WILMER CUTLER PICKERING
HALE AND DORR LLP

INVESTIGATIONS AND
CRIMINAL LITIGATION UPDATE

July 29, 2005

Non-traditional Approaches to Indemnification: The Dubious Value of Arbitration Clauses in Employee Undertakings

Delaware law requires corporations to reimburse the legal expenses of current or former officers and directors arising out of actual or threatened civil or criminal actions related to their employment. In addition, most companies also have corporate by-laws that require the advancement of legal expenses in these circumstances, subject to the legal requirement that the proposed indemnitee sign an undertaking.

Traditionally, the undertaking has been a simple document principally containing two representations: (1) that the indemnitee, at all times, acted in good faith and in the best interest of the corporation while so employed; and (2) that the indemnitee will repay any advancement of legal expenses if it is ultimately adjudicated that he or she had not acted in good faith and in the best interests of the corporation. However, many corporations are now rethinking their indemnification and advancement obligations in light of the financial burden they represent in complex business litigation and regulatory enforcement matters, as well as their impact upon a company's relationship with government regulatory and enforcement bodies.

The Department of Justice (DOJ) has grown increasingly impatient with companies advancing legal expenses to targeted employees. In fact, DOJ policy specifically states that indemnification and advancement—beyond that which is explicitly required by state law—may be considered by the prosecutor in weighting the extent and value of the corporation's cooperation.[1] Likewise, the Securities and Exchange Commission (SEC) recently sanctioned Lucent Technologies for its decision to provide *permissive* indemnification (not specifically required by the company's by-laws) to certain employees.[2]

In light of these newly aggressive DOJ and SEC policies, there is an understandable desire on the part of corporations to rethink their advancement obligations. One proposed solution is to insert a clause in the undertakings that would allow the corporation to commence an arbitration proceeding against the indemnitee(s), seeking to terminate indemnity/advancement rights based upon their bad faith actions. However, as discussed more fully below, the value of such an arbitration clause is dubious and the exercise of such a clause may actually be counter to the corporation's interests in many—if not most—instances.

Negotiation of the Arbitration Clause

As an initial matter, negotiation of the undertaking will likely be complicated by the inclusion of an arbitration clause. The individual seeking advancement of legal expenses will likely resist the inclusion of such a clause, viewing it as a diminution of his or her statutory and contractual rights. Thus, the corporation will likely face a difficult challenge in the negotiation of the undertaking in order to obtain the individual's acceptance of the arbitration clause. Should the corporation attempt to force the issue by, for example, refusing to share relevant documents and information important to the individual's defense, such

1. *Memorandum from Deputy Attorney General Larry Thompson to Heads of Department Components and U.S. Attorneys*, Principles of Federal Prosecution of Business Organizations at **http://www.usdoj.gov/dag/cftf/business_organizations.pdf** (January 20, 2003).

2. *Securities and Exchange Commission v. Lucent Technologies, Inc.*, 82 S.E.C. Docket 3224, 2004 WL 1091129 (May 17, 2004).

wilmerhale.com

Baltimore
Beijing
Berlin
Boston
Brussels
London
Munich
New York
Northern Virginia
Oxford
Palo Alto
Waltham
Washington

tactics will undoubtedly create a contentious atmosphere and strain the relationship between the parties. This situation may be especially uncomfortable where the corporation needs the cooperation of the individual in defending against pending or threatened actions.

The Corporation's (Uncomfortable) Position As Plaintiff in an Arbitration Proceeding to Terminate an Indemnitee's Rights

Even assuming that an arbitration clause is successfully negotiated with limited damage to the relationship between the parties, there will be a myriad of pitfalls if the corporation decides to exercise the clause. For example, absent a corporate by-law presumptively requiring advancement, the corporation should have made an informed business judgment that such advancement, on balance, would be likely to promote the corporation's interests.[3] Thus, the corporation's attorney may need to explain the inconsistency of the corporation's position to the arbitrator (i.e., why the advancement was granted in the first instance and what has happened to materially affect that determination). Absent significant *new* facts justifying the corporation's position, the arbitrator may well view the corporation's actions as cynical cost-savings tactics. The corporation may also find itself having to explain its contradictory position in a subsequent shareholder derivative suit for breach of fiduciary duties insofar as the corporation advanced legal fees to an individual who was a bad faith actor while employed by the corporation.

Moreover, the indemnitee will undoubtedly seek access to any relevant internal investigation that may have been conducted by the corporation, thus raising complex privilege and waiver issues (e.g., is such a disclosure or an *in camera* review by the arbitrator a waiver to third parties and government agencies?). Even if the arbitration clause in the undertaking prohibits discovery, the indemnitee will inevitably argue that that any evidence brought forward by the corporation was the fruit of the internal investigation and should be barred absent full disclosure of same.

There are numerous other problems with the corporation acting as a plaintiff, especially where the allegations against the indemnitee involve charges of fraud or violations of securities laws. Such misconduct is seldom the work of one individual, and the arbitration may force the corporation to advocate for the proposition that there was a conspiracy among multiple members of its upper management to engage in illegal behavior. Thus, the impact of the arbitration on any pending government investigation, shareholder suit or derivative action will have to be carefully considered.

One should also not forget the heavy burden a corporation bears in revoking or denying an indemnitee's rights. Delaware courts have expressed a strong preference for advancement and indemnification under Section 145. That preference is fundamental to Delaware's public policy of encouraging capable individuals to serve as corporate officers and directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity will be borne by the corporation they served. Most states have similar statutes to Delaware's and share the same policy concerns.

The weight of this burden does not change simply because the indemnitee's rights are adjudicated in an arbitration proceeding as opposed to a courtroom. Overcoming this burden may be particularly difficult where the corporation is trying to preserve the privilege of its internal investigation and where witnesses are reluctant to cooperate in light of pending criminal investigations.

Finally, the cost and difficulty of such an arbitration proceeding should not be underestimated. Given the stakes involved (an individual's ability to defend oneself against criminal prosecutions) and the former relationship of the parties, the arbitration will almost certainly turn into a contentious and protracted endeavor for both parties. In addition, other indemnitees will probably view the arbitration proceeding with great concern, which could affect the corporation's relationship with those individuals necessary for its defense. In short, while an arbitration clause in an undertaking may seem like a way to simply and inexpensively adjudicate an indemnitee's rights, it may well be neither.

For more information on this issue, please contact:

Robert D. Keefe
617 526 6634
robert.keefe@wilmerhale.com

J. Kevin McCarthy
212 230 8801
kevin.mccarthy@wilmerhale.com

3. *Advanced Mining Systems, Inc. v. Fricke*, 623 A.2d 82, 84-85 (Del. Ch. 1992) (holding that even where indemnification is mandatory under a corporation's by-laws, advancement is not automatic and must be based upon a determination that such advancement is in the interests of the corporation).