indemnification under § 145(a) for "any person" (including officers, directors, employees and agents) who acts in good faith and in a manner reasonably believed to not be opposed to the best interests of the company. Some companies have chosen to limit the scope of their bylaws and policies related to indemnification and advancement to cover only officers and directors.

The Third Circuit was recently confronted with the issue of who is an officer when that term is undefined. *Aleynikov v. Goldman Sachs Group, Inc.*, 765 F.3d 350 (3d Cir. 2014). A former vice president at Goldman Sachs alleged to have stolen proprietary code from the company sought advancement of fees for defending a series of criminal actions against him. The District Court found that "officer" included Aleynikov and granted summary judgment in his favor, holding that the terms were unambiguous but, even if they were ambiguous, were to be construed against the company that drafted them based on Delaware's strong public policy in favor of advancement of fees. *Aleynikov v. Goldman Sachs Group, Inc.*, No. 12-5994(KM), 2013 WL 5739137 (D.N.J. 2013).

The Third Circuit reversed, holding that the definition of "officer" at Goldman, a third of whose employees have at least the title of "Vice President," was ambiguous and that summary judgment was inappropriate at that time. The court held that, under Delaware law, the bylaws should not be construed against the drafter (the corporation) under the

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doctrine of *contra proferentem* because it would be improper to do so where the issue is the existence, not the scope, of rights under the contract. Further, the court determined that Goldman's evidence of course of dealing and trade usage were improperly discounted by the district court and presented material issues of fact for a jury. On remand, the district court denied Aleynikov's renewed summary judgment motion based on the Third Circuit's determination that the state of the record did not allow the ambiguity of the term "officer" to be resolved on summary judgment. *Aleynikov v. Goldman Sachs Group, Inc.*, No. 12-5994(KM-MAH), 2015 WL 225804 (D.N.J. Jan. 16, 2015).

While defending an officer's or director's claim for fee advancement based on whether he or she is covered may be a viable strategy where that coverage is ambiguous, defenses based on whether that person would be ultimately eligible for indemnification are unlikely to succeed under Delaware law. Recently, the Delaware Court of Chancery was confronted with the issue of whether an officer who pled guilty to insider trading based on his status as a tippee should be entitled to fee advancement for the defense of parallel civil charges where the indemnification policy had a carve-out specifically excluding insider trading from indemnification. *Holley v. Nipro Diagnostics, Inc.*, C.A. No. 9679-VCP, 2014 WL 7336411 (Del. Ch. 2014).

The Court of Chancery held that the officer was entitled to advancement of fees despite his guilty plea, the carve-out and a provision limiting indemnification to conduct "by reason of the fact" that he was an officer of the company. The court emphasized that advancement is to be considered independently of indemnification and that an officer is not required to prove that he will be indemnified in order to obtain advancement. Despite the company's arguments that indemnification is not permitted under the policy, the court concluded that that plaintiff might nevertheless be indemnified. The court determined that the officer's guilty plea did not foreclose success on the merits, because the civil US Securities and Exchange Commission (SEC) action involved conduct beyond that admitted in the guilty plea and the officer could still succeed on at least part of these additional claims.

In regard to the requirement that the conduct be "by reason of the fact" he is an officer, the court determined that litigation regarding tips of inside information in breach of the defendant's fiduciary duty may be "by reason of the fact" of the defendant's employment because that employment is the source of the fiduciary duty that was allegedly breached. While the policy explicitly excluded insider trading from indemnification coverage, the court concluded that reading such a policy to exclude indemnification related to meritless insider trading claims would violate the mandatory indemnification provisions of DGCL 145 (c). Therefore, the court read this clause as prohibiting indemnification only for insider trading violations, not allegations, and would not prohibit advancement.

The decisions in *Aleynikov* and *Holley* provide some practical guidance when seeking advancement of fees:

- A litigant will not be considered an "officer" for fee advancement simply based on his or her title. Instead, where that term is ambiguous, courts may look at the corporation's course of dealing and other factors in determining whether to allow fees to be advanced.
- Where bylaws tie fee advancement to indemnification, officers and directors need not prove that they will be indemnified to obtain fee advancement. Instead, fees may be advanced where success on the merits and future indemnification is possible.
- Losing or conceding on the merits in parallel actions may not foreclose fee advancement where the allegations in the allegations are not identical.
- "By reason of the fact" is language that may not exclude activity related to wrongdoing arising from duties owed to a corporation such as breaches of fiduciary duty for the purpose of fee advancement.
- A Delaware corporation cannot preclude indemnification for entire categories of wrongdoing, regardless of whether the officer or director prevails on the merits. Therefore, carve-outs for certain categories of activity, such as insider trading, should not affect eligibility for fee advancement where success on the merits is still possible.

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