Fordham Law Review

Volume 80 | Issue 4 Article 7

March 2012

Fear of Commitment: Why CA, Inc. v. AFSCME Leaves Mandatory Advancement Bylaws Undisturbed

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FEAR OF COMMITMENT: WHY *CA, INC. V. AFSCME* LEAVES MANDATORY ADVANCEMENT BYLAWS UNDISTURBED

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Fiduciary duties bind a board of directors to manage a corporation in the best interests of its shareholders at all times. The prominence of fiduciary duties under Delaware corporate law has led Delaware courts to invalidate corporate contracts that would prevent directors from exercising their fiduciary duties. The Delaware Supreme Court extended this doctrine to bylaws in CA, Inc. v. AFSCME Employees Pension Plan *by invalidating a proposed bylaw that would mandate board action in violation of the board's fiduciary duties.*

At the same time, the CA, Inc. *decision called into question the continued validity of mandatory advancement bylaws. It is well established in Delaware corporate law that corporations may advance the legal expenses of directors defending lawsuits related to their service on a corporate board. Moreover, Delaware courts have broadly upheld directors' advancement rights where a corporation has adopted a bylaw mandating advancement to the full extent of Delaware law.*

This Note examines the contours of fiduciary duty and advancement jurisprudence in Delaware corporate law. Next, it discusses the perceived impact the CA, Inc. *decision has had on the enforceability of mandatory advancement bylaws. It then proposes that the Delaware General Assembly and stakeholders in Delaware corporations should independently take action to protect advancement rights following* CA, Inc. *Finally, this Note concludes that the* CA, Inc. *decision will not disturb mandatory advancement bylaws in light of the particular standard of review employed by the* CA, Inc. *court and cases relating to advancement bylaws.*

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* J.D. Candidate, 2013, Fordham University School of Law; B.S., 2008, Cornell University. I would like to thank my family and friends for their encouragement throughout this process. I would also like to thank my advisor, Professor Sean Griffith, for his guidance. I am especially grateful to Alissa for her patience and invaluable support.

INTRODUCTION

Marc Hermelin joined the board of directors and became CEO of K-V Pharmaceutical Company (KV) in 1975.[1] After two pharmacies reported in 2008 that KV had manufactured and distributed oversized morphine tablets, KV's Audit Committee conducted an internal investigation that culminated in Hermelin's termination.[2]

Following Hermelin's departure, the U.S. Attorney's Office for the Eastern District of Missouri conducted its own investigation of KV's error.[3] As a result, Hermelin ultimately pled guilty to two federal strict liability misdemeanors, resulting in $1.9 million in fines and forfeitures, and a jail term of "30 days or less," of which Hermelin served fifteen days.[4]

During Hermelin's time in the St. Louis County Jail, authorities there recorded Hermelin's conversations with visitors pursuant to the jail's policy.[5] A reporter with *The St. Louis Post-Dispatch* requested access to these recordings and to jail records concerning Hermelin's incarceration to continue the *Post-Dispatch*'s coverage of the imbroglio at KV.[6] When Hermelin initiated a lawsuit to prevent release of the recordings, the Circuit Court of St. Louis County permanently enjoined the release on the ground that the conversations were of a private nature.[7]

Around the time that Hermelin brought suit, his counsel submitted invoices to KV for fees relating to the jail records matter with the expectation that the board would advance Hermelin's legal expenses as provided under an Indemnification Agreement that was executed in 2008

1. Hermelin v. K-V Pharm. Co., No. 6936, 2012 WL 395826, at *2 (Del. Ch. Feb. 7, 2012). KV is a Delaware corporation based in St. Louis, Missouri that markets generic and branded pharmaceutical products. *See About Us*, KV PHARMACEUTICAL, http://www.kvpharmaceutical.com/about_us_landing.aspx (last visited Feb. 23, 2012). Hermelin's father, Victor Hermelin, founded KV in 1942, and the Hermelin family retains control over the firm. *See* Jim Doyle, *Federal Target Quits KV Board*, ST. LOUIS POST-DISPATCH, Nov. 18, 2010, at A1.

2. *Hermelin*, 2012 WL 395826, at *2. This internal investigation discovered that KV had also manufactured additional oversized tablets, including propafenone, an anti-arrhythmic drug, and dextroamphetamine sulfate, a stimulant. *Id.* These drugs could pose safety risks if taken in oversized form. Verified Amended Complaint ¶ 21, *Hermelin*, 2012 WL 395826 (Del. Ch. Oct. 27, 2011) (No. 6936), 2011 WL 5128206; Answer of Defendant K-V Pharmaceutical Company ¶ 21, *Hermelin*, 2012 WL 395826 (Del. Ch. Nov. 10, 2011) (No. 6936), 2011 WL 5617844. KV notified the FDA of its discovery of the oversized morphine sulfate tablets, but it did not report its discovery of the other oversized pills. *Hermelin*, 2012 WL 395826, at *2.

3. *Hermelin*, 2012 WL 395826, at *3.

4. *Id.*

5. *Id.* at *5.

6. *Id.*

7. *Id.*

pursuant to KV's bylaws.[8] When KV denied this request, Hermelin filed a claim against KV seeking the advancement payments.[9]

While the agreement at issue did not provide advancement for legal action initiated by Hermelin,[10] Hermelin argued that he was, in fact, entitled to advancement because he had not initiated the matter but instead "employed the only defense available to him" under the circumstances.[11] Moreover, Hermelin asserted that his lawsuit represented a compulsory counterclaim not excepted under the agreement.[12] KV argued that Hermelin's action for an injunction fell squarely within the exceptions to Hermelin's advancement rights under the agreement.[13] KV also contended that Hermelin's suit did not qualify as a compulsory counterclaim as defined by federal or state law.[14]

Finding KV's interpretation persuasive, the Delaware Court of Chancery ultimately held that Hermelin was not entitled to advancement because the relevant agreement did not afford Hermelin advancement for any "part" of a legal proceeding he initiated.[15] Furthermore, even if the agreement mandated advancement for compulsory counterclaims, Hermelin's action for an injunction fell short of the Court of Chancery Rules' definition of a compulsory counterclaim.[16]

Had Hermelin's agreement indeed mandated advancement in this case, KV's counsel might have found it advantageous to pursue the newly viable argument that compliance with the agreement's advancement provision would cause the board to violate its fiduciary duties.[17] Fiduciary duties require that directors act in the best interests of their shareholders.[18] Here, the board could plausibly argue that it would be gross mismanagement of KV shareholders' wealth to hand over $375,000[19] to a former CEO who had pled guilty to federal crimes and then sued the jail in which he was incarcerated.

This argument became available in this context following the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension*

8. *Id.* at *6–7; *see also* Defendant's Opening Brief Opposing Advancement for the Jail Records Litigation at 6, *Hermelin*, 2012 WL 395826 (Del. Ch. Dec. 27, 2011) (No. 6936), 2011 WL 6934085.

9. *Hermelin*, 2012 WL 395826, at *5 ("Hermelin seeks advancement for his legal fees and expenses in prosecuting an action for injunctive relief against the St. Louis County Jail, where Hermelin was incarcerated following his conviction in the Criminal Matter.").

10. *Id.* at *7

11. *Id.* at *5.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* at *7.

16. *Id.* at *8 (citing DEL. CT. CH. R. 13(a)).

17. *See infra* note 300 and accompanying text.

18. *See infra* Part I.A.1.

19. Opening Pre-Hearing Brief of Plaintiff Marc S. Hermelin in Support of His Claim for Advancement in the "Jail Records Matter" and in Support of His Claim for Fees-for-Fees as to Count I at 2, *Hermelin*, 2012 WL 395826 (Del. Ch. Dec. 27, 2011) (No. 6936), 2011 WL 6934086.

Plan.[20] There, the court considered the validity of a proposed bylaw that would require a board to reimburse expenses reasonably incurred by shareholders in a successful electoral challenge to incumbent directors.[21] In its decision, the court relied on precedent holding that directors' fiduciary duties always supersede contractual obligations,[22] rendering unenforceable agreements that interfere with the exercise of fiduciary duties.[23] Along these lines, the court held the proposed bylaw in *CA, Inc.* invalid because bylaws mandating board action in breach of fiduciary duties are invalid as well, unless they contain a "fiduciary out" provision expressly permitting the board to exercise its duties.[24]

Thus, *CA, Inc.* dictates that a mandatory advancement bylaw lacking a fiduciary out is also invalid, as it would require a board to breach its fiduciary duties by expending corporate funds to defend a disreputable director.[25] Inclusion of a fiduciary out would cure this defect, but it would also permit a board to avoid a clear obligation to advance, thereby gutting the mandatory nature of mandatory advancement bylaws.[26]

This Note explores the impact of the Delaware Supreme Court's decision in *CA, Inc.* on mandatory advancement bylaws. Part I first examines how directors' fiduciary duties came to supersede corporate contracts and explains the *CA, Inc.* court's extension of this doctrine to the bylaw context. It then introduces Delaware's indemnification and advancement regime and describes the scope of mandatory advancement bylaws. Part II explores how the *CA, Inc.* holding conflicts with well-established law that mandatory advancement bylaws lacking fiduciary outs are indeed enforceable. Finally, Part III offers two approaches to protect mandatory advancement should *CA, Inc.* render existing mandatory advancement bylaws invalid. The Note concludes, however, that *CA, Inc.* does not, in fact, invalidate current mandatory advancement bylaws due to the standard of review employed in *CA, Inc.*, and given Delaware precedent enforcing advancement bylaws broadly.

I. BURDENS AND BENEFITS: FIDUCIARY DUTIES AND ADVANCEMENT RIGHTS

Part I begins by reviewing corporate directors' fiduciary duties under Delaware law.[27] Next, it examines Delaware case law invalidating

20. 953 A.2d 227 (Del. 2008); *infra* note 302 and accompanying text (noting a Delaware Vice Chancellor's opinion that an argument such as Hermelin's may be asserted in good faith following *CA, Inc.*); *see also infra* Part I.5.

21. *See infra* Part I.A.5.

22. *See infra* notes 143–48 and accompanying text.

23. *See infra* Part I.A.4.

24. *See infra* notes 151–52 and accompanying text.

25. *See infra* notes 288–91 and accompanying text.

26. *See infra* note 292 and accompanying text.

27. This Note examines Delaware law because Delaware is the state of incorporation of the vast majority of America's most significant corporations and because its corporate law is followed by many other states. *See* DEL. DIVISION CORPS., http://corp.delaware.gov (last

corporate contracts that would preclude directors from exercising their fiduciary duties and the extension of this principle in *CA, Inc.* to mandatory bylaws. It then explains the regime for directorial indemnification and advancement under the Delaware General Corporation Law (DGCL). Part I concludes by describing the contours of a director's advancement entitlement pursuant to a mandatory advancement bylaw.

A. The Primacy of Fiduciary Duties

This section briefly discusses the function and substance of directors' traditional and enhanced fiduciary duties. It then traces a line of decisions in which the Delaware Supreme Court struck down agreements that would require directors to breach their fiduciary duties. Next, it explains the origin of the requirement that merger agreements contain "fiduciary out" provisions to preserve directors' ability to exercise their duties. It concludes by describing the *CA, Inc.* court's decision to invalidate a mandatory bylaw because it would interfere with the discharge of fiduciary duties.

1. The Rationale for Fiduciary Duties

A defining feature of public corporations in the United States is that their ownership and management are independent of each other.[28] This separation of ownership and control, which Adolf Berle and Gardiner Means famously documented in 1932,[29] results from typically dispersed networks of shareholders who lack the resources necessary to manage corporations collectively.[30] As a result, shareholders entrust control of a corporation to a board of directors, which commands a broad power to manage the corporation's "business and affairs."[31]

Despite their expansive power, directors occasionally face situations where they are unsure what course of action is in the best interests of the corporation.[32] Moreover, the interests of shareholders and directors are

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visited Feb. 23, 2012) (noting that more than 50 percent of all U.S. publicly traded companies and 63 percent of the Fortune 500 are incorporated in Delaware).

28. *See, e.g.*, ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (1932) (describing a modern corporation as one "in which a large measure of separation of ownership and control has taken place through the multiplication of owners"). *See generally* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983).

29. *See generally* Berle & MEANS, *supra* note 28.

30. *See* Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 29 (2003) ("[C]onsider the difficulties shareholders would face in acting as the public corporation's central decision-makers. At the most basic level, the mechanical difficulties of achieving consensus amongst thousands of decision-makers impede shareholders from taking an active role.").

31. DEL. CODE ANN. tit. 8, § 141(a) (2001) (providing that "every [Delaware] corporation . . . shall be managed by or under the direction of a board of directors").

32. *See* UniSuper Ltd. v. News Corp., No. 1699, 2005 WL 3529317, at *7 (Del. Ch. Dec. 20, 2005) (illustrating this problem using an example from agency law).

often different.[33] Indeed, given their power, directors may be tempted to act opportunistically, exploiting shareholder wealth for their own gain.[34] This unfortunate prospect gives rise to "agency costs": expenses shareholders bear to ensure the board acts in shareholders' best interests.[35]

As agency costs represent a chief concern of corporate law, identifying strategies to mitigate self-serving directorial conduct has become a central question of legal scholarship.[36] A principal mechanism to address agency costs is the imposition of "fiduciary duties" on directors to guide board decision making when the optimal course of action is unclear.[37] Fiduciary duties exist to ensure that directors eschew self-interest and act in the best interests of shareholders.[38] As a result, Delaware corporate law heavily relies on fiduciary duties to reduce agency costs in public corporations.[39]

2. The Traditional Duties of Care and Loyalty

Directors' fiduciary duties have traditionally fallen into two broad categories: the duty of care and the duty of loyalty.[40] A director is always

33. *See* BERLE & MEANS, *supra* note 28, at 6 (noting that the separation of ownership and control "produces a condition where the interests of owner and of ultimate manager may, and often do, diverge"); *see also* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1433 (1985) (noting the potential for "self-dealing or possible self-aggrandizing behavior" by agents, including corporate directors).

34. *See, e.g.*, Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J. CORP. L. 409, 411–12 (2009) (noting that "an incentive exists [for directors] to exploit . . . shareholder wealth in the form of higher management salaries, bonuses, and perquisites" and that "the risk of [board] exploitation of shareholder wealth and investment is great").

35. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (defining agency costs generally as the sum of "the monitoring expenditures by the principal[,] the bonding expenditures by the agent[, and] the residual loss"); *cf.* Bainbridge, *supra* note 30, at 6 ("Agency costs arise because agents have incentives to shirk, which we might define as any action by a member of a production team that diverges from the interests of the team as a whole.").

36. *See, e.g.*, BERLE & MEANS, *supra* note 28; Brudney, *supra* note 33; Fama & Jensen, *supra* note 28; Jensen & Meckling, *supra* note 35.

37. *See* UniSuper Ltd. v. News Corp., No. 1699, 2005 WL 3529317, at *7 (Del. Ch. Dec. 20, 2005) ("Fiduciary duties exist in order to fill the gaps in the contractual relationship between the shareholders and directors of the corporation."); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92–93 (1991) (noting that "the fiduciary principle is a rule for completing incomplete bargains in a contractual structure").

38. *See* Christopher Fawal, Note, *Protecting Shareholder Access to Director Elections: A Response to* CA, Inc. v. AFSCME *Urging the Adoption of a* Blasius *Standard of Review for the Exercise of a Fiduciary-Out Clause*, 59 DUKE L.J. 1457, 1482 (2010) (describing the "logic" of fiduciary duties).

39. *See* Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 783 (2011).

40. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (holding, despite precedent characterizing directors' fiduciary duty as a "triad" comprising good faith, due care, and loyalty, that there are only two fiduciary duties: the duty of care and the duty of loyalty); *see also infra* note 48 (describing the duty of good faith as a duty attendant to the duty of loyalty).

expected to act in accordance with these basic duties.[41] The duty of care requires a director to use an "amount of care which ordinarily careful and prudent men would use in similar circumstances."[42] The Delaware Supreme Court has interpreted this to mean that a director must consider all material information reasonably available before he makes a business decision.[43]

In cases alleging breach of the duty of care, courts employ the business judgment rule, which presumes that a director making a business decision "'acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'"[44] Indeed, a court will presume a director has exercised sound business judgment as long as the challenged business decision can be attributed to a rational purpose.[45] Therefore, only conduct amounting to gross negligence comprises a breach of the duty of care.[46]

The duty of loyalty requires a director to refrain from conduct that would deny a benefit to the corporation and its stockholders.[47] Essentially, the duty of loyalty prevents a director from subordinating corporate interests to his own through transactions that exploit the corporation.[48]

In cases alleging breach of the duty of loyalty, courts employ the entire fairness standard, which first burdens the plaintiff to establish a director's personal interest in the challenged transaction.[49] The burden then shifts to the interested director to demonstrate that the terms of the transaction are

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41. Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of* Omnicare v. NCS Healthcare, 29 J. CORP. L. 569, 575 (2004) ("[A] director's good faith adherence to the duties of care and loyalty are expected to guide her *conduct* at all times.").

42. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

43. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties.").

44. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson*, 473 A.2d at 812).

45. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.").

46. *See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814, 826 (N.J. 1981) (noting that a director's failure to read and understand financial statements and to make reasonable attempts at detection and prevention of illegal conduct by management constituted a breach of her duty of care).

47. *See* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) ("In short, directors must eschew any conflict between duty and self-interest.").

48. *See* RODMAN WARD, JR., EDWARD P. WELCH, & ANDREW J. TUREZYN, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2.1.1 (4th ed. Supp. I 2006) (noting that the duty of loyalty "proscribes a [director] from any means of misappropriation of assets entrusted to his management and supervision"). The duty of loyalty encompasses the attendant duty of good faith, which prohibits a "conscious disregard for [directorial] responsibilities." Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006).

49. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) ("[I]t is first the burden of the plaintiff attacking the [transaction] to demonstrate some basis for invoking the fairness obligation.").

intrinsically fair to the corporation.[50] This doctrine's rationale is that a director should be an independent corporate decision maker.[51] Thus, when a director's conduct falls short of this goal, a court will stand in as an objective arbiter both to confirm that the transaction is fair to the corporation and to hold the interested director liable when it is not.[52]

3. Enhanced Duties in Change of Control and Defensive Circumstances

Given that courts defer to a board's business judgment unless a director has effectively swindled the corporation, most corporate transactions are not subject to rigorous judicial review.[53] Courts will only scrutinize a board's decision to engage in either (1) a transaction that represents a sale of corporate control, or (2) a short-term defensive tactic.[54]

A sale of control triggers directors' *Revlon* duties, which require directors to maximize short-term value to shareholders.[55] Either a sale of all shares for cash[56] or a stock-for-stock merger that results in a combined company with a majority shareholder[57] comprises a sale of control.[58] Thus, when such transactions are challenged, courts hold directors' conduct to a standard of "*immediate* shareholder wealth maximization."[59]

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50. *See id.* at 710 ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."). The two basic aspects of fairness are fair dealing and fair price. *Id.* at 711.

51. *See* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

52. *See id.* Nevertheless, section 144 of the DGCL furnishes two methods by which a director may cleanse the taint of an unfair, self-interested transaction: when a director fully discloses her interest and a majority of either (1) the disinterested directors, or (2) the disinterested shareholders approves the transaction, it is not voidable solely due to the director's interest. DEL. CODE ANN. tit. 8, § 144 (2001 & Supp. 2010).

53. *See* Griffith, *supra* note 41, at 576 ("The business judgment rule shields directors from judicial second-guessing for all but the most careless acts, and courts will only consider the substantive fairness of a deal when the loyalty of directors is compromised by a conflict of interest.").

54. *See* Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1912 (2003) (synthesizing rules derived from "classic takeover cases").

55. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986) (Once directors decide to negotiate the sale of a corporation, "the directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company").

56. *See, e.g.*, *id.* at 178–79.

57. *See, e.g.*, Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 43 (Del. 1993) (explaining that the shareholders in that case "will have no leverage in the future to demand another control premium" such that the sale represents their last opportunity to monetize their investment fully).

58. Notably, there is no sale of control in (1) a stock-for-stock merger resulting in a diffusely held combined company, *see, e.g.*, Paramount Commc'ns, Inc. v. Time, Inc., Nos. 10866, 10670, 10935, 1989 WL 79880, at *23 (Del. Ch. July 14, 1989), *aff'd on other grounds*, 571 A.2d 1140 (Del. 1989), or (2) a merger realizing a board's long-term strategy, *see, e.g.*, *Time*, 571 A.2d 1140.

59. Griffith, *supra* note 41, at 576.

Courts also apply enhanced review when a board adopts a short-term device to defend against a hostile takeover bid.[60] In such circumstances, courts scrutinize the board's decision under the *Unocal* standard in an effort to protect shareholders from the "omnipresent specter" of board self-entrenchment.[61] *Unocal* scrutiny requires that directors establish (1) that the board reasonably perceived a threat to corporate policy and effectiveness,[62] and (2) that the defensive measure adopted is proportional and reasonable in relation to the threat posed.[63] Once a board has satisfied this standard, its decision receives the protection of the business judgment rule.[64]

4. Anti-precommitment Doctrine and the "Fiduciary Out" Requirement in Corporate Contracts

In corporate transactions, boards often find it useful to commit in advance, or "precommit," to a particular deal or course of action to guarantee certain outcomes and to control perceived risks.[65]

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60. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985); *see also* Justin W. Oravetz, Comment, *Is a Merger Agreement Ever Certain? The Impact of the* Omnicare *Decision on Deal Protection Devices*, 29 DEL. J. CORP. L. 805, 809 (2004) ("Delaware courts apply the *Unocal* heightened standard of review when a board of directors adopt[s] defensive protection devices in response to a hostile takeover."). Notably, *Unocal* analysis is not applied when the defensive measure in question is actually a merger realizing the board's pre-existing strategy. *See* Griffith, *supra* note 54, at 1909 n.39 ("[A]s long as the target board is not under *Revlon* and can argue that its [merger] plan pre-dates the appearance of the [hostile takeover] bid, *Unocal* will not force it to deal with unsolicited bidders.").

61. *Unocal*, 493 A.2d at 954–55. This enhanced duty and attendant judicial review exist because a board defending a takeover bid "may be acting primarily in its own interests, rather than those of the corporation and its shareholders." *Id.* *Unocal* was decided prior to *Revlon*.

62. *Id.* at 955. A board can satisfy this burden by showing it took action in good faith based upon reasonable investigation. *Id.*

63. *Id.* In identifying a proportional response, a board must analyze the nature of the takeover threat and its effect on the corporation as a whole, including the following factors: "[the] inadequacy of the price offered, [the] nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange." *Id.* "Coercive" or "preclusive" measures are per se unreasonable, as the board "'does not have unbridled discretion to defeat any perceived threat by any Draconian means available.'" Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387–88 (Del. 1995) (quoting *Unocal*, 493 A.2d at 955). A response is coercive when it is "aimed at forcing upon stockholders a management-sponsored alternative to a hostile offer," and a response is preclusive if it "deprives stockholders of the right to receive [any bid] or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise." Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 935 (Del. 2003) (citing *Unitrin*, 651 A.2d at 1387; *Time*, 571 A.2d at 1154). Courts will defer, however, to a board that has adopted a defensive measure that falls within a "range of reasonableness." *Unitrin*, 651 A.2d at 1388.

64. *See Unitrin*, 651 A.2d at 1387–88.

65. *See* Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 20 (2003) ("[P]recommitment strategies are useful . . . because they protect against passion and time inconsistency."). Planned transactions often fall apart for any number of reasons, including one party's poor business

Precommitment strategies also protect against the possibility that a board could lose its resolve to execute a farsighted plan as circumstances change.[66]

Nevertheless, common law dictates that a contract is invalid and unenforceable if it compels a board to breach its fiduciary duties.[67] Delaware judicial decisions have incorporated this doctrine into the state's jurisprudence as well.[68] As a result, in a string of significant cases, the Delaware Supreme Court nullified corporate contracts that would precommit boards to a course of action—whether commitment to or avoidance of a particular deal—when fiduciary duties would demand action (or inaction) otherwise.[69] Thus, the court curbed use of precommitment strategies, adopting instead the rule that boards have an "ongoing duty to constantly reevaluate" decisions in light of fiduciary duties.[70]

In *Paramount Communications, Inc. v. QVC Network, Inc.*,[71] a target corporation's board adopted measures to protect a deal with a preferred acquirer, including a no-shop provision, a termination fee, and a grant of stock options to the acquirer.[72] Consistent with these obligations, the board refused to negotiate with an intervening bidder that offered a higher bid for the target's shares.[73] When the bidder brought suit, the Delaware Supreme Court held that the contract's provisions were invalid and unenforceable to the extent they limited fiduciary duties or prevented the board from exercising its *Revlon* duty to maximize value in a sale of control.[74] Thus, the court held that provisions that would precommit the target board to a

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performance, fluctuations in stock price that devalue the assets to be exchanged, fluctuations in interest rates that render financing untenable, and intervening bids that call into question the deal's desirability. *See* Griffith, *supra* note 54, at 1900.

66. Griffith, *supra* note 41, at 597 (noting that an individual undertaking a precommitment strategy "acknowledges that in the future, her preferences will change and she will lack the will to carry out her current plans").

67. *See* RESTATEMENT (SECOND) OF CONTRACTS § 193 (1981) ("A promise by a fiduciary [director] to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy."); *see also id.* cmt. a ("Directors . . . of a corporation act in a fiduciary capacity and are subject to the rule stated in this Section.").

68. *See, e.g.*, McAllister v. Kallop, No. 12856, 1995 WL 462210, at *21 (Del. Ch. July 28, 1995) ("To the extent that a contract, or a portion of a contract, limits a director's exercise of his fiduciary duties, it is unenforceable.").

69. *See* UniSuper Ltd. v. News Corp., No. 1699, 2005 WL 3529317, at *7 (Del. Ch. Dec. 20, 2005) ("Generally speaking, these cases stand for the proposition that a contract is unenforceable if it would require the board to refrain from acting when the board's fiduciary duties require action.").

70. Bainbridge, *supra* note 65, at 20.

71. 637 A.2d 34 (Del. 1993).

72. *Id.* at 39. The no-shop provision provided that the target board would "not solicit, encourage, discuss, negotiate, or endorse any competing transaction" unless certain circumstances were present. *Id.*

73. *Id.* at 48 ("The Paramount defendants contend that they were precluded by certain contractual provisions, including the No-Shop Provision, from negotiating with QVC or seeking alternatives.").

74. *See id.*; *see also supra* notes 55–59 and accompanying text (discussing *Revlon* duties).

specific deal despite a superior bid impermissibly infringed on the board's exercise of its fiduciary duties.[75]

In *Quickturn Design Systems, Inc. v. Shapiro*,[76] a target board amended the corporation's shareholder rights plan, or "poison pill,"[77] so that a newly elected board could not redeem the pill for six months after taking office.[78] This delayed redemption provision—known as a "no hand" pill—represented a measure to protect against a takeover bid calling for *Unocal* analysis.[79] When the bidder brought suit, the Delaware Supreme Court held the provision invalid and unenforceable because it would prevent a future board from redeeming the pill "even under circumstances where the [future] board would be required to do so because of its fiduciary duty to [its] stockholders."[80] By precommitting its successor to pass over a potentially desirable takeover bid, the current board would constrain its successor from exercising its fiduciary duties, rendering the no hand pill void.

The *QVC* and *Quickturn* decisions clearly demonstrate the Delaware Supreme Court's "dim view" of precommitments restricting exercise of fiduciary duties.[81] Nevertheless, it was not until the *Omnicare, Inc. v. NCS Healthcare, Inc.*[82] decision that the court finally introduced a judicial solution to impose flexibility on agreements promising precommitment: a "fiduciary out"[83] requirement.[84]

The corporations in *Omnicare* assembled two mechanisms to protect the merger from competing bids.[85] First, the board of one of the corporations, NCS Healthcare, would submit the deal to its stockholders even if the board ultimately decided that the merger was not in the corporation's best

75. *See QVC*, 637 A.2d at 50 (noting that the target board "squandered" its opportunity "to negotiate on the stockholders' behalf" and to discharge its "obligation to seek the best value reasonably available").

76. 721 A.2d 1281 (Del. 1998).

77. A "poison pill" is defined as "[a] corporation's defense against an unwanted takeover bid whereby shareholders are granted the right to acquire equity or debt securities at a favorable price to increase the bidder's acquisition costs." BLACK'S LAW DICTIONARY 1275 (9th ed. 2009).

78. *Quickturn*, 721 A.2d at 1287.

79. *Id.* at 1289–90.

80. *Id.* at 1292–93.

81. Ace Ltd. v. Capital Re Corp., 747 A.2d 95, 107 (Del. Ch. 1999).

82. 818 A.2d 914 (Del. 2003).

83. *See* William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653, 653 (2000) ("Fiduciary outs are anomalous contract provisions that generally provide an escape hatch to a target corporation from performing some contractual undertaking meant to advance the closing of an acquisition agreement."); *see also infra* notes 94–95 and accompanying text.

84. *See Omnicare*, 818 A.2d at 942 (Veasey, C.J., dissenting) (describing the majority's decision as holding that "[a] merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up stockholder approval and does not contain a 'fiduciary out' provision, is per se invalid when a later significant topping bid emerges").

85. *See id.* at 918.

interests.[86] Second, two NCS directors—who together owned a majority of the company's voting power—agreed to vote in favor of the merger.[87] A bare majority of the Delaware Supreme Court invalidated these protective measures under the *Unocal* standard.[88] Even though the NCS board reasonably perceived a danger to the corporation,[89] the court held that the measures adopted were unreasonable because they made it virtually impossible for a competing proposal to succeed.[90]

Alternatively, the court held that the merger agreement was invalid and unenforceable because it resulted in the board disabling its own ability to exercise its fiduciary duties.[91] The court observed that contractual obligations "must yield to the supervening responsibility" of directors to exercise their "unremitting" fiduciary duties on a continuing basis.[92] Accordingly, the court held that the NCS board was *required* to negotiate a fiduciary out clause so that it could exercise its fiduciary duties in case of a superior offer, thereby imposing a new requirement on merging corporations.[93]

Fiduciary out provisions allow a corporation "to renege on the performance of contractual obligations when the board determines that such performance" would violate the board's fiduciary duties.[94] Accordingly,

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86. *Id.* at 925. The parties included this provision as permitted under section 251(c) of the DGCL as amended in 1998. *See* DEL. CODE ANN. tit. 8, § 251(c) (2001) ("The terms of the agreement may require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it."). In 2003, the Delaware General Assembly removed this rule from section 251(c) and moved it to new section 146 to expand its application from mergers and consolidations to any matter submitted to stockholders. *See* An Act to Amend Title 8 of the Delaware Code Relating to the General Corporation Law, § 11, 74 Del. Laws 214 (2003); *see also* DEL. CODE ANN. tit. 8, § 251(c) (Supp. 2010).

87. *Omnicare*, 818 A.2d at 926.

88. *See supra* notes 61–63 and accompanying text.

89. *Omnicare*, 818 A.2d at 935 (noting "the possibility of losing the . . . offer and being left with no comparable alternative transaction").

90. *See* Orman v. Cullman, No. 18039, 2004 WL 2348395, at *6 (Del. Ch. Oct. 20, 2004) (The devices "accomplished a *fait accompli*, i.e., they 'made it 'mathematically impossible' and 'realistically unattainable' for . . . any other proposal to succeed, no matter how superior the proposal'" (quoting *Omnicare*, 818 A.2d at 936)).

91. *Omnicare*, 818 A.2d at 937.

92. *Id.* at 938–39.

93. *See id.* at 939.

94. Fawal, *supra* note 38, at 1480. The following no-talk example contains a "fiduciary out":

> The Target shall not . . . participate in any negotiations or discussions regarding any Alternative Transaction; *provided, however*, that if, at any time prior to the adoption of this Agreement by the stockholders of the Target, the Board of Directors of the Target determines in good faith, based on advice from outside counsel, that the failure to provide such information or participate in such negotiations or discussions would result in the breach of the fiduciary duties of the Board of Directors of the Target to the Target's stockholders under applicable law, then the Target may . . . furnish information with respect to the Target and its subsidiaries . . . pursuant to a customary confidentiality agreement containing terms no less restrictive than the terms of the confidentiality agreement entered

such provisions are simply a way to reconcile a board's decisions with its underlying duties to shareholders.[95] In this way, *Omnicare*'s holding that a corporation can only enter into an exclusive merger agreement if it also negotiates a fiduciary out clause allowing the board to "terminate the deal if a better one emerges" represents the pinnacle of Delaware's anti-precommitment jurisprudence.[96]

5. *CA, Inc. v. AFSCME Employees Pension Plan*: Extending Commitmentphobia to Bylaws

The Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan* extends its anti-precommitment jurisprudence to the corporate bylaw context. This section describes the court's decision in *CA, Inc.* and the limited impact of this decision on subsequent law.

a. The Occasion for the Decision

On March 13, 2008, AFSCME Employees Pension Plan,[97] a stockholder of CA, Inc.,[98] submitted a proposed amendment to CA's bylaws[99] for inclusion in proxy materials for CA's 2008 annual meeting.[100] The

> into between the Target and the Acquiror . . . and . . . participate in discussions regarding such proposal.

Griffith, *supra* note 54, at 1901 n.9 (quoting *Panel on Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219, 286 (2002) (Appendix F)).

95. Fawal, *supra* note 38, at 1480 (citing *Omnicare*, 818 A.2d at 938–39).

96. Sabrina Ursaner, Note, *Keeping "Fiduciary Outs" out of Shareholder-Proposed Bylaws: An Analysis of* CA, Inc. v. AFSCME, 6 N.Y.U. J. L. & BUS. 479, 500 (2010). Notably, the *Omnicare* decision produced vigorous dissents by Chief Justice Veasey and Justice Steele. *See Omnicare*, 818 A.2d at 939 (3–2 decision) (Veasey, C.J., dissenting); *id.* at 948 (Steele, J., dissenting) (asserting that the majority adopted "proscriptive rules that invalidate or render unenforceable precommitment strategies negotiated between two parties to a contract who will presumably, in the absence of conflicted interest, bargain intensely over every meaningful provision of a contract after careful cost benefit analysis"). The *Omnicare* decision also gave rise to a wealth of scholarly commentary and criticism on the decision's impact on the validity of exclusive merger agreements. *See generally* Bainbridge, *supra* note 65; Griffith, *supra* note 41; Griffith, *supra* note 54; Oravetz, *supra* note 60.

97. The AFSCME Employees Pension Plan is associated with the American Federation of State, County and Municipal Employees Union. *See About AFSCME*, AFSCME, http://www.afscme.org/union/about (last visited Feb. 23, 2012).

98. Formerly known as CA, Inc. and Computer Associates, CA Technologies is one of the world's largest providers of information technology management software. *See About Us*, CA TECHS., http://www.ca.com/ca/en/about-us.aspx (last visited Feb. 23, 2012). CA is a Delaware corporation with a twelve-member, non-classified board of directors. *See* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 229 (Del. 2008).

99. Under the federal rules that govern proxy voting, a company must include bylaws proposed by shareholders in its proxy materials when certain conditions are met. *See* 17 C.F.R. § 240.14a-8 (2011) (addressing "when a company must include a shareholder's [bylaw] proposal in its proxy statement").

100. Letter from Gerald W. McEntee, Chairman, AFSCME Emps. Pension Plan, to Kenneth V. Handal, Exec. V.P., Global Risk & Compliance, & Corp. Sec'y, CA, Inc., 1 (Mar. 13, 2008) [hereinafter McEntee Letter], *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-a.pdf. This letter appears as Annex A to CA's No-Action Request. *See* Letter from David B. Harms, Sullivan & Cromwell LLP, to Office of Chief Counsel, Div. of

proposed bylaw would have required CA to reimburse the reasonable expenses incurred by shareholders whose candidates were successfully elected to CA's board of directors.[101] According to the proposal's supporting statement, AFSCME proposed the reimbursement bylaw because the shareholders' power to elect the CA board is "the most important mechanism" to ensure that the board manages CA in its shareholders' interests, and because reimbursement encourages electoral challenges to the incumbent board.[102]

As a result of AFSCME's proposal, CA's counsel sent a letter to the U.S. Securities and Exchange Commission's Division of Corporation Finance seeking a no-action letter confirming that the SEC would not recommend enforcement action against CA if CA excluded the proposal from its proxy materials for non-conformity with the proxy rules.[103] CA sought to exclude AFSCME's bylaw proposal on four grounds pursuant to the proxy rules: (1) that the proposal related to a director nomination or election;[104] (2) that the proposal was not a proper subject for shareholder action;[105] (3) that the

Corp. Fin., SEC at enclosure (Apr. 18, 2008) [hereinafter CA No-Action Request], *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-a.pdf.

101. The text of AFSCME's proposed bylaw was:

> RESOLVED, that pursuant to section 109 of the Delaware General Corporation Law and Article IX of the bylaws of CA, Inc., stockholders of CA hereby amend the bylaws to add the following Section 14 to Article II:
>
> The board of directors shall cause the corporation to reimburse a stockholder or group of stockholders (together, the "Nominator") for reasonable expenses ("Expenses") incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors, including, without limitation, printing, mailing, legal, solicitation, travel, advertising and public relations expenses, so long as (a) the election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated by the Nominator are elected to the corporation's board of directors, (c) stockholders are not permitted to cumulate their votes for directors, and (d) the election occurred, and the Expenses were incurred, after this bylaw's adoption. The amount paid to a Nominator under this bylaw in respect of a contested election shall not exceed the amount expended by the corporation in connection with such election.

CA, Inc., 953 A.2d at 229–30; *see also* McEntee Letter, *supra* note 100, at enclosure.

102. McEntee Letter, *supra* note 100, at enclosure.

103. *See* CA No-Action Request, *supra* note 100, at 1. CA enclosed the opinion of its Delaware counsel, Richard, Layton & Finger P.A., supporting CA's assertion that the proposal, if implemented, would violate Delaware law. *See* Letter from Richards, Layton & Finger P.A. to CA, Inc. (Apr. 17, 2008), *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-a.pdf. The letter appears as Annex B to CA's No-Action Request. *See* CA No-Action Request, *supra* note 100, at enclosure.

104. *See* CA No-Action Request, *supra* note 100, at 3–6; *see also* 17 C.F.R. § 240.14a-8(i)(8) (2008) (permitting exclusion "[i]f the proposal relates to a nomination or an election for membership on the company's board of directors . . . or a procedure for such nomination or election").

105. *See* CA No-Action Request, *supra* note 100, at 6–8; *see also* 17 C.F.R. § 240.14a-8(i)(1) (permitting exclusion "[i]f the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization").

proposal, if implemented, would cause CA to violate applicable law,[106] and; (4) that the proposal ran contrary to the proxy rules.[107]

In reply, AFSCME's counsel stated that CA failed to meet its burden to authorize exclusion under each basis claimed in its no-action request.[108] CA's counsel responded that the claimed bases for exclusion remained valid and that AFSCME's reply failed to address CA's concerns about the proposed bylaw.[109] The SEC rejected CA's claims that the proposal related to an election and ran contrary to the proxy rules, ultimately finding that CA could not properly exclude the proposal on these grounds.[110]

In addition, the SEC certified the remaining grounds for exclusion to the Delaware Supreme Court "to secure [the court's] determination of significant questions of Delaware corporation law, and thereby assist the [SEC] in applying [the applicable proxy rules] to CA's no-action request and to similar requests in the future." To this end, the SEC's General Counsel submitted two certified questions of law regarding the proposed bylaw's status under Delaware law,[111] which the court accepted.[112] The two questions were: "(I) Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law? (II) Would the

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106. *See* CA No-Action Request, *supra* note 100, at 6–8; *see also* 17 C.F.R. § 240.14a-8(i)(2) (permitting exclusion "[i]f the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject").

107. *See* CA No-Action Request, *supra* note 100, at 8–9; *see also* 17 C.F.R. § 240.14a-8(i)(3) (permitting exclusion "[i]f the proposal . . . is contrary to any of the Commission's proxy rules").

108. Letter from Charles Jurgonis, Plan Sec'y, AFSCME Emps. Pension Plan, to Office of Chief Counsel, Div. of Corp. Fin., SEC 1–5 (May 21, 2008) [hereinafter AFSCME No-Action Response], *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-b.pdf. AFSCME enclosed the opinion of its Delaware counsel, Grant & Eisenhofer P.A., discussing why the proposed bylaw was indeed proper and would not violate Delaware law if implemented. *See* Letter from Grant & Eisenhofer P.A. to Gerald W. McEntee, Chairman, Pension Comm., AFSCME Emps. Pension Plan (May 16, 2008) [hereinafter G & E Opinion], *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-b.pdf. The letter appears as Exhibit A to AFSCME's No-Action Response. *See* AFSCME No-Action Response, *supra*, at enclosure.

109. Letter from David B. Harms, Sullivan & Cromwell LLP, to Office of Chief Counsel, Div. of Corp. Fin., SEC (June 3, 2008), *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-c.pdf.

110. CA, Inc., SEC No-Action Letter, 2008 WL 2568454, at *1 (June 27, 2008).

111. SEC, Cert'n of Questions of Law Arising from Rule 14a-8 Proposal by S'holder of CA, Inc. at 2, ¶ 1(i) (June 27, 2008) [hereinafter SEC Certification], *available at* http://www.sec.gov/rules/other/2008/ca14a8cert.pdf. A recent amendment to the Delaware Constitution authorized the Delaware Supreme Court to hear questions of law certified by the SEC. *See* DEL. CONST. art. IV, § 11(8); An Act Concurring in a Proposed Amendment to Article IV, Section 11 of the Delaware Constitution of 1897, as Amended, Relating to Certification of Questions of Law to the Supreme Court, § 1, 76 Del. Laws 34 (2007); *see also* DEL. SUP. CT. R. 41(a)(ii) (authorizing the certification procedure). The *CA, Inc.* decision was the first time in which the SEC utilized this new certification. *See* Letter from Brian G. Cartwright, Gen. Counsel, SEC, to Clerk, Sup. Ct. of Del. (June 27, 2008), *available at* http://www.law.du.edu/images/uploads/corporate-governance/sec-governance-ca-letter-cartwright.pdf.

112. Order Accepting Questions Certified from the SEC, CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227 (Del. 2008) (No. 329, 2008).

AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?"[113]

b. The First Certified Question: AFSCME's Proposed Bylaw Is a Proper Subject for Shareholder Action

As a threshold matter, the relative powers of CA's board and shareholders to adopt, amend, and repeal bylaws.[114] The court noted that section 109(a) of the DGCL empowers both shareholders and directors of Delaware corporations to adopt, amend, and repeal bylaws,[115] and that CA's certificate of incorporation confers such power on CA's board pursuant to section 109(a),[116] with the result that both CA's shareholders and directors hold this power "independently and concurrently."[117]

Even though the bylaw power of shareholders is "legally sacrosanct,"[118] the court stipulated that shareholders still do not share an "identical and coextensive" power to adopt, amend, and repeal bylaws with the board of directors, given the broad grant of managerial power to the board under DGCL section 141(a).[119] Indeed, a cardinal precept of Delaware law is that directors, rather than shareholders, manage the business and affairs of the corporation.[120] A board's management prerogatives therefore necessarily check shareholders' bylaw power.[121]

Thus, the Delaware Supreme Court recognized that the precise task before it was to delineate the "scope of shareholder action that Section 109(b) permits yet does not improperly intrude upon the directors' power to manage [the corporation] under Section 141(a),"[122] and to determine whether AFSCME's proposed bylaw actually falls within that permissible scope.[123]

To this point, CA asserted that AFSCME's proposed bylaw must fall outside the scope of permissible shareholder action because it would restrict

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113. SEC Certification, *supra* note 111, at 4.

114. *See CA, Inc.*, 953 A.2d at 231–33.

115. *Id.* at 231 ("'[T]he power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote . . . ; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors.'" (quoting DEL. CODE ANN. tit. 8, § 109(a))).

116. CA, Inc., Restated Certificate of Incorporation art. VII, § 2 (Mar. 8, 2006) ("[T]he power to make, alter, or repeal, the By Laws, and to adopt any new By Law . . . shall be vested in the Board of Directors."). CA's restated certificate of incorporation appears as exhibit 3.3 to CA's Form 8-K filed March 6, 2006. *See* CA, Inc., Current Report (Form 8-K) exhibit 3.3 (Mar. 6, 2006).

117. *CA, Inc.*, 953 A.2d at 231.

118. *Id.* at 232 (noting that shareholders' bylaw power cannot be "non-consensually eliminated or limited by anyone other than" the Delaware General Assembly).

119. *Id.* ("'The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .'" (quoting DEL. CODE ANN. tit. 8, § 141(a))).

120. *Id.* (quoting Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)).

121. *See id.*

122. *Id.* at 234.

123. *Id.* at 232.

the board's authority to decide whether to reimburse, and DGCL section 102(b)(1) provides that any such limitation on the board's power must appear in the corporation's certificate of incorporation, not in its bylaws.[124] The court rejected this argument,[125] however, in favor of AFSCME's contention that section 109(b) permits bylaws relating to shareholders' rights, and AFSCME's proposed bylaw would relate to shareholders' right to participate in the director election process.[126]

Acknowledging that it could not capably "articulate with doctrinal exactitude a bright line" that divides valid and invalid shareholder bylaws, the court suggested that proper bylaws may "define the process and procedures" for board decision making without mandating "specific substantive business decisions."[127] As such, the court ultimately framed the first certified question as whether AFSCME's proposed bylaw either "establishes or regulates" a process for director decision making or mandates the decision itself.[128]

The court observed that a bylaw that "requires the expenditure of corporate funds does not, for that reason alone, become automatically deprived of its process-related character."[129] Therefore, the court found that it must look to the bylaw's context and purpose in determining whether it is process-related.[130] With respect to AFSCME's proposed bylaw, the context was the director election process, in which shareholders have a "legitimate and protected interest,"[131] while the purpose was to promote the integrity of that process by facilitating shareholder participation.[132]

124. *Id.* at 233–34 (The certificate of incorporation may contain "'[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders, or any class of the stockholders'" (quoting DEL. CODE ANN. tit. 8, § 102(b)(1))).

125. *See id.* at 234 (observing that CA's argument, "taken to its logical extreme," would eliminate shareholders' rights to adopt bylaws altogether).

126. *See id.* at 233; *see also* DEL. CODE ANN. tit. 8, § 109(b) (2001) ("The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.").

127. *CA, Inc.*, 953 A.2d at 234–35. The court also pointed to certain sections of the DGCL as examples of proper bylaws. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(b) (Supp. 2010) (bylaws setting number of directors and establishing board quorum and voting requirements); *id.* § 141(f) (bylaws precluding board action without meeting); *id.* § 211(a)–(b) (2001) (bylaws to establish date and location of annual stockholders meeting); *id.* § 211(d) (2001) (bylaws specifying the conditions for calling special stockholders meetings); *id.* § 216 (Supp. 2010) (bylaws establishing stockholders meeting quorum and voting requirements); *id.* § 222 (Supp. 2010) (bylaws regulating notice requirements for adjourned stockholders meetings).

128. *CA, Inc.*, 953 A.2d at 235.

129. *Id.* at 236.

130. *Id.* at 236–37.

131. *Id.* at 237 & n.21 ("'Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights.'" (quoting Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 660 n.2 (Del. Ch. 1988))).

132. *Id.*

Though AFSCME "infelicitously couched [its proposal] as a substantive-sounding mandate," the bylaw's procedural nature would have been clear had its language emphasized shareholders' entitlement to reimbursement rather than the board's obligation to reimburse.[133] Thus, the court answered the first certified question affirmatively, holding that AFSCME's proposed bylaw was indeed a proper subject for shareholder action.[134]

c. The Second Certified Question: AFSCME's Proposed Bylaw Would Cause the CA Board to Violate Delaware Law

Having determined that AFSCME's proposed bylaw would comply with the DGCL and CA's certificate of incorporation, the Delaware Supreme Court observed that the second certified question before it was whether the bylaw would violate Delaware decisional law.[135] Moreover, since CA's challenge preempted the bylaw's adoption, this issue failed to present the court with a concrete application of the bylaw to a specific set of facts, which would ordinarily inform the court's analysis.[136] Because the second certified question demanded "a determination of the validity of the [b]ylaw in the abstract," the *CA, Inc.* court recognized that it must consider the bylaw's validity in "any possible circumstance under which a board of directors might be required to act."[137]

As a result, the court concluded that the board's compliance with the bylaw would breach its fiduciary duties in at least one "hypothetical," thereby rendering the bylaw invalid under Delaware law.[138] Specifically, a board may properly reimburse shareholders' reasonable proxy expenses when a proxy contest[139] is based upon a "question of policy as distinguished from personnel o[r] management."[140] Nevertheless, when the election is driven by "personal or petty concerns," or to promote interests that may be injurious to the corporation, the board's fiduciary duties "compel that reimbursement be denied altogether."[141] Thus, the court held AFSCME's proposed bylaw invalid in line with its prohibition against contracts committing the board to action in breach of its fiduciary duties.[142]

133. *Id.* at 235, 236 n.20.
134. *Id.* at 237.
135. *Id.* at 238.
136. *Id.*
137. *Id.*
138. *Id.*
139. A "proxy contest" is defined as a "struggle between two corporate factions to obtain the votes of uncommitted shareholders" that usually occurs "when a group of dissident shareholders mounts a battle against the corporation's managers." BLACK'S LAW DICTIONARY, *supra* note 77, at 1346.
140. *CA, Inc.*, 953 A.2d at 240 (alteration in original) (citing Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226, 227 (Del. Ch. 1934)); *cf.* Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 345 (Del. 1983) (permitting reimbursement of proxy expenses where the proxy contest "was actually one involving substantive differences about corporation policy.").
141. *CA, Inc.*, 953 A.2d at 240.
142. *Id.* at 238 (citing Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998); Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994)).

To reach its holding, the Delaware Supreme Court relied heavily on its *QVC*[143] and *Quickturn*[144] merger and takeover decisions as precedent in support of its reasoning.[145] In *QVC*, the court voided a merger agreement's "no-shop" provision to prevent a board from intervening bids;[146] in *Quickturn*, the court invalidated a "no hand" pill that would preclude a board's successor from redeeming its poison pill for six months.[147] Without comment on the dissimilarities of these cases to *CA, Inc.*, the court held them up as examples in which the court "invalidated contracts that would require a board to act or not act in such a fashion that would limit the exercise of their fiduciary duties."[148] Moreover, the court found two specific issues irrelevant to its analysis: (1) that CA's shareholders (and not the board itself) would bind the board through the proposed bylaw,[149] and (2) that the proposed bylaw would effectively relieve the board of its duties concerning the decision to reimburse.[150] Put simply, the Delaware Supreme Court held that *QVC* and *Quickturn* were controlling, despite factual differences with *CA, Inc.*, because AFSCME's proposed bylaw amounted to an internal governance contract that would mandate reimbursement even "in circumstances that a proper application of fiduciary principles could preclude."[151]

Nevertheless, the court urged in its conclusion that AFSCME's proposed bylaw would be valid if it contained a fiduciary out provision reserving to CA's directors "full power to exercise their fiduciary duty" in reimbursement decisions.[152] The court also suggested, perhaps less vigorously, that AFSCME seek to amend CA's certificate of incorporation to include the proposed bylaw's substance, or to encourage the Delaware General Assembly to amend the DGCL to authorize proxy expense reimbursement bylaws.[153] Without a fiduciary out, however, the court held

143. *QVC*, 637 A.2d at 34; *see supra* notes 71–74 and accompanying text.

144. *Quickturn*, 721 A.2d at 1291–92; *see supra* notes 76–80 and accompanying text.

145. *See CA, Inc.*, 953 A.2d at 238–39.

146. *Id.* at 238 (citing *QVC*, 637 A.2d at 51); *see also supra* notes 71–74 and accompanying text.

147. *CA, Inc.*, 953 A.2d at 238–39 (citing *Quickturn*, 721 A.2d at 1291–92) *see also supra* notes 76–80 and accompanying text.

148. *CA, Inc.*, 953 A.2d at 238.

149. *See id.* at 239 (characterizing this as a "distinction . . . without a difference").

150. *See id.* at 239–40 (characterizing this argument as more "semantical than substantive" and as conceding "the very proposition" that renders the bylaw invalid).

151. *Id.* at 239–40. Given the Delaware Supreme Court's reliance on *QVC* and *Quickturn*, it seems unusual that the Court failed to mention its related decision in *Omnicare*, which originated the fiduciary out requirement that the court ultimately extended to mandatory bylaws in *CA, Inc*. One commentator who noticed this omission hypothesized that the court did not rely or cite *Omnicare* in its *CA, Inc.* decision due to the "considerable backlash and criticism" that the *Omnicare* decision produced. Ursaner, *supra* note 96, at 500–01; *see also supra* note 96 (describing *Omnicare*'s dissenting opinions and subsequent commentary).

152. *CA, Inc.*, 953 A.2d at 240.

153. *Id.*; *see also* DEL. CODE ANN. tit. 8, § 242(b)(1) (Supp. 2010) (establishing that both the board of directors and a majority of stockholders must approve any amendment to a corporation's certificate of incorporation).

that the bylaw, if implemented, would indeed violate Delaware law, answering the second certified question in the affirmative.[154]

d. CA Inc.*'s Modest Impact on Delaware Law*

The Delaware Supreme Court's decision in *CA, Inc.* has been a subject of considerable analysis.[155] Nonetheless, *CA, Inc.*'s impact on Delaware decisional and statutory law has been quite limited in the years following the decision.

In the years following the *CA, Inc.* decision courts have only cited that case as authority in support of rudimentary points of Delaware law. *CA, Inc.* has been cited in subsequent cases to buttress the following propositions: (1) de novo review is the appropriate standard of review for a certified question of law;[156] (2) a board whose certificate of incorporation has conferred the power to adopt, amend, and repeal bylaws pursuant to section 109(a) of the DGCL may adopt a bylaw as long as the bylaw is valid under Delaware law;[157] (3) shareholders' statutory power to amend bylaws is not coextensive with the board's concurrent bylaw power and is limited by the board's management prerogatives;[158] and (4) bylaws represent a contract between a corporation and its shareholders.[159] Thus, the *CA, Inc.* decision has had limited influence on subsequent case law, and this case law has failed to interpret the *CA, Inc.* decision's impact on other mandatory bylaws.

Notwithstanding the limited reach of *CA, Inc.*'s influence on subsequent case law, the Delaware General Assembly adopted statutory reforms in 2009 to codify the Delaware Supreme Court's answer to *CA, Inc.*'s first certified question by expressly authorizing shareholder-proposed bylaws to regulate the director election process.[160] To this end, the new section 113 of the DGCL[161] permits Delaware corporations to adopt a proxy expense reimbursement bylaw.[162]

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154. *See CA, Inc.*, 953 A.2d at 240.

155. *See infra* Part II.B.

156. *See* Lincoln Nat'l Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust, 28 A.3d 436, 438 n.3 (Del. 2011) (citing *CA, Inc.*, 953 A.2d at 231); PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust *ex rel.* Christiana Bank & Trust Co., 28 A.3d 1059, 1064 n.3 (Del. 2011) (citing *CA, Inc.*, 953 A.2d at 231); Lambrecht v. O'Neal, 3 A.3d 277, 281 n.8 (Del. 2010) (citing *CA, Inc.*, 953 A.2d at 231).

157. *See* Kurz v. Holbrook, 989 A.2d 140, 157 (Del. Ch. 2010) (citing *CA, Inc.*, 953 A.2d at 231–32) (concerning a bylaw amendment purporting to reduce the size of the board).

158. *See In re* CNX Gas Corp. S'holders Litig., No. 5377, 2010 WL 2705147, at *10 & n.12 (Del. Ch. July 5, 2010) (citing *CA, Inc.*, 953 A.2d at 232) (finding that Delaware law calls for a "consistently board-centric approach" in cases of controller tender offers).

159. *See* Galaviz v. Berg, 763 F. Supp. 2d 1170, 1174 (N.D. Cal. 2011) (citing *CA, Inc.*, 953 A.2d at 239) (considering the enforceability of a venue provision in a corporation's bylaws).

160. *See* An Act to Amend Title 8 of the Delaware Code Relating to the General Corporation Law, §§ 1–2, 77 Del. Laws ch. 14 (2009), *available at* http://delcode.delaware.gov/sessionlaws/ga145/Chp014.pdf.

161. DEL. CODE ANN. tit. 8, § 113 (Supp. 2010).

162. *See* Michael Tumas & John Grossbauer, *Amendments to the Delaware Corporation Code*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Feb. 28, 2009, 4:24

Notably, section 113 does not require that a proxy expense reimbursement bylaw contain a fiduciary out provision for directors, as *CA, Inc.* required of AFSCME's proposed bylaw.[163] Nevertheless, it seems likely that a court interpreting section 113 may decide that the *CA, Inc.* decision implicitly requires some fiduciary out provision.[164]

B. Mandatory Advancement Bylaws

This section begins by introducing the policies underlying Delaware's permissive indemnification and advancement regime. Next, it describes directors' statutory entitlement to indemnification and advancement. It then examines the relationship between directors' indemnification and advancement rights. Part I.B concludes by explaining the difficulty posed by mandatory advancement bylaws, and describing the contours of directors' advancement entitlement under such bylaws.

1. Indemnification and Advancement Under DGCL Section 145

Along with fiduciary duties, directors' entitlements to indemnification of liabilities and to advancement of legal defense expenses comprise another important aspect of corporate law.[165] Section 145 of the DGCL serves as the statutory basis for corporate indemnification and advancement in Delaware.[166]

Delaware courts have recognized that indemnification and advancement jointly serve two discrete objectives: (1) attracting competent directors and officers, and (2) encouraging these managers to resist legal action perceived

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PM), http://blogs.law.harvard.edu/corpgov/2009/02/28/proposed-amendments-to-the-delaware-general-corporation-law-2/. In the same statute, the Delaware General Assembly also amended the DGCL to include a new section 112, which authorizes Delaware corporations to adopt a "proxy access" bylaw granting stockholders the right to include in the corporation's proxy materials stockholders' nominees for directors. *See* DEL. CODE ANN. tit. 8, § 112; *see also* Tumas & Grossbauer, *supra*.

163. D. Gordon Smith, Matthew Wright, & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 158 (2011).

164. *See id.* Given the apparent significance of the *CA, Inc.* decision and its subsequent codification in section 113, it is notable that Vice Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery remarked in the lone decision to comment on section 113 since its adoption that the new amendments "ma[de] plain that which had always been understood by most Delaware corporate lawyers." Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 356 n.244 (Del. Ch. 2010) (rejecting the shareholder plaintiff's argument that sections 112 and 113 represented a policy shift that should have invalidated the poison pill at issue in that case).

165. *See, e.g.*, Joseph M. McLaughlin, *Directors' and Officers' Liability: Advancement of Legal Expenses*, N.Y. L.J., June 10, 2004, at 5 (explaining that indemnification and advancement, along with directors' and officers' liability insurance and DGCL § 102(b)(7), represent "a cornerstone of the effort to reduce the risk of personal liability arising out of board conduct"). Section 102(b)(7) of the DGCL authorizes a provision in a corporation's certificate of incorporation to eliminate or limit the liability of directors for damages resulting from non-intentional, non-bad faith breaches of duty. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) ("[T]he certificate of incorporation may also contain . . . [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director.").

166. *See* DEL. CODE ANN. tit. 8, § 145 (2001 & Supp. 2010).

to be meritless.[167] While courts construe bylaws furnishing indemnification and advancement using established rules of contract interpretation, they "simultaneously apply the patina of section 145's policy" in their decisions[168] and must "eschew narrow construction of [section 145] where an overliteral reading would disserve these policies."[169]

Moreover, Delaware courts have observed that indemnification and advancement actually benefit the corporation more than the director. A liberal corporate indemnification and advancement policy eliminates "the chilling effect of potential personal liability" on the part of directors, thereby encouraging the flexible board decision making and prudent risk taking that benefits all corporate constituencies.[170] Thus, indemnification and advancement do not represent an "individual benefit arising from personal employment [but the] desirable underwriting of risk by the corporation in anticipation of greater corporate-wide rewards."[171]

2. Indemnification of Directors' Liabilities

Section 145 authorizes a corporation to indemnify[172] its directors for certain specified liabilities depending on the type of action brought against the director.[173] When a shareholder brings a direct action against a corporate director,[174] section 145(a) permits a corporation to indemnify a director for attorney's fees and any judgments, fines, or settlement amounts the director actually and reasonably incurs.[175] To qualify for indemnification in a particular case, the director must have acted in good faith and for a purpose she reasonably believed to be in the corporation's best interests.[176] Notably, termination of a direct action by judgment or

167. VonFeldt v. Stifel Fin. Corp., 714 A.2d 79, 84 (Del. 1998) (noting that Delaware courts "have long recognized that section 145 serves the dual policies of: (a) allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity" (citing Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 344 (Del. 1983))).

168. Reinhard & Kreinberg v. Dow Chem. Co., No. 3003, 2008 WL 868108, at *2 (Del. Ch. Mar. 28, 2008).

169. *VonFeldt*, 714 A.2d at 84.

170. Scharf v. Edgcomb Corp., No. 15224, 1997 WL 762656, at *4 (Del. Ch. Dec. 4, 1997) ("Analyzing director and officer indemnification provisions as if they were salary, company cars or other personal corporate prerequisites [sic] simply makes no sense.").

171. *Id.*

172. "Indemnification" is defined as "[t]he action of compensating for loss or damage sustained" and, alternatively, "compensation so made." BLACK'S LAW DICTIONARY, *supra* note 77, at 837.

173. *See generally* DEL. CODE ANN. tit. 8, § 145(a)–(b) (2001).

174. A "direct action" is defined as "[a] lawsuit to enforce a shareholder's rights against a corporation," to which a director may be joined as a defendant. BLACK'S LAW DICTIONARY, *supra* note 77, at 525–26.

175. DEL. CODE ANN. tit. 8, § 145(a) ("A corporation shall have power to indemnify any person [in] any . . . suit or proceeding . . . (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director . . . against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement . . . .").

176. *Id.*

settlement does not by itself suggest that the director has failed to satisfy this standard of conduct.[177]

Section 145(b) authorizes a much narrower indemnification right in derivative actions,[178] affording indemnification only for *expenses* actually and reasonably incurred, such as attorney's fees.[179] While the entitlement requires the same standard of directorial conduct required in direct actions,[180] section 145(b) does not afford indemnification for settlements and judgments, as a director defending a derivative suit has allegedly breached his fiduciary duties.[181] Despite this limitation, section 145(g) permits insurance to cover such non-indemnifiable amounts.[182]

Indemnification of corporate directors is not self-executing; instead, indemnification requires a determination that the director's conduct qualifies under section 145's standard.[183] Section 145 provides that such determination may be made as follows: (1) by a majority vote of directors who are not parties to the pertinent proceeding, even if less than a quorum of the board; (2) by a committee of such non-defendant directors designated by a majority of such directors, even if less than a quorum; (3) if there are no non-defendant directors, or if such directors elect, by independent legal counsel in a written opinion; or, (4) by a majority of the stockholders.[184]

Nevertheless, section 145 also dictates that corporations must indemnify directors in certain circumstances.[185] Specifically, indemnification is mandatory when a director has been "successful on the merits or otherwise" in defense of any proceeding described in the statute, regardless of whether his conduct satisfies the standard.[186]

3. Advancement of Directors' Litigation Expenses

In addition to indemnification for liabilities, section 145 also authorizes advancement: corporate payment of a defendant director's litigation expenses (i.e., attorneys' fees), which the director must repay if such

177. *Id.*

178. A "derivative action" is defined as "a suit asserted by a shareholder on the corporation's behalf against a third party [the director] because of the corporation's failure to take some action against the [director]." BLACK'S LAW DICTIONARY, *supra* note 77, at 509.

179. DEL. CODE ANN. tit. 8, § 145(b).

180. *See id.*; *see also supra* note 176 and accompanying text.

181. McLaughlin, *supra* note 165. In contrast, a director defending a direct suit may reasonably expect "broad corporate reimbursement" because she presumably acted in the best interests of the corporation in injuring the plaintiff. *Id.*

182. *See* DEL. CODE ANN. tit. 8, § 145(g) ("A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director . . . against any liability asserted against such person and incurred by such person . . . whether or not the corporation would have the power to indemnify such person against such liability under this section.").

183. *See* McLaughlin, *supra* note 165.

184. DEL. CODE ANN. tit. 8, § 145(d) (Supp. 2010).

185. *See id.* § 145(c) (2001).

186. *Id.*

expenses are ultimately deemed non-indemnifiable.[187] Advancement, which is an "especially important corollary" to indemnification in attracting talented directors, provides "immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved" with litigation defense.[188]

Like its grant of indemnification, Delaware's scheme for advancement is best characterized as permissive.[189] Corporations enjoy broad flexibility in specifying the terms and conditions upon which directors may receive advancement (such as a proof of ability to repay or posting of a secured bond).[190] Unlike indemnification, advances to a director do not require a determination that his conduct has met a minimum standard.[191]

While section 145 conditions advancement to current directors on an "undertaking" that the director repay the corporation if advanced expenses are ultimately ineligible for indemnification, the statute fails to "prescribe a standard of solvency, require collateral, or specify minimum financial requirements."[192] Moreover, section 145 does not impose any conditions on advances to former directors.[193]

Although section 145 does not require corporations to advance legal expenses, "a great many corporate charters, bylaws and [private] indemnification agreements" include mandatory advancement

187. *Id.* § 145(e) (Supp. 2010) ("Expenses (including attorneys' fees) incurred by . . . [a] director of the corporation in defending any . . . suit or proceeding may be paid by the corporation in advance of the final disposition of such action . . . upon receipt of an undertaking by or on behalf of such director . . . to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation . . . .").

188. Homestore, Inc. v. Tafeen, 888 A.2d 204, 211 (Del. 2005).

189. *See* Richard A. Rossman, Matthew J. Lund & Kathy K. Lochman, *A Primer on Advancement of Defense Costs: The Rights and Duties of Officers and Corporations*, 85 U. DET. MERCY L. REV. 29, 34 (2007) ("[A]dvancement statutes of most states are described as 'permissive' because they establish only the ability of a corporation to grant advancement.").

190. *See Homestore*, 888 A.2d at 212; *see also* Gentile v. Singlepoint Fin., Inc., 788 A.2d 111, 113 (Del. 2001) (holding that a corporation did not provide for advancement to the broadest extent possible under the law but limited advancement to certain situations).

191. Joseph M. McLaughlin, *Directors' and Officers' Liability: Consider the Implications of Mandatory Advancement*, N.Y. L.J., Feb. 14, 2008, at 5 ("Advancement . . . ordinarily is not conditioned on a finding that the party seeking advancement has met any standard of conduct.").

192. Regina Robson, *Paying for Daniel Webster: Critiquing the Contract Model of Advancement of Legal Fees in Criminal Proceedings*, 7 HASTINGS BUS. L.J. 275, 280–81 (2011); *see, e.g.*, Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82, 84 (Del. Ch. 1992) ("This undertaking [for advancement] need not be secured."). Thus, any unsecured undertaking by a director accused of criminal wrongdoing is "particularly hollow" because a guilty verdict will not only render her advances ineligible for indemnification but will also likely deprive her of adequate resources to repay the funds advanced. Robson, *supra*, at 280–81.

193. *See* DEL. CODE ANN. tit. 8, § 145(e) (Supp. 2010) ("Such expenses (including attorneys' fees) incurred by former directors . . . may be so paid upon such terms and conditions, if any, as the corporation deems appropriate."); *see also Homestore*, 888 A.2d at 211 ("Section 145(e) provides corporations with the flexibility to advance funds to *former* corporate officials . . . without an express undertaking.").

provisions.[194] Such provisions often reproduce section 145's language, thereby granting an advancement entitlement "to the fullest extent of the law."[195] Where a mandate is in place, a director's right to advancement is enforceable as under a contract.[196] Moreover, section 145 imposes no limit on the amount of corporate funds to be advanced under mandatory provisions.[197]

Section 145 vests the Delaware Court of Chancery with exclusive jurisdiction over actions for advancement.[198] The scope of an advancement proceeding is typically summary in nature,[199] reflecting the policy determination that the court "should be receptive to and accord expedited treatment" to advancement claims.[200] Indeed, if advancement is not made promptly, its benefit to a director is "forever lost" because the absence of prompt advancement will influence what counsel and litigation strategy the director can afford.[201] Advancement cases are particularly appropriate, then, for "resolution on a paper record."[202]

4. The Relationship Between Indemnification and Advancement

Although they are typically correlative, indemnification and advancement rights are legally separate and distinct.[203] An extension of indemnification rights concomitantly extends the amount by which a corporation may be legally liable.[204] A totally unrelated decision to advance expenses is, essentially, the decision to advance credit to a director.[205] Thus, an

194. *E.g.*, *Homestore*, 888 A.2d at 212 (citing Citadel Holding Corp. v. Roven, 603 A.2d 818 (Del. 1992)); *id.* ("Homestore's bylaws contain[] a *mandatory* and *unconditional* advancement provision."); *see also infra* Part I.B.5.

195. Robson, *supra* note 192, at 284; *see also Fricke*, 623 A.2d at 83 ("[M]ost corporations and virtually all public corporations have by bylaw exercised the authority recognized by Section 145 so as to mandate the extension of indemnification [and advancement] rights in circumstances in which indemnification [and advancement] would be permissible under Section 145.").

196. *See* Gentile v. Singlepoint Fin., Inc., 787 A.2d 102, 106 (Del. Ch. 2001).

197. Robson, *supra* note 192, at 306–07. Nevertheless, directors' and officers' liability insurance policies typically cover advancement expenses. *See id.* at 295.

198. DEL. CODE ANN. tit. 8, § 145(k) (2001).

199. *See id.* ("The Court of Chancery may summarily determine a corporation's obligation to advance expenses (including attorneys' fees)."); *see also* Weinstock v. Lazard Debt Recovery GP, LLP, No. 20048, 2003 WL 21843254, at *2 (Del. Ch. Aug. 8, 2003) (stating that "summary judgment practice is an efficient and appropriate method" to decide most advancement disputes).

200. Bergonzi v. Rite Aid Corp., No. 20453, 2003 WL 22407303, at *4 (Del. Ch. Oct. 20, 2003).

201. Homestore, Inc. v. Tafeen, 886 A.2d 502, 505 (Del. 2005).

202. DeLucca v. KKAT Mgmt., L.L.C., No. 1384, 2006 WL 224058, at *6 (Del. Ch. Jan. 23, 2006). Summary advancement proceedings are inappropriate, however, for litigating collateral indemnification or recoupment claims, which generally require more "detailed analysis." Kaung v. Cole Nat'l Corp., 884 A.2d 500, 510 (Del. 2005).

203. Homestore, Inc. v. Tafeen, 888 A.2d 204, 212 (Del. 2005) (citing *Kaung*, 884 A.2d at 509).

204. Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82, 84 (Del. Ch. 1992).

205. *Id.*

advancement right is not dependent on an indemnification right,[206] and a mandatory indemnification bylaw does not include an attendant advancement obligation before it has been determined that indemnification is proper.[207]

Furthermore, a director is only entitled to mandatory indemnification when he prevails "on the merits or otherwise" in defending a proceeding to be entitled to indemnification.[208] In contrast, section 145 evidently contemplates an advancement right greater than this mandatory indemnification right, as a director must repay expenses advanced when he is ineligible for indemnification.[209]

5. The Scope of Mandatory Advancement Rights

The prevalence of mandatory advancement bylaws has accordingly produced a "maddening" outcome in recent cases: an unconditional corporate obligation to fund the legal defense of a director "the board believes has acted against the interests of the corporation or even criminally."[210] In a common scenario, the board has already "drawn harsh conclusions about the integrity and fidelity" of the director seeking advancement, and it may even have a "firm basis to believe [the director] intentionally injured the corporation."[211] Understandably, the board is reluctant to advance funds for his defense, "fearing that the funds will never be paid back and resisting the idea of seeing further depletion of corporate resources at the insistence of someone perceived to be a faithless fiduciary."[212]

The Delaware Court of Chancery has asserted, however, that it is "no answer" that the corporation has come to believe that the director has been unfaithful.[213] Indeed, it is "in those very cases that the right to advancement attaches most strongly."[214] In fact, the court has criticized boards denying advancement, in one case sarcastically labeling them "sage businesspersons" seeking to escape "the consequences of their own contractual freedom."[215] Previously content with mandatory advancement bylaws "drafted with holes large enough to drive a truck through," suddenly the board resembles "a sinner who finally finds religion . . . insisting on a rigorous interpretation" of bylaws that only condition advancement on a

206. *Homestore*, 888 A.2d at 212; *see also* Citadel Holding Corp. v. Roven, 603 A.2d 818, 826 (Del. 1992) (holding that an indemnification agreement's exclusion of violations of federal securities laws from indemnification had no impact on a director's entitlement to advancement to defend such claims).

207. *Fricke*, 623 A.2d at 84.

208. DEL. CODE ANN. tit. 8, § 145(c) (2001).

209. *See Fricke*, 623 A.2d at 84.

210. McLaughlin, *supra* note 191 (citing Reddy v. Elec. Data Sys. Corp., No. 19467, 2002 WL 1358761, at *5 (Del. Ch. June 18, 2002)).

211. *Reddy*, 2002 WL 1358761, at *5.

212. *Id.*

213. Radiancy, Inc. v. Azar, No. 1547, 2006 WL 4762868, at *1 (Del. Ch. Jan. 23, 2006).

214. *Id.*

215. DeLucca v. KKAT Mgmt., L.L.C., No. 1384, 2006 WL 224058, at *2, *13 (Del. Ch. Jan. 23, 2006).

"hollow, worthless promise to repay."[216] Regretting the broad advancement right it "forged on a clear day," the board requests that the court ignore the "plain language" of the bylaw to generate an "after-the-fact judicial contract that reflects [its] current preference."[217]

Nonetheless, the court reminds recalcitrant boards that section 145 does not command that advancement provisions "be written broadly or in a mandatory fashion."[218] Where an advancement bylaw is, "by its plain terms, expansively written and mandatory, it will be enforced as written."[219] It is not the court's responsibility to "relieve sophisticated parties of the burdens of contracts they wish they had drafted differently."[220] A corporation that adopts a bylaw mandating unconditional, unsecured advancement "will be held to that decision and will be deemed to have waived the opportunity to examine whether the extension of credit to a particular [director] is in the corporation's best interests" when the advance is requested.[221] Indeed, the court "does not relish and will not perform the task of playground monitor, refereeing needless and inefficient skirmishes in the sandbox."[222]

In sum, where a corporation could easily have drafted a mandatory advancement bylaw differently and did not, the board must "maintain its bargain" with its director.[223] Because a director's typically high level of compensation would facilitate securing an undertaking for advancement, any excuse "falls woefully short" of explaining a board's failure to require collateral.[224] In fact, the court has held that denying advancement due would weaken section 145,[225] thereby undermining the beneficial public policies it serves.[226] While stockholders regrettably "get it coming and

216. Tafeen v. Homestore, Inc., No. 023, 2004 WL 556733, at *1 (Del. Ch. Mar. 22, 2004).

217. *DeLucca*, 2006 WL 224058, at *2.

218. *Id.* at *13.

219. *Id.*

220. *Id.* at *2.

221. Joseph M. McLaughlin, *Directors' and Officers' Liability: Indemnification Update*, N.Y. L.J., June 12, 2008, at 5.

222. Reinhard & Kreinberg v. Dow Chem. Co., No. 3003, 2008 WL 868108, at *5 (Del. Ch. Mar. 28, 2008).

223. Bergonzi v. Rite Aid Corp., No. 20453, 2003 WL 22407303, at *3 (Del. Ch. Oct. 20, 2003).

224. Tafeen v. Homestore, Inc., No. 023, 2004 WL 3053129, at *3 (Del. Ch. Oct. 27, 2004) ("People with far less substantial bank accounts than [directors] are required to post secured bonds every day in [the Court of Chancery]. For a [director] being paid hundreds of thousands of dollars or more a year in salary and benefits, this Court is hard pressed to understand why it would be difficult to attract people to such positions if they were required to post a bond to secure the advancement of fees and costs related to litigation arising from their service in that capacity.").

225. *See* Radiancy, Inc. v. Azar, No. 1547, 2006 WL 4762868, at *5 (Del. Ch. Jan. 23, 2006).

226. *See* Reddy v. Elec. Data Sys. Corp., No. 19467, 2002 WL 1358761, at *5–6 (Del. Ch. June 18, 2002).

going" in advancement actions,[227] the Delaware Court of Chancery has categorically held that boards may not "unilaterally rescind" directors' advancement rights.[228]

As a result, it is vital to understand the advancement entitlement that a mandatory advancement bylaw affords directors. The following sections describe the circumstances in which advancement is available and the potential arguments of boards seeking to avoid their obligation to advance.

a. Covered Directors

Section 145 authorizes indemnification in proceedings brought against a person "by reason of the fact" that the person is a corporate director.[229] Because a corporation may only advance potentially indemnifiable expenses, advancement is also only available in suits brought against a director due to her office.[230]

As a result, the Delaware Court of Chancery has held that a mandatory advancement bylaw entitles a director to advancement where there is a "nexus or causal connection" between any of the underlying proceedings contemplated by section 145(e) and the director's official corporate duties.[231] Such connection exists where the director's corporate powers were utilized to commit the alleged misconduct.[232] Indeed, a claim entitling a corporation to avoid advancement must clearly involve a contractual obligation without any such nexus or causal connection to official duties.[233]

Notably, a director's motivation for engaging in misconduct is ultimately irrelevant to this analysis.[234] In fact, precedent upholds advancement to directors charged with serious misconduct even when this misconduct was allegedly inspired by "personal greed."[235] To justify this result, the Court of Chancery has observed that it would be highly problematic if directors' advancement rights depended on the motivation "ascribed to their conduct

227. Barrrett v. Am. Country Holdings, Inc., 951 A.2d 735, 746–47 (Del. Ch. 2008) (noting that shareholder wealth ultimately bears the litigation expenses of both the director and the company).

228. *Bergonzi*, 2003 WL 22407303, at *3.

229. DEL. CODE ANN. tit. 8, § 145(a)–(b) (2001).

230. *See, e.g.*, Paolino v. Mace Sec. Int'l, Inc., 985 A.2d 392, 398 (Del. Ch. 2009) (describing a bylaw granting "broad and mandatory advancement rights to any covered person faced with 'defending' a 'proceeding' in which indemnification theoretically could be available").

231. *See* Homestore, Inc. v. Tafeen, 888 A.2d 204, 213–14 (Del. 2005) (citing Perconti v. Thornton Oil Corp., No. 18630, 2002 WL 982419, at *3–5 (Del. Ch. May 3, 2002)); *see also Perconti*, 2002 WL 982419, at *6–8.

232. *See Paolino*, 985 A.2d at 406 (citing Bernstein v. TractManager, Inc., 953 A.2d 1003, 1011 (Del. Ch. 2007)).

233. *See id.* at 407.

234. *Homestore*, 888 A.2d at 213–14.

235. Reddy v. Elec. Data Sys. Corp., No. 19467, 2002 WL 1358761, at *6 (Del. Ch. June 18, 2002).

by the suing parties."[236] Otherwise, a director might not be able to defend, for example, a claim that she breached her duty of loyalty.[237]

b. Covered Proceedings

Section 145 authorizes advancement to directors "in defending" a contemplated proceeding.[238] When a claim, counterclaim, or third party claim has been asserted against a director, she is defending that proceeding and is entitled to advancement.[239] A director may also be defending against threatened claims when the board engages in discovery of the director in the director's own claim against the corporation.[240]

Moreover, a director is entitled to advancement of the costs of both asserting affirmative defenses[241] and appealing a conviction.[242] Asserting a counterclaim comprises defending when (1) the counterclaim would qualify as a compulsory counterclaim under Delaware and federal civil procedure, and (2) the counterclaim "so directly relates to a claim against a [director] such that success on the counterclaim would operate to defeat the affirmative claims" against the director.[243] Furthermore, a director is entitled to advancement of fees to assert defamation claims as part of her litigation strategy.[244]

c. Duration of Coverage

A person is not automatically entitled to advancement rights upon becoming a director or even upon accrual of the cause of action for which advancement is sought.[245] Rather, advancement rights vest "when the director is named in a proceeding for which advancement is available, or some firm indication exists (such as an investigation)" that the potential claimant is contemplating claims against the director.[246]

A corporation must provide advancement to a director until the underlying proceeding is resolved, "in the sense that its outcome is not subject to further disturbance."[247] Put simply, the advancement obligation

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236. *See id.* at *5.

237. *Id.* (noting that if directors' motivation influenced their advancement entitlement, directors would not be able to defend "claims that they took official action for the primary purpose of diverting corporate resources to their own pocketbooks").

238. DEL. CODE ANN. tit. 8, § 145(e) (Supp. 2010).

239. Paolino v. Mace Sec. Int'l, Inc., 985 A.2d 392, 400 (Del. Ch. 2009).

240. Schoon v. Troy, 948 A.2d 1157, 1170 (Del. Ch. 2008).

241. Citadel Holding Corp. v. Roven, 603 A.2d 818, 824 (Del. 1992).

242. Sun-Times Media Grp., Inc. v. Black, 954 A.2d 380, 398 (Del. Ch. 2008).

243. Zaman v. Amedeo Holdings, Inc., No. 3115, 2008 WL 2168397, at *35–36 (Del. Ch. May 23, 2008) ("In other words, a counterclaim fits within the 'in defending' language if it defends the corporate official by directly responding to *and* negating the affirmative claim.").

244. *See* Duthie v. CorSolutions Med., Inc., No. 3048, 2008 WL 4173850, at *1 (Del. Ch. Sept. 10, 2008).

245. *See* McLaughlin, *supra* note 221 (citing *Schoon*, 948 A.2d at 1165–66).

246. *Id.*

247. *Black*, 954 A.2d at 395.

does not terminate until the non-appealable conclusion of a proceeding.[248] For example, a director who has entered a guilty plea before sentencing remains entitled to advancement, as his plea did not represent the proceedings' final disposition.[249]

d. Rejected Defenses

In recent cases, the Delaware Court of Chancery has rejected several defenses raised by recalcitrant boards to excuse noncompliance with a mandatory advancement bylaw. These include severe financial hardship[250] and a corporation's inchoate recoupment claim.[251] Even clear evidence that advanced expenses will not be indemnified—such as a director's sworn admission to deliberate falsification of financial statements—does not comprise a valid excuse.[252] A claim that the director fraudulently induced an employment agreement is equally unavailing, but the court has granted that the board may assert this claim in a separate action against the director.[253]

e. The Potential Defense of Fiduciary Duty

One novel defense that boards have not raised in defending advancement claims is that advancement in a particular instance would constitute a breach of the board's fiduciary duties. To this end, a board might claim that advancement represents gross mismanagement of corporate assets, amounting to a breach of the board's duty of care.[254] Alternatively, a board could argue that a decision to extend advancement to one of its member directors is a self-interested transaction in breach of the board's duty of loyalty.[255]

While no advancement case in Delaware has yet considered this defense, an interesting string of decisions from federal courts in Pennsylvania and Delaware, and the Commonwealth Court of Pennsylvania, may shed some light on this defense's viability before the Delaware Court of Chancery.

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248. *See id.* at 397.

249. *See* Bergonzi v. Rite Aid Corp., No. 20453, 2003 WL 22407303, at *2 (Del Ch. Oct. 20, 2003).

250. *See* Tafeen v. Homestore, Inc., No. 023, 2004 WL 556733, at *10 (Del. Ch. Mar. 22, 2004).

251. *See* Kaung v. Cole Nat'l Corp., 884 A.2d 500, 502 (Del. 2005) (holding that the summary nature of an advancement proceeding made hearing a counterclaim for recoupment inappropriate).

252. *See Tafeen*, 2004 WL 556733, at *4–5.

253. *See Bergonzi*, 2003 WL 22407303, at *3 (holding that a contract providing for advancement precludes an inquiry into whether claimant will qualify for indemnification).

254. *See supra* note 46 and accompanying text.

255. Travis Laster, CA v. AFSCME*: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, DEALLAWYERS.COM BLOG (July 18, 2008, 7:29 AM), http://www.deallawyers.com/blog/archives/000924.html; *see also supra* notes 47–48 and accompanying text.

In *Fidelity Federal Savings & Loan Ass'n v. Felicetti*,[256] the U.S. District Court for the Eastern District of Pennsylvania considered claims of former directors of a Pennsylvania corporation to advancement under a mandatory advancement bylaw to defend claims asserted against them by the corporation.[257] Granting that the advancement bylaw did not directly conflict with the Pennsylvania Business Corporation Law's advancement provision,[258] the court found that the bylaw ran "contrary to the fiduciary obligations imposed upon directors" under Pennsylvania law and the bylaws.[259] The bylaw could not supersede the overriding duty of the directors to act in the best interest of the corporation, which, the court determined, dictated that advancement be denied in this case.[260] Thus, the corporation successfully avoided advancement to the former directors.[261]

Two years later, *Ridder v. CityFed Financial Corp.*[262] involved employees of a Delaware corporation seeking advancement under the corporation's mandatory advancement bylaw to defend suits brought against them by the receiver of the parent corporation.[263] The Third Circuit rejected the defendant's argument that the court adopt the approach taken in *Felicetti*, concluding that it was required to follow the decisions of Delaware courts concerning issues of Delaware law.[264] Moreover, the court found the reasoning in *Felicetti* unpersuasive because, the court asserted, "[r]arely, if ever, could it be a breach of fiduciary duty . . . to comply with the requirements of the corporation's by-laws, as expressly authorized by [section 145]."[265]

Only ten months later, in *Neal v. Neumann Medical Center*,[266] the Commonwealth Court of Pennsylvania considered the claims of former officers against a Pennsylvania nonprofit corporation to enjoin the corporation's suit against the officers until the corporation advanced the officers' defense costs, pursuant to a mandatory advancement bylaw.[267] The court declined to follow *Felicetti*, and instead adopted the *Ridder*

256. 830 F. Supp. 262 (E.D. Pa. 1993).

257. *Id.* at 263–65.

258. The Pennsylvania Business Corporation Act's advancement provision is modeled in part on section 145 of the DGCL. *See id.* at 266 ("Most states have adopted legislation which is modeled after either the Delaware [General] Corporation Law . . . § 145, or the Model Business Corporation Act . . . . Pennsylvania's indemnification provision is a hybrid of the two."); *see also* 15 PA. STAT. ANN. § 1745 (West Supp. 2011).

259. *Felicetti*, 830 F. Supp. at 268–69.

260. *See id.* at 269 ("In this case, the [directors] are backed into a corner by simultaneously being required by [the bylaws] to advance the expenses of this lawsuit to [the defendant directors] and being bound by their fiduciary duties to act only in the best interest of the corporation, actions which the directors have definitively decided are irreconcilable.").

261. *See id.* at 269–70.

262. 47 F.3d 85 (3d Cir. 1995).

263. *Id.* at 86.

264. *See id.* at 87.

265. *Id.*

266. 667 A.2d 479 (Pa. Commw. Ct. 1995).

267. *Id.* at 480. The Pennsylvania Nonprofit Corporation Act's advancement provision is modeled in part on section 145 of the DGCL. *Id.* at 484 (Smith, J., dissenting) (describing the advancement provision as "a hybrid between Delaware provisions and the Model Business Corp. Act"); *see also* 15 PA. STAT. ANN. § 5745 (West Supp. 2011).

court's reasoning, asserting that "directors can only act in the corporation's best interests by implementing the mandatory advancement provision, since the bylaws which contain it were presumably adopted for [the corporation's] benefit."[268]

Each of these decisions addresses whether a board's compliance with a mandatory advancement bylaw may cause it to breach its fiduciary duties. The Delaware Supreme Court's decision in *CA, Inc.* that a mandatory bylaw is indeed invalid for that reason seems to set the stage for a board seeking to deny advancement to make the same argument.

II. TALKING OUT OF BOTH SIDES OF YOUR MOUTH: THE IMPACT OF *CA, INC.* ON MANDATORY ADVANCEMENT BYLAWS

Part II analyzes the conflict between the *CA, Inc.* decision and the general enforceability of mandatory advancement bylaws. First, it explores the parties' arguments in *CA, Inc.* that compare the proposed bylaw in that case to mandatory advancement bylaws. It then reviews commentary by relevant practitioners that discuss the *CA, Inc.* decision's potential impact on mandatory advancement bylaws.

A. The Parties' Arguments in CA, Inc. *Recognize a Link*

It is telling that AFSCME, in its *CA, Inc.* brief, likened its proposed bylaw to mandatory advancement bylaws, whose validity is well established.[269] With respect to the second certified question, AFSCME advanced two arguments that drew on parallels to mandatory advancement bylaws.

First, AFSCME argued that valid bylaws may mandate payment of corporate funds without improperly interfering with the directors' fiduciary duties.[270] As an example, AFSCME pointed out that Delaware courts regularly enforce mandatory advancement bylaws.[271] While section 145 expressly authorizes advancement, it does not mandate advancement in any circumstance and remains silent with respect to the adoption of advancement bylaws.[272] Nevertheless, virtually all public corporations guarantee advancement in their bylaws,[273] and, where a mandatory advancement bylaw exists, such rights are enforced as a contract.[274]

Second, AFSCME argued that a mandatory bylaw cannot cause a board to violate its fiduciary duties because directors are not "called upon to exercise any discretion on the payment itself" where such a provision

268. *Neal*, 667 A.2d at 482 (majority opinion).
269. *See generally* Brief of Appellee at 27–39, *CA, Inc.* (No. 329, 2008).
270. *See id.* at 31.
271. *Id.* at 28 (citing Underbrink v. Warrior Energy Servs. Corp., No. 2982, 2008 WL 2262316 (Del. Ch. May 30, 2008); Orloff v. Shulman, No. 852, 2005 WL 5750635 (Del. Ch. Nov. 23, 2005)).
272. *Id.* at 29 (citing VonFeldt v. Stifel Fin. Corp., 714 A.2d 79, 81 (Del. 1998)).
273. *See id.* at 30 (citing *VonFeldt*, 714 A.2d at 81).
274. *See id.* at 30 (citing Gentile v. Singlepoint Fin., Inc., 787 A.2d 102, 106 (Del. Ch. 2001)).

exists.[275] Again, AFSCME employed the example of mandatory advancement bylaws, which do not implicate the directors' business judgment regarding the advancement decision.[276] Instead, advancement in such cases is required, "just like the terms of any other contract."[277]

In its reply brief, CA elected not to rebut these arguments directly.[278] In fact, CA only referred to mandatory advancement bylaws in its discussion of the first certified question,[279] criticizing a citation in the opinion of AFSCME's Delaware counsel enclosed as part of AFSCME's response to CA's no-action request.[280] There, CA asserted that reliance on a case enforcing a mandatory advancement bylaw was inapposite because advancement is a matter that section 145 "*specifically* provides may be regulated" by law, whereas AFSCME's proposed bylaw lacked express statutory authorization.[281]

The Delaware Supreme Court clearly held in *CA, Inc.* that a bylaw is invalid if it mandates corporate expenditures in circumstances where a proper application of fiduciary principles might preclude such payments, and that a fiduciary out provision could cure this defect.[282] Following the *CA, Inc.* decision, however, the Delaware General Assembly acted to nullify CA's argument that AFSCME's proposed bylaw ought not to be treated like valid mandatory advancement bylaws.[283] DGCL section 113 now specifically authorizes corporations to adopt mandatory proxy expense reimbursement bylaws,[284] placing AFSCME's proposed bylaw and mandatory advancement bylaws adopted pursuant to DGCL section 145 on equivalent statutory footing.[285] In fact, absent this distinction, AFSCME's argument that mandatory proxy expense reimbursement bylaws and mandatory advancement bylaws occupy the same legal status seems persuasive indeed.[286]

These points lead to one inevitable conclusion. Where mandatory advancement bylaws are valid and enforceable without fiduciary outs, then mandatory proxy expense reimbursement bylaws must also be valid without fiduciary outs. In the *CA, Inc.* decision, however, the Delaware Supreme Court held that a mandatory proxy expense reimbursement bylaw lacking a

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275. *Id.* at 37.

276. *Id.*

277. *Id.*

278. *See generally* Brief of Appellant, CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227 (Del. 2008) (No. 329, 2008).

279. *Id.* at 37.

280. *See* G & E Opinion, *supra* note 108, at 4 (citing Gentile v. Singlepoint Fin., Inc., 787 A.2d 102, 106 (Del. Ch. 2001)).

281. Brief of Appellant, *supra* note 278, at 37 & n.21 (arguing that section 145 is a "statutory exception to the general rule" of board discretion under section 141(a)).

282. *See CA, Inc.*, 953 A.2d at 240.

283. *See supra* notes 160–62 and accompanying text (describing the new section 113 of the DGCL).

284. *See supra* notes 160–62 and accompanying text; *see also* DEL. CODE ANN. tit. 8, § 113 (Supp. 2010).

285. *See* DEL. CODE ANN. tit. 8, § 145(e).

286. *See supra* notes 270–78 and accompanying text.

fiduciary out is invalid and unenforceable. It follows that a mandatory advancement bylaw without a fiduciary out must be invalid as well.

B. Practitioner Commentary Analyzes the Implications

Two accounts interpreting *CA, Inc.*'s impact on mandatory advancement bylaws are particularly valuable in interpreting this conflict. The first is an article by AFSCME's Delaware counsel that details the *CA, Inc.* case.[287] There, the authors highlight the Delaware Supreme Court's perceived failure to (1) distinguish the legal status of mandatory advancement bylaws from AFSCME's proposed proxy expense reimbursement bylaw, and (2) to explain why *CA, Inc.*'s holding would not disturb mandatory advancement bylaws.[288]

Absent this explanation, the authors are left to speculate: if a bylaw cannot require mandatory reimbursement of proxy expenses without a fiduciary out, "how can a bylaw require mandatory advancement of expenses without a fiduciary out? And, if a fiduciary out is necessary, [thereby permitting a board to avoid mandatory advancement,] is there really such a thing as mandatory advancement of expenses after *CA, Inc.*?"[289] In light of this ambiguity, the authors contend that "many directors now fear that their protection of 'mandatory' advancement of expenses is now subject to the Board's fiduciary duty at the time of the request."[290]

The second relevant commentary is that of Travis Laster, a Vice Chancellor of the Delaware Court of Chancery who analyzed the *CA, Inc.* decision before taking the bench.[291] Echoing AFSCME's counsel, Laster observed that *CA, Inc.*'s fiduciary out requirement represents a "fiduciary trump card," with the result that mandatory bylaws "may no longer be mandatory."[292]

According to Laster, litigation over mandatory advancement represents the most obvious situation in which a conflict between fiduciary duties and a mandatory bylaw can arise.[293] Of course, courts have enforced mandatory advancement bylaws even where a board "believes the recipient [director] is a bad actor and that it would be a breach of the board's duties

287. Stuart M. Grant & John C. Kairis, *Shareholder Proposals for Reimbursement of Expenses Incurred in Proxy Contests: Recent Guidance from the Delaware Supreme Court*, *in* WHAT ALL BUSINESS LAWYERS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 2009, at 519, 526–33 (PLI Corp. Law & Practice, Course Handbook Series No. 19172, 2009), WL 1740 PLI/Corp 519. Grant and Kairis are Directors of Grant & Eisenhofer P.A. and served as counsel to AFSCME in *CA, Inc. v. AFSCME Employees Pension Plan*.

288. *See id.* at 534–35.

289. *Id.* at 534.

290. *Id.* at 535.

291. *See* Laster, *supra* note 255. Laster was sworn in as Vice Chancellor of the Delaware Court of Chancery on October 9, 2009. *Court of Chancery Judicial Officers*, DEL. ST. CTS., http://courts.delaware.gov/chancery/judges.stm (last visited Feb. 23, 2012) (select "J. Travis Laster" tab).

292. *See* Laster, *supra* note 255.

293. *See id.*

to provide the advancements."[294] Nevertheless, *CA, Inc.*'s prescribed fiduciary out serves to restore broad discretion to the board whenever circumstances implicate its fiduciary duties.[295]

Laster envisions two scenarios occurring at a corporation that has adopted a mandatory advancement bylaw with a fiduciary out.[296] First, the board elects to advance a particular expense, either confident that its fiduciary duties dovetail with the bylaw, or uncertain of what decision its fiduciary duties require and hesitant to violate the bylaw.[297] Following *CA, Inc.*, directors that act in reliance on a mandatory bylaw can be "second-guessed" on the ground that their fiduciary duties actually required them not to advance.[298] Thus, a board's decision to advance despite a fiduciary out will, predictably, expose the board to breach of fiduciary duty actions by shareholders.[299]

Alternatively, the board may deny advancement, arguing that a mandatory advancement bylaw cannot preclude operation of its fiduciary duties, and that it therefore has the discretion to avoid the obligation to advance.[300] Indeed, Laster predicts that the next development in advancement jurisprudence will feature boards making this very claim.[301] While this argument was not, in fact, viable under advancement jurisprudence before the *CA, Inc.* decision, Laster posits that it could be asserted in good faith following *CA, Inc.*[302]

Ultimately, Laster expects that Delaware courts will "find a way" to uphold mandatory advancement bylaws.[303] He points out, however, that reaching such a result will require that courts distinguish advancement actions from *CA, Inc.*, without specifying how this can be achieved.[304] One expects that Laster, as Vice Chancellor, will play an instrumental role in crafting the Delaware Court of Chancery's approach to this conflict.

III. CREDIT WHERE CREDIT IS DUE: THE CONTINUING VALIDITY OF MANDATORY ADVANCEMENT BYLAWS

As detailed in Part II, the Delaware Supreme Court's extension of anti-precommitment doctrine to invalidate a mandatory proxy expense

294. *Id.*
295. Ursaner, *supra* note 96, at 507.
296. *See* Laster, *supra* note 255.
297. *See id.*
298. *Id.*
299. *See* Ursaner, *supra* note 96, at 507 (characterizing such actions as claims the board "otherwise would not be subject to").
300. Laster, *supra* note 255. *But see supra* Part I.B.5.e (discussing this argument in the context of the *Felicetti-Ridder-Neal* line of cases).
301. *See* Travis Laster, *Rock Bottom: Here We Come…*, THECORPORATECOUNSEL.NET BLOG (Oct. 24, 2008, 6:40 AM), http://www.thecorporatecounsel.net/Blog/2008/10/rock-bottom-here-we-come.html (under *Despite Conviction: Advancement Rights Continue Through Appeal*).
302. *Id.*
303. Laster, *supra* note 255.
304. *See id.*

reimbursement bylaw in *CA, Inc*.[305] has also purportedly nullified mandatory advancement bylaws[306] that the Court of Chancery has consistently enforced.[307] Part III first suggests that amendments mandating advancement to either the DGCL or a corporation's certificate of incorporation would protect mandatory advancement in the event the *CA, Inc.* decision invalidates mandatory advancement bylaws. It continues by proposing that the standard of review that the Delaware Supreme Court employed in *CA, Inc.* reveals a reason that the *CA, Inc.* decision will not render mandatory advancement bylaws invalid.

In light of *CA, Inc.*'s requirement that mandatory bylaws include fiduciary out provisions, boards that advance directors' litigation expenses will do so at their peril, exposing themselves to fresh breach of duty claims.[308] The risk of shareholder litigation will discourage boards from granting advances even when their fiduciary duties permit advancement, effectively gutting the mandatory aspect of mandatory advancement bylaws.[309]

Denying advancement also presents the board with a litigation risk in the form of claims to enforce mandatory advancement bylaws by directors seeking advancement.[310] Here, *CA, Inc.*'s fiduciary out requirement appears to provide recalcitrant boards an excuse from their obligations: that advancement in a particular case would breach their fiduciary duties.[311]

Assuming that the *CA, Inc.* holding does, in fact, implicate the validity of mandatory advancement bylaws under Delaware law, the question this Note seeks to address is how boards should act (1) to protect their advancement entitlement as currently recognized under Delaware law, and (2) to minimize the risk of litigation resulting from their decisions in the advancement sphere. This Note suggests that an amendment to the DGCL or to a given corporation's certificate of incorporation would each serve to restore the mandatory nature of advancement bylaws.

Nevertheless, this Note also intends to refute the assumption that the *CA, Inc.* holding, by itself, renders invalid mandatory advancement bylaws lacking fiduciary outs. Because the *CA, Inc.* case reached the court by certification, the court employed a standard of review that took into account the entirety of Delaware precedent, a circumstance that is not ordinarily present in advancement actions.[312] The *CA, Inc.* court was bound to invalidate the proposed mandatory proxy expense reimbursement bylaw by precedent dictating that a board's compliance with such a bylaw would, in certain circumstances, comprise a breach of its fiduciary duties.[313]

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305. *See supra* Parts I.A.4–5.
306. *See supra* Part II.B.
307. *See supra* Part I.B.5.
308. *See supra* notes 297–99 and accompanying text.
309. *See supra* note 292 and accompanying text.
310. *See supra* notes 300–03 and accompanying text.
311. *See supra* notes 300–03 and accompanying text.
312. *See supra* notes 136–37 and accompanying text.
313. *See supra* notes 138–42 and accompanying text.

Of course, advancement actions before the Delaware Court of Chancery ordinarily present the court with a set of facts upon which to apply the Delaware law.[314] Nonetheless, even if a particular advancement case demanded the rigorous standard of review employed in *CA, Inc.*, the court would still not invalidate the mandatory advancement bylaw at issue.

No Delaware precedent holds that advancement pursuant to a mandatory advancement bylaw constitutes a breach of the board's fiduciary duty.[315] Indeed, the Delaware Court of Chancery has upheld directors' advancement rights and enforced mandatory advancement bylaws in even the most egregious cases.[316] Because no set of facts has dictated such a result in the past, precedent does not compel invalidation if a certified question were to present this issue in the future. Moreover, given the court's enforcement of mandatory advancement bylaws in the most egregious cases, it seems unlikely that the court will find itself confronted with a case whose facts demand such a result.

Thus, the requirement to include fiduciary outs in mandatory advancement bylaws will not gut their mandatory nature. Instead, these mandatory advancement bylaws will effectively disable the escape hatch of fiduciary outs.

A. Boards Should Protect Advancement by Amending Certificates of Incorporation

In the *CA, Inc.* decision, the Delaware Supreme Court concluded that AFSCME's proposed mandatory proxy expense reimbursement bylaw could only be valid under Delaware law if: (1) the proposed bylaw included a fiduciary out provision; (2) the CA, Inc. certificate of incorporation was amended to allow such a restriction on the board's powers; or (3) the Delaware General Assembly amended the DGCL to expressly permit such a bylaw.[317]

Thus, the first step directors can take to secure their advancement entitlements is to amend their corporations' certificates of incorporation to mandate advancement to directors to the full extent of Delaware law.

CA, Inc. purportedly requires mandatory advancement bylaws to include fiduciary outs because mandatory advancement bylaws otherwise impermissibly constrain a board's ability to exercise its fiduciary duties. Nevertheless, section 102(b)(1) of the DGCL dictates that restrictions on a board's managerial authority are permissible so long as they appear in the corporation's certificate of incorporation.[318]

Therefore, a board may certainly precommit to a mandatory advancement policy without implicating its fiduciary duties if it amends the corporation's

314. *Cf. supra* note 136 and accompanying text.
315. *See supra* Part I.B.5.
316. *See supra* Part I.B.5.
317. *See supra* note 153 and accompanying text.
318. *See supra* note 124 and accompanying text.

certificate of incorporation to that effect.[319] This strategy would ultimately preserve advancement rights to the full extent permitted under Delaware law while also protecting directors from the claim that an advance breached their fiduciary duties.

B. The Delaware General Assembly Should Protect Advancement by Amending the DGCL

The second step directors can take to secure advancement entitlements is to encourage the Delaware General Assembly to amend section 145 of the DGCL to mandate advancement to the full extent of Delaware decisional law. Section 145 contemplates a liberal advancement regime to serve a number of salutary public policies.[320] As a result, Delaware courts have interpreted and enforced mandatory advancement bylaws to craft expansive advancement rights.[321] Because a board may attempt to deny advancement after *CA, Inc.* given the fiduciary out requirement, the Delaware General Assembly may find it necessary to mandate advancement in the DGCL to shore up the public policies that advancement supports. In light of section 145(c)'s mandate of indemnification,[322] a mandate of advancement will likely support these beneficial policies as well.

C. Why CA, Inc. *Ultimately Leaves Mandatory Advancement Bylaws Intact*

The preceding two proposals presume that directors will use *CA, Inc.*'s fiduciary out requirement to avoid their advancement obligations. In other words, these approaches are advisable given that boards will capably demonstrate that their fiduciary duties in fact preclude advancement. This assumption overlooks a crucial difference, however, that distinguishes bylaws mandating advancement from those mandating proxy expense reimbursement. This difference ultimately protects directors' advancement entitlement from the exercise of fiduciary outs.

Because *CA, Inc.* reached the Delaware Supreme Court via certification, the case lacked a factual record upon which to apply Delaware law.[323] Under ordinary circumstances, the court would have considered the parties' evidence and decided whether a particular reimbursement of proxy expenses precluded the board's exercise of its fiduciary duties.[324] In *CA, Inc.*, however, the court had to consider whether the proposed bylaw's mandate to reimburse proxy expenses would preclude the board's exercise of its fiduciary duties in any possible circumstance.[325] Ultimately, the court found that the bylaw would indeed interfere with the board's fiduciary duties in one specific scenario—when the proxy contest was motivated by

319. This approach requires that both the board and a majority of shareholders approve the proposed amendment to the certificate. *See supra* note 153.

320. *See supra* notes 167–71 and accompanying text.

321. *See supra* Part I.B.5.

322. *See supra* notes 185–86 and accompanying text.

323. *See supra* notes 136–37 and accompanying text.

324. *See supra* notes 136–37 and accompanying text.

325. *See supra* notes 136–37 and accompanying text.

personal or petty concerns.[326] Under this precedent, the Delaware Supreme Court was bound to hold that AFSCME's proposed bylaw, if adopted, would cause CA to violate Delaware law,[327] and that a fiduciary out would be sufficient to cure this flaw.[328]

The critical difference between bylaws mandating proxy expense reimbursement and those mandating advancement is that the Delaware Court of Chancery has never found that a board's obligation to advance pursuant to a mandatory bylaw actually precludes the exercise of the board's fiduciary duties.[329] *CA, Inc.* correctly presumes that a fiduciary out will impact a proxy expense reimbursement bylaw precisely because the proper exercise of fiduciary duties will preclude a board from reimbursing proxy expenses in a proxy contest based on personal or petty concerns. Nevertheless, the Delaware Court of Chancery has never recognized a factual context in which a mandatory advancement bylaw would, in fact, constrain the board's ability to exercise its fiduciary duties.[330]

This difference is significant because a board denying advancement will not be able to argue successfully, as the law currently stands, that its fiduciary duties preclude advancement. Indeed, even where a director has pled guilty to an offense that would render him ineligible for indemnification, the court has enforced his advancement rights.[331]

In even the most unfavorable case, then, it seems clear that an intractable board could not successfully claim that its fiduciary duties preclude advancement. Because boards will not be able to avoid the obligation to advance, *CA, Inc.*'s fiduciary out requirement will have no effect on the validity and enforceability of mandatory advancement bylaws.

CONCLUSION

The Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan* invalidated a proposed bylaw mandating proxy expense reimbursement because compliance with the bylaw in one scenario would cause the board to breach its fiduciary duties. The *CA, Inc.* decision thereby extended Delaware jurisprudence against precommitment arrangements that prevent directors from fully discharging their duties to shareholders.

The *CA, Inc.* court suggested that inclusion of fiduciary out provisions would render mandatory bylaws valid, but this requirement might also permit boards to escape their obligation to advance defendant directors' legal expenses under mandatory advancement bylaws.

Nonetheless, boards will not succeed in exercising fiduciary outs to deny advancement because the Delaware Court of Chancery recognizes no situation where advancement would actually breach directors' fiduciary

326. *See supra* notes 138–42 and accompanying text.
327. *See supra* note 142 and accompanying text.
328. *See supra* note 152 and accompanying text.
329. *See supra* Part I.B.5.
330. *See supra* Part I.B.5.
331. *See supra* note 249 and accompanying text.

duties. While corporations and the Delaware General Assembly may act to protect directors' advancement rights, the *CA, Inc.* decision itself does not disturb mandatory advancement bylaws.