

## INDEMNIFICATION AND EXCULPATION OF PROFESSIONAL PERSONS IN BANKRUPTCY CASES

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### INTRODUCTION

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### INTRODUCTION

The inclusion of indemnification and exculpation provisions in engagement agreements between debtors in possession and management companies, financial advisors or other professionals has become commonplace<sup>1</sup> in the wake of the claims asserted against an accounting firm in the *In re Merry-Go-Round Enterprises*<sup>2</sup> bankruptcy case and the \$185 million settlement of those claims. Indemnification

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<sup>1</sup> See e.g., *Unsecured Creditors' Comm. v. Joel Pelofsky (In re Thermadyne Holdings Corp.)*, No. 02-6031EM, 2002 WL 31190927, at \*4, \*6 (B.A.P. 8th Cir. Sept. 17, 2002) (holding indemnification provision is not *per se* impermissible, but upholding bankruptcy court's refusal to approve indemnification provision); *In re DEC Int'l*, 282 B.R. 423, 424 (W.D. Wis. 2002) (holding that indemnification is not *per se* impermissible and upholding bankruptcy court approval of provisions at issue); *In re Metricom, Inc.*, 275 B.R. 364, 371-72 (Bankr. N.D. Cal. 2002) (declining to approve indemnity provision but holding that indemnification not *per se* impermissible); *In re Halpern, Inc.*, 248 B.R. 43, 47 (Bankr. S.D.N.Y. 2000) (permitting indemnification of financial advisors, but requiring extension of exclusionary language), *aff'd*, 2000 WL 1800690 (S.D.N.Y. Dec. 6, 2000); *In re Mortgage & Realty Trust*, 123 B.R. 626, 628 (Bankr. C.D. Cal. 1991) (holding debtor may not indemnify investment advisor through agreement); *In re Gillett Holdings, Inc.*, 137 B.R. 452, 458-49 (Bankr. D. Colo. 1991) (refusing to approve indemnification agreement, but holding that determination should be made on "case-by-case" basis); *In re Allegheny Int'l Inc.*, 100 B.R. 244, 246 (Bankr. W.D. Pa. 1989) (concluding provision allowing indemnification for gross negligence of investment bankers too broad); *In re Drexel Burnham Lambert Group, Inc.*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) (holding indemnification is inappropriate); *In re Comdisco, Inc.*, No. 02-C 1174, 02 C 1397, 2002 WL 31109431, at \*5-6 (N.D. Ill. Sept. 23, 2002) (rejecting United States Trustee's position that indemnification agreements are *per se* impermissible in bankruptcy cases).

<sup>2</sup> 244 B.R. 327, 333 (Bankr. D. Md. 2000).

and exculpation provisions have generated significant litigation between debtors in possession, professionals and the Offices of The United States Trustees.<sup>3</sup> This article addresses the permissible scope of such indemnification and exculpation provisions.

## I. SECTION 328(A) AND STATE LAW IN GENERAL

Section 328(a) of the Bankruptcy Code provides that a debtor in possession, "with the court's approval, may employ or authorize the employment of a professional person under section 327 . . . on any reasonable terms and conditions of employment."<sup>4</sup> The party seeking approval of a professional person's employment bears the burden of proving that the terms of the agreement are reasonable.<sup>5</sup> In determining whether a party has met that burden, a court should consider the totality of the circumstances, including without limitation, the debtor in possession's fiduciary duty to parties in interest, the professional persons fiduciary duty to the debtor in possession, the standards for employment of professional persons in the non-bankruptcy context, the support or lack thereof demonstrated by creditors and other parties in interest that would bear the financial burden of indemnification or exculpation, and the permissibility of the proposed terms of employment under applicable state law.

Officers and directors of a Delaware corporation owe a fiduciary duty to creditors and other parties in interest where the corporation is operating in the "vicinity of insolvency."<sup>6</sup> Filing a bankruptcy petition does not insulate

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<sup>3</sup> See Joseph A. Guzinski, *The United States Trustees: Ongoing Challenges*, 820 PLI COMM. L. PRACTICE COURSE HANDBOOK SER. 251, 274–75 (2001) (asserting opposition of United States Trustees to indemnification of professionals for their work in bankruptcy cases); see also *In re DEC Int'l*, 282 B.R. at 426 ("According to the Trustee, this challenge is one of a number that United States Trustees are bringing in opposition to the approval of similar agreements signed with financial advisers."); *In re Comdisco, Inc.*, 2002 WL 31109431, at \*2 (noting several United States Trustees have been opposing indemnification provisions because United States Trustees claim that "they invite substandard care in the conduct of bankruptcy proceedings.") (quoting Trustee's reply brief at 3).

<sup>4</sup> 11 U.S.C. § 328(a) (2000).

<sup>5</sup> See *In re Thermadyne Holdings Corp.*, 2002 WL 31190927, at \*5; *In re Metricom, Inc.*, 275 B.R. at 371 (moving party bears burden of proving terms of engagement, including that indemnification and exculpation provisions, are "reasonable" under section 328(a)); *In re Hathaway Ranch P'ship*, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990) (party seeking to employ professional bears burden of proving that terms of engagement are "reasonable" under section 328(a)); see also *In re C & P Auto Transp. Inc.*, 94 B.R. 682, 686 (Bankr. E.D. Cal. 1988) ("Burden of proof to establish that proposed terms and conditions of employment are reasonable is on the moving party.").

<sup>6</sup> See *LaSalle Nat'l Bank v. Perelman*, 82 F. Supp. 2d 279, 290 (D. Del. 2000) ("Under Delaware law, officers and directors of a corporation generally do not owe a fiduciary duty to the creditors of the corporation unless the corporation is insolvent.") (citing *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp.*, CIV. A. No. 12150, 1991 WL 277613, at \*34 (Del. Ch. Dec. 30, 1991)); see also *In re Hechinger Inv. Co. of Del.*, 274 B.R. 71, 89 (D. Del. 2002) (commenting that fiduciary duties to creditors materialize moment corporation becomes insolvent); *In re Buckhead Am. Corp.* 178 B.R. 956, 968 (Bankr.

management's conduct from review under state corporate law fiduciary principles.<sup>7</sup> A debtor in possession and its officers and directors also owe a similar fiduciary duty to creditors and other parties in interest.<sup>8</sup> Thus, where a debtor in possession is liquidating all or substantially all of its assets and; therefore, the debtor in possession has no significant interest at stake, the debtor in possession, and the court, should give significant deference to the creditors' viewpoint before approving exculpation or indemnification provisions.

Section 328 should not be interpreted as pre-empting state law regarding a corporation's powers and the limits thereon. Thus, a court should also consider the appropriateness of the terms of the proposed employment, including indemnification and exculpation provisions, under applicable state corporation law.

State law is "suspended 'only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress.'"<sup>9</sup>

While Congress, under its Bankruptcy power, certainly has the constitutional prerogative to pre-empt the States, . . . the usual rule is that congressional intent to pre-empt will not be inferred lightly. Pre-emption must either be explicit, or compelled due to an unavoidable conflict between the state law and the federal law. Consideration of whether a state provision violates the supremacy clause starts with the basic assumption that Congress did not intend to displace state law.<sup>10</sup>

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D. Del. 1994) (noting "where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to corporate enterprise.") (quoting *Credit Lyonnais Bank Nederland, N.V.*, 1991 WL 277613, at \*34); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (defining insolvency for purposes of determining when fiduciary duty to creditors arises as "insolvency in fact" and not "insolvency due to statutory filing").

<sup>7</sup> See *In re Schepps Food Stores, Inc.*, 160 B.R. 792, 799 (Bankr. S.D. Tex. 1993) ("[S]tate law standards continue to apply to post-petition fiduciary obligations"); Dennis F. Dunne, *The Revlon Duties and the Sale of Companies in Chapter 11*, 52 BUS. LAW 1333, 1340 (1997) (discussing same); see also *Wolf v. Weinstein*, 372 U.S. 633, 649 (1963) ("[S]o long as the debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession"); *Pepper v. Litton*, 308 U.S. 295, 306 (1939) ("[R]ules governing fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy.").

<sup>8</sup> See *CFTC v. Weintraub*, 471 U.S. 343, 355 (1985) (asserting that directors of debtor in possession have same fiduciary obligation to creditors and shareholders as would trustee for debtor out of possession).

<sup>9</sup> *Chicago Title and Trust Co. v. Forty-One Thirty-Six Wilcox Bldg. Corp.*, 302 U.S. 120, 126 (1937) (quoting *Stellwagen v. Clum*, 245 U.S. 605, 613 (1918)); see also *Morton v. Nat'l Bank of N.Y.* (*In re Morton*), 866 F.2d 561, 563 (2d Cir. 1989) (quoting same); *Missouri ex rel. Darr v. A.B. Collins & Co.*, 34 F. Supp. 550, 554 (W.D. Mo. 1940) ("[I]f a bankruptcy law conflicts with some state procedure, of course the state procedure must give way . . .").

<sup>10</sup> *Penn Terra, Ltd. v. Dep't. of Env'tl. Res.*, 733 F.2d 267, 272-73 (3d Cir. 1984) (citations omitted); see also *Maryland v. Louisiana*, 451 U.S. 725, 746 (1981) (asserting that consideration under Supremacy Clause starts with basic assumption that Congress did not intend to displace state law); *In re Hechinger Inv. Co. of Del.*, 274 B.R. at 96 ("[F]ederal law may preempt state law either expressly or impliedly - the latter either by occupying the field, or because state and federal laws conflict.").

The application of state corporation law to the engagement of professional persons does not frustrate federal bankruptcy law and, therefore, should not be interpreted as pre-empted by section 328.<sup>11</sup>

Considering whether a debtor in possession may indemnify or exculpate a professional person, the bankruptcy court should consider the standard terms of employment of professional persons in the non-bankruptcy context. Consideration of those standard terms is important to insure that competent specialists continue to practice in the bankruptcy courts.<sup>12</sup> Professional persons, however, may claim that very broad indemnity and exculpation provisions are standard in the non-bankruptcy context even where the facts do not strongly support the claim.<sup>13</sup> Notwithstanding the fact that a bankruptcy court should consider the terms of engagement of professional persons in the non-bankruptcy market, courts should also ask whether the unsecured creditors will bear the full brunt of an indemnity or exculpation claim, particularly in cases where the debtor in possession may be less concerned about professional fees because it will sell all or substantially all of its assets and discontinue its operations. Although state law is relevant, it should provide the ceiling rather than the floor. In other words, in determining whether any proposed indemnification or exculpation is "reasonable" under section 328, the court should consider the permissibility of such indemnification or exculpation provision under state law. Alternatives such as any available insurance and the cost thereof should also be considered.

## II. INDEMNIFICATION UNDER DGCL SECTION 145

When addressing the propriety of indemnification and exculpation provisions, a court should consider any limits imposed by the relevant state corporation law.<sup>14</sup>

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<sup>11</sup> See Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should the Meeting Be Cancelled Altogether?*, 58 GEO. WASH. L. REV. 1214, 1244 (1990) (stating "[N]onbankruptcy corporation law should be incorporated into bankruptcy law" because, *inter alia*, debtor will eventually emerge from chapter 11 and continue operating under such corporation law); see also *Stellwagen*, 245 U.S. at 613 ("[N]otwithstanding this requirement as to uniformity the bankruptcy acts of Congress may recognize the laws of the State in certain particulars, although such recognition may lead to different results in different States").

<sup>12</sup> See, e.g., *In re Busy Beaver Bldg. Ctrs., Inc.*, 19 F.3d 833, 849 (3d Cir. 1994) (indicating how bankruptcy courts consider what non-bankruptcy lawyers typically charge for services when reviewing attorney fee applications).

<sup>13</sup> See, e.g., *In re Dailey Int'l, Inc.*, Case No. 99-1233 (PJW), letter ruling at 7 (Bankr. D. Del. July 1, 1999) (finding professional person's affidavit under Federal Rule of Bankruptcy Procedure 2014 did not provide credible evidence to support claim that proposed indemnification and exculpation provisions were standard in marketplace outside of bankruptcy); see also *In re DEC Int'l, Inc.*, 282 B.R. 423, 429 (W.D. Wis. 2002) (noting reference to indemnification agreements as "usual and customary" might be "nothing more than a self-fulfilling prophecy").

<sup>14</sup> See *Atherton v. FDIC*, 519 U.S. 213, 224 (1997) ("[S]tates normally look to the State of a business' incorporation for the law that provides the relevant corporate governance general standard of care."); *Davis & Cox v. Summa Corp.*, 751 F.2d 1507, 1527 (9th Cir. 1985) ("[I]ndemnification of corporate directors is an

Section 145 of the Delaware General Corporation Law ("DGCL")<sup>15</sup> governs discretionary and mandatory indemnification by Delaware corporations. The purpose of section 145 is "to encourage capable persons to serve as officers, directors, employees or agents of Delaware corporations, by assuring that their reasonable legal expenses will be paid."<sup>16</sup>

Section 145(a) provides a Delaware corporation with discretionary authority to indemnify officers, directors, employees or agents. Section 145(a) governs the corporation's discretionary power of indemnity with respect to third party actions as follows:

(a) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (*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, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, *against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement* actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted *in good faith* and in a manner the person *reasonably believed* to be in or not opposed to the best interests of the corporation . . . .<sup>17</sup>

As set forth above, section 145(a) authorizes a Delaware corporation to indemnify a party against judgments, fines, settlement payments, attorneys' fees and expenses in a third party action.

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'internal affair' of a corporation and is therefore subject to the law of the state of incorporation."); Teren v. Howard, 322 F.2d 949, 950 (9th Cir. 1963) (noting law of state of incorporation governs corporation's power to indemnify); RESTATEMENT (SECOND) CONFLICTS OF LAWS § 309 (1971) (discussing application of law of state of incorporation to director's liability).

<sup>15</sup> DEL. CODE ANN. tit. 8, § 145 (2001).

<sup>16</sup> Mayer v. Executive Telecard, Ltd., 705 A.2d 220, 223 (Del. Ch. 1997); *see also* Witco Corp. v. Beekhuis, 38 F.3d 682, 691 (3d Cir. 1994) (discussing purpose of DGCL provisions in encouraging individuals to serve in positions without fear of desertion by corporation); Chamison v. Healthtrust, Inc., 735 A.2d 912, 925 n.45 (Del. Ch. 1999) (explaining purpose of legislation is to "encourage capable men [and women] to serve in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve.") (quoting Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 343-44 (Del. Super. Ct. 1983)), *aff'd*, 748 A.2d 407 (Del. Supr. 2000).

<sup>17</sup> DEL. CODE ANN. tit. 8, § 145(a) (emphasis added).

Section 145(b) of the DGCL governs the corporation's discretionary power of indemnity with respect to claims brought by, or on behalf of, the corporation as follows:

(b) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit *by or in the right of the corporation* to procure a judgment in its favor by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise *against expenses (including attorneys' fees)* actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit if the person acted *in good faith* and in a manner the person *reasonably believed* to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.<sup>18</sup>

Section 145(b) does not authorize a Delaware corporation to indemnify a party against judgments or settlement payments in actions brought by, or on behalf of, the corporation.<sup>19</sup> Section 145(b) permits only the limited indemnification of attorneys' fees and other expenses in actions brought by, or on behalf of, the corporation.

Sections 145(a) and (b) do not authorize indemnification in every action brought by a third party or by or on behalf of the corporation. Rather, sections 145(a) and (b) only authorize indemnification in an action brought "by reason of the fact that the person is or was" an officer, director, or corporate agent.<sup>20</sup>

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<sup>18</sup> *Id.* section 145(b) (emphasis added).

<sup>19</sup> See R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, at 4-83 (3d ed. 2001) (construing tit. 8, § 145(b)).

<sup>20</sup> DEL. CODE ANN. tit. 8, § 145(a)–(b); *see also* Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82, 83 (Del. Ch. 1992) (stating tit. 8 § 145 defines scope of indemnification to be confined to losses by "officer, director, employee, or agent . . . incurred by reason of holding any such position."). *See generally* ERNEST L. FOLK, III, DELAWARE GENERAL CORPORATION LAW, A COMMENTARY AND ANALYSIS 98 (1972).

In *Cochran v. Stifel Financial Corp.*, the Delaware Court of Chancery considered whether someone who was at the same time a corporate officer, director and employee was entitled to indemnification in a dispute concerning alleged breach of his employment contract.<sup>21</sup> The court declared that when a corporate officer negotiates a contract with a corporation he does so in an adversarial, arm's length transaction.<sup>22</sup> The officer has a personal obligation to perform his obligations under the contract.<sup>23</sup> The court concluded that when a corporation brings a breach of employment contract claim against the officer and proves its entitlement to relief, it is "problematic to conclude that the suit has been rendered an 'official capacity' suit subject to indemnification under section 145."<sup>24</sup> The court added that such a conclusion would render the officer's duty to perform his side of the contract illusory.<sup>25</sup> It held a breach of employment contract claim against a corporate officer is not subject to indemnification under section 145 as a claim brought "by reason of the fact that the person is or was" an officer of the corporation.<sup>26</sup>

Section 145(c) of the DGCL governs mandatory indemnification.<sup>27</sup> Section 145(c) requires a Delaware corporation to indemnify an officer or director as follows:

(c) To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections

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(discussing how statutory emphasis lies in "fact that [the individuals] are sued by reason of their status as director or officer.") (quoting *Essential Enters. Corp. v. Automatic Steel Prods., Inc.*, 164 A.2d 437, 441 (Del. Ch. 1960)).

<sup>21</sup> No. Civ. A. 17350, 2000 WL 1847676, at \*6 (Del. Ch. Dec. 13, 2000), *aff'd in relevant part, rev'd in part on other grounds*, 2002 WL 1316240, at \*1 (Del. Jun 13, 2002) ("[W]e agree that the claims litigated in the arbitration action were properly characterized as personal, not directed at Cochran in his 'official capacity' as an officer and director.").

<sup>22</sup> See *Cochran*, 2000 WL 1847676 at \*6; see also *In re Auto Specialties Mfg. Co.*, 153 B.R. 503, 508 (W.D. Mich. 1993) (describing test for determining whether parties deal at arm's length as "whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.") (quoting *Pepper v. Litton*, 308 U.S. 295 (1939)); BLACK'S LAW DICTIONARY 42 (2d Pocket ed. 2001) (defining "arm's length transaction" as one "[o]f or relating to dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power").

<sup>23</sup> See *Cochran*, 2000 WL 1847676, at \*6 (holding director bound himself to important personal obligations, including: commitment to repay excessive compensation received within ten days of proper notice by corporation; to repay balance of promissory note in event of termination for cause in accordance with agreement; not to compete with corporation for one year after his contract was terminated; and to arbitrate any disputes arising out of agreement).

<sup>24</sup> *Id.*; see also *Reddy v. Elec. Data Sys. Corp.*, No. CIV.A. 19467 2002 WL 1358761, at \*5 (Del. Ch. June 18, 2002) (discussing how "official capacity" defense vitiates protections of tit. 8, § 145 because corporate directors, officers, and employees can invoke defense when their primary purpose is to divert corporate resources to own pocket).

<sup>25</sup> *Cochran*, 2000 WL 1847676, at \*6.

<sup>26</sup> *Id.* at \*7; see also *Reddy*, 2002 WL 1358761, at \*6 (allowing indemnification by reason of defendant's corporate function when conduct arose in capacity of corporate officer).

<sup>27</sup> DEL. CODE ANN. tit. 8, § 145(c) (2001).

(a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.<sup>28</sup>

Section 145(c) requires a Delaware corporation to indemnify an "officer" or "director" in a third-party action or an action brought by, or on behalf of, a corporation where the officer or director has been successful on the merits or otherwise.<sup>29</sup> Mandatory indemnification under section 145(c) applies only to attorneys' fees and other expenses. Section 145(c) does not apply to "agents."<sup>30</sup>

Section 145(f) of the DGCL provides that the other provisions of that section are not exclusive of the right to indemnification and advancement of expenses under any "by-law, agreement, vote of stockholders or disinterested directors or otherwise."<sup>31</sup> Section 145(f), however, provides a standard for officers, directors, or other agents, such as management companies or financial advisors, to obtain indemnity agreements. Section 145(f) has been interpreted as allowing corporations to indemnify officers, directors, or agents subject to the same limitations on conduct set forth in subsections (a) and (b) of section 145.

The Second Circuit has held section 145(f) only authorizes a Delaware corporation to indemnify a party that either (i) acted in good faith in a manner that it reasonably believed to be in the best interests of the corporation, or (ii) has been successful on the merits or otherwise.<sup>32</sup> The Delaware Court of Chancery adopted

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<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> See *Cochran*, 2000 WL 1847676, at \*2 n.6 (noting tit. 8, § 145(c) was amended to remove requirement of mandatory indemnity of agents); BALOTTI & FINKELSTEIN, *supra* note 19, at 4-85 n.443 (stating tit. 8, § 145(c) was amended to eliminate mandatory statutory indemnification for agents).

<sup>31</sup> DEL. CODE ANN. tit. 8, § 145(f) (2001); see also *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 344 (Del. 1983) (stating tit. 8, § 145(f) gives corporations power to "grant indemnification rights beyond those provided by the statute."); *Mooney v. Willys-Overland Motors, Inc.*, 106 F.Supp. 253, 257 n. 25 (D. Del. 1952) (discussing settlement agreement with indemnification provision that is not exclusive of other rights entitled to any director or officer), *aff'd*, 204 F.2d 888 (3d Cir. 1953); Michael J. Dougherty, *Are You Covered? VonFeldt v. Stifel Financial Corporation: Indemnification of Extra-Corporate Personnel Under Delaware Law*, 61 U. PITT.L.REV. 527, 542 (2000) ("[T]he flexibility inherent in subsections (a) and (b) is reinforced by subsection (f) which explicitly makes the statutory scheme 'nonexclusive'").

<sup>32</sup> See *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87, 95 (2d Cir. 1996) (holding good faith requirement of tit. 8, § 145(a) and (b) cannot be waived by statute's nonexclusivity provision); see also *Owens Corning v. Nat'l Union Fire Ins. Co.*, 257 F.3d 484, 494 (6th Cir. 2001) (explaining limits of indemnification under tit. 8, § 145(f)); RODMAN WARD, JR., EDWARD P. WELCH & ANDREW J. TUREZYN, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 145.8 (4th ed. 2002) (stating director or officer must show either actions in good faith or success on merits); Note, Kurt A. Mayr, II, *Indemnification of Directors and Officers: The "Double Whammy" of Mandatory Indemnification Under Delaware Law in Waltuch v. Conticommodity Services, Inc.*, 42 VILL.L.REV. 223, 264 (1997) (acknowledging tit. 8, § 145(f) "cannot be read to free a corporation from the good faith limit explicitly imposed upon the real grant of power to indemnify found in subsections (a) and (b).").



the Second Circuit's interpretation of section 145(f) and held a Delaware corporation may not indemnify a party that has been adjudged liable or has made a settlement payment where that party did not act in good faith or in the best interests of the corporation.<sup>33</sup> Pursuant to an agreement under section 145(f) of the DGCL, the debtor in possession may be able to indemnify an agent to the extent permitted under section 145(a) or (b) even where the agent did not act in good faith or with a reasonable belief that its actions were in the debtor in possession's best interest if the agent successfully defended against third party claims or claims brought by or on behalf of a debtor in possession.<sup>34</sup> Of course, the corporation may purchase insurance covering claims against which the corporation may not indemnify the officer, director, or agent.<sup>35</sup>

To the extent that an individual consultant has been employed as an officer or director of a debtor in possession under section 327(b), the individual should be entitled to mandatory, and may benefit from permissive, indemnification within the limits of section 145. To the extent that a professional person to be engaged by a debtor in possession as a consultant under section 327(a) is an "agent" of the corporation, the professional person may be indemnified only within the limits of section 145.

### III. "AGENCY" UNDER DGCL SECTION 145

Often an engagement agreement between a debtor in possession and a professional person provides that the professional person is an independent contractor. An independent contractor, however, may be an "agent." "One who contracts to act on behalf of another and subject to the other's control except with

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<sup>33</sup> See *VonFeldt v. Stifel Fin. Corp.*, No. Civ.A. 15688, 1999 WL 413393, at \*2 (Del. Ch. June 11, 1999), (stating Delaware corporation lacks power to indemnify party who did not act in good faith or in best interests of corporation); *Mayer v. Executive Telecard, Ltd.*, 705 A.2d 220, 224 n.6 (Del. Ch. 1997) ("[T]his Court agrees with the Second Circuit's construction of section 145 that a Delaware corporation lacks the power to indemnify a party who did not act in good faith."); *Kapoor v. Fujisawa Pharm. Co., Ltd.*, C.A. No. 93C-06-050 SCD, 1997 Del. Super. LEXIS 386, at \*11 (Del. Super. Aug. 22, 1997) (denying right to indemnification because no good faith attempt was made); *BALOTTI & FINKELSTEIN*, *supra* note 19, at 4-102 (stating tit. 8, § 145(f) is subject to policy limitations of subsections (a) and (b)); *WARD, WELCH, & TUREZYN*, *supra* note 32, § 145.8 (stating Delaware corporation does not have power to indemnify party who did not act in good faith).

<sup>34</sup> See *Cochran*, 2000 WL 1847676, at \*10 n.41 (stating how good faith requirement cannot be imposed "when section 145(c) expressly dictates indemnification to directors and officers without a showing of good faith.").

<sup>35</sup> See DEL. CODE ANN. tit. 8, § 145(g) (2001) (discussing how corporation may purchase and maintain insurance on behalf of any director, officer, employee or agent of corporation, against any liability "whether or not the corporation would have the power to indemnify such person against such liability under this section."). See generally 11 U.S.C. § 363(b)(1) (2000) (requiring bankruptcy court approval to purchase such insurance where purchase of such insurance was outside debtor in possession's ordinary course of business); *In re Roth American, Inc.*, 975 F.2d 949, 952-53 (3d Cir. 1992) (discussing vertical and horizontal tests for determination of whether transaction is in "ordinary course of business").

respect to his physical conduct is an agent and also an independent contractor."<sup>36</sup> Thus, an "attorney at law, the broker, the factor, the auctioneer and other similar persons employed either for a single transaction or for a series of transaction are agents, although as to their physical activities they are independent contractors."<sup>37</sup>

Under Delaware law, "the determination of whether an agency relationship exists is normally a question of fact."<sup>38</sup> An agency relationship for purposes of section 145 is created in Delaware "when one party consents to have another act on its behalf, with the principal controlling and directing the acts of the agent."<sup>39</sup> In *In re Shoe-Town, Inc.*, the Delaware Court of Chancery declared that a financial advisor "hired by management to work for and answer to management" was, "[i]n effect," an "agent" of management.<sup>40</sup>

As an "agent" of the debtor in possession, a management company or a financial advisor is a fiduciary to the debtor in possession.<sup>41</sup> Although a management company or financial advisor is a fiduciary of a debtor in possession, the management company or financial advisor is not necessarily a fiduciary to the debtor in possession's creditors or shareholders.<sup>42</sup> The fact that a professional person is an agent and fiduciary of a debtor in possession does not, by itself, preclude a debtor in possession from indemnifying a professional person.<sup>43</sup>

It is not enough to receive indemnification that a corporate agent has been sued by a third party or by or on behalf of the corporation. Such a claim is only subject

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<sup>36</sup> RESTATEMENT (SECOND) OF AGENCY § 14N (1958).

<sup>37</sup> *Id.* section 1 cmt. e.

<sup>38</sup> *Fisher v. Townsends, Inc.*, 695 A.2d 53, 61 (Del. 1997); see *Cochran*, 2000 WL 286722, at \*17 (citing *Fisher* as Delaware law); *Gooden v. Mitchell*, 21 A.2d 197, 201 (Del. Super. Ct. 1941) (noting no one factor in relationship can be decisive and each case necessarily must be decided on individual facts).

<sup>39</sup> *Fisher*, 695 A.2d at 57 (quoting *Sears Mortgage Corp. v. Rose*, 634 A.2d 74, 79 (N.J. 1993)); see *Cochran*, 2000 WL 286722, at \*17 (acknowledging *Fisher* as controlling law).

<sup>40</sup> *In re Shoe-Town, Inc. Stockholders Litig.*, C.A. No. 9483, 1990 WL 13475, at \*7 (Del. Ch. Feb. 12, 1990).

<sup>41</sup> See RESTATEMENT (SECOND) OF AGENCY §§ 1(1)–(3) (1958); 3 AM. JUR. 2D *Agency* § 1 (2002) (defining agency as "a fiduciary relationship by which a party confides to another the management of some business to be transacted in the former's name or on his or her account, and by which such other assumes to do the business and render an account of it.").

<sup>42</sup> See *In re Shoe-Town, Inc.*, 1990 WL 13475, at \*7 (discussing how financial advisor is generally not trustee and; therefore, does not stand in fiduciary duty to corporation's shareholders); *Hanson, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 457 (D. Utah 1998) ("As a general principle, attorneys owe no duty to nonclients. Thus counsel for the debtor-in-possession would not have any fiduciary duty to the beneficiaries of the estate because they are not clients."). But see *In re Imperial "400" Nat'l, Inc.*, 456 F.2d 926, 929 (3d Cir. 1972) ("A trustee in reorganization is an officer of the court who occupies a special fiduciary position, and counsel for the trustee has equivalent fiduciary responsibilities to the estate in reorganization and the creditors.").

<sup>43</sup> See *In re Halpern, Inc.*, 248 B.R. 43, 45–46 (Bankr. S.D.N.Y. 2000) (noting that fiduciaries may be indemnified with respect to certain acts), *aff'd*, 2000 WL 1800690 (S.D.N.Y. Dec. 6, 2000); *Stark v. United States Trust Co. of N.Y.*, 445 F.Supp. 670, 683 (S.D.N.Y. 1978) (stating exculpation provisions are recognized under New York law in inter vivos trusts); cf. RESTATEMENT (SECOND) OF AGENCY § 419 (1958) (explaining principal may release claims against agent).

to the indemnification provisions of section 145 if the claim is brought "by reason of the fact that the person is or was" an agent of the corporation.<sup>44</sup>

#### IV. EXCULPATION UNDER DGCL SECTION 102(B)(7)

In addition to indemnifying professional persons, debtors in possession often agree to exculpate or cap the liability of professional persons. While indemnification involves one party's agreement to protect the other party from claims made against it, exculpation involves one party's releasing another party from liability for otherwise valid claims that it may have against the released party.<sup>45</sup> Indemnification shifts responsibility for payment of damages from one party to another, while exculpation relieves one party from the consequences of its actions.<sup>46</sup>

Section 102(b)(7) of the DGCL authorizes a corporate debtor to exculpate, or to cap the liability of, directors from certain breaches of the duty of care.<sup>47</sup> However,

<sup>44</sup> DEL. CODE ANN. tit. 8, §§ 145(a)–(b) (2001); *see also* *Advanced Mining Sys., Inc. v. Fricke*, 623 A.2d 82, 83 (Del. Ch. 1992) (stating title 8 § 145 defines scope of indemnification to be confined to losses by "officer, director, employee, or agent . . . incurred by reason of holding any such position."). *See generally* FOLK, *supra* note 20, at 98 (discussing how statutory emphasis lies in "fact that [the individuals] are sued by reason of their status as director or officer.") (quoting *Essential Enters. Corp. v. Automatic Steel Prods., Inc.*, 164 A.2d 437, 441 (Del. Ch. 1960)).

<sup>45</sup> *See In re Metricom*, 275 B.R. 364, 368 (Bankr. N.D. Cal. 2002) ("Indemnity or contribution and exculpation are different methods of reaching similar, but not identical, results."); *Candid Camera Video World, Inc. v. Mathews*, 334 S.E.2d 94, 95–96 (N.C. Ct. App. 1985) ("[T]here is a distinction between contracts whereby one seeks to wholly exempt himself from liability for the consequences of his negligent acts, and contracts of indemnity against liability imposed for the consequences of his negligent acts"), *review denied*, 338 S.E.2d 879 (N.C. 1986); *Arnold v. Shawano County Agr. Soc.*, 317 N.W.2d 161, 165 (Wis. Ct. App. 1982).

Indemnification agreements must be distinguished from exculpatory releases. An exculpatory clause is one which excuses one party from liability for otherwise valid claims which may be made against him by another . . . . An Indemnification or Hold Harmless Agreement . . . is an agreement whereby one party to a lease or other contract agrees to protect the other from claims for loss or damage made against the indemnitee by a third party.

*Id.* (quoting Collins & Dugan, *Indemnification Contracts--Some Suggested Problems and Possible Solutions*, 50 MARQ. L. REV. 77 (1966)), *aff'd*, 330 N.W.2d 773 (Wis. 1983), *overruled on other grounds*, *Green Spring Farms v. Kersten*, 401 N.W.2d 816, 821 (Wis. 1987); Francis M. Dougherty, J.D., Annotation, *Applicability to Exculpatory Clause in Lease to Lessee's Damages Resulting from Defective Original Design or Construction*, 30 A.L.R.4th 971 n.1 (1984) ("[E]xculpatory clause should be distinguished from the apparently similar, but actually quite distinguishable, 'indemnity clause.'").

<sup>46</sup> *See* *Gatley v. United Parcel Serv., Inc.* 662 F. Supp. 200, 203 (D. Me. 1987) (explaining exculpatory clause would relieve defendant entirely of any liability); *McMinn v. Cavanaugh*, 532 N.E.2d 343, 345 (Ill. App. Ct. 1988) (explaining exculpation excuses one party from liability for otherwise valid claims that may be made against it by other party); John R. Collins & Denis Dugan, *Indemnification Contracts- Some Suggested Problems and Possible Solutions*, 50 MARQ. L. REV. 77 (1966) (stating exculpatory clause excuses one party from liability).

<sup>47</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); *see also In re Reliance Sec. Litig.*, 135 F. Supp. 2d 480, 519 (D. Del. 2001) (finding clause shields directors from liability for claims based on breach of duty of care

section 102(b)(7) does not permit a corporation to release a director from liability for breaches of the duty of loyalty, intentional misconduct, knowing violation of law or from liability for any transaction from which the director derived an improper personal benefit.<sup>48</sup>

Section 102(b)(7) does not apply to officers or agents of a corporation. Thus, section 102(b)(7) does not authorize a debtor to release, or to cap the liability of, officers or agents from a breach of *any* fiduciary duty.<sup>49</sup> One could argue that the Delaware legislature's omission of officers and agents from section 102(b)(7) evidences an intent to hold officers and agents liable for their breaches of fiduciary duties, including the duty of care. There is no established Delaware case law or other significant authority, that specifically provides that the omission of "agents" from section 102(b)(7) precludes a corporation from entering into agreements exculpating "agents" from breaches of the duty of care.

Assuming the omission of "agents" from section 102(b)(7) does not evidence an intent to preclude corporations from exculpating corporate agents, one must also determine the permissible scope of exculpation of corporate agents. In Delaware,<sup>50</sup>

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made in good faith); *In re Frederick's of Hollywood, Inc.*, No. C.A. 15944, 2000 WL 130630, at \*6 n.12 (Del. Ch. Jan. 31, 2000) (explaining title 8, § 102(b)(7) shields corporation's directors against judgment for money damages); *Emerald Partners v. Berlin*, 726 A.2d 1215, 1224 (Del. 1999) (finding that where factual basis for claim solely implicates violation of duty of care, protections of such charter provision may properly be invoked); *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 914 (Del. Ch. 1999) (explaining it is settled title 8, § 102(b)(7) exculpates directors from liability where factual basis for claim of breach of fiduciary duty against directors solely implicates violation of duty of care); BALOTTI & FINKELSTEIN, *supra* note 19, at 4-110. Even claims of "gross negligence" are barred if a corporate charter contains the full measure of exculpation permitted by section 102(b)(7). *Malpied v. Towson*, 780 A.2d 1075, 1094-95 (Del. 2001) ("[W]e have held that, even if the plaintiffs had stated a claim for gross negligence, such a well-pleaded claim is unavailing because defendants have brought forth the Section 102(b)(7) charter provision that bars such claims. This is the end of the case."); *In re Lukens, Inc. Shareholders Litigation*, 757 A.2d 720, 734 n.37 (Del. Ch. 1999) (stating section 102(b)(7) bars claims for gross negligence); *John Hancock Capital Growth Mgmt., Inc. v. Aris Corp.*, Del. Ch., C.A. No. 9920, 1990 WL 126656 at \*2 (Del. Ch. Aug. 24, 1990) (stating claims of directorial gross negligence are "not cognizable" where section 102(b)(7) applies).

<sup>48</sup> DEL. CODE ANN. tit. 8, § 102(b)(7); see *In re The Limited, Inc. Shareholders Litigation*, Civ. Action 17148-NC, 2002 WL 537692, at \*10 n.65 (Del. Ch. March 27, 2002) (stating title 8, § 102(b)(7) is inapplicable to duty of loyalty claim); *Malpiede*, 780 A.2d at 1095 (stating title 8, § 102(b)(7) does not apply to claim for duty of loyalty violations and bad faith claims); *Emerald Partners*, 726 A.2d at 1227 (determining "[s]ection 102(b)(7) protections do not apply to violations of the fiduciary duties of good faith or loyalty" and cannot eliminate court's entire fairness analysis); *Leslie v. Telephonics Office Technologies, Inc.*, Del. Ch. C.A. No. 13045, 1993 WL 547188 at \*9-10 (Del. Ch. Dec. 30, 1993) (refusing to bar plaintiff's claims on account of section 102(b)(7) provision where complaint alleges "international scheme to siphon off the company's assets.").

<sup>49</sup> See BALOTTI & FINKELSTEIN, *supra* note 19, at 4-83 (discussing indemnification of corporate officers); see also *Bell Atl. Corp. v. Bolger*, 2 F.3d 1304, 1312 (3d Cir. 1993) ("By its terms, § 102(b)(7) only applies to directors."); *Arnold v. Soc. for Sav. Bancorp.*, 650 A.2d 1270, 1288 ("Where defendant is director and officer, only those actions taken solely in capacity as officer are outside purview of section 102(b)(7).") (citing BALOTTI & FINKELSTEIN, *supra* note 19, at 4-117).

<sup>50</sup> Although it is clear that the law of the state of incorporation governs corporate governance issues, it is less clear whether the public policy of the state of incorporation, the forum state, or the state in which the contract was entered will govern the issue of the permissible scope of exculpation of corporate agents. See,

an agreement to relieve a party from its intentional or willful acts is "invariably held to be unenforceable as being against clear public policy."<sup>51</sup> Generally, absent a statutory prohibition, exculpatory clauses that merely relieve a party from "mere negligence" do not violate Delaware public policy.<sup>52</sup> Delaware courts, however, carefully scrutinize exculpatory clauses in light of the relative bargaining power and sophistication of the parties.<sup>53</sup>

In a chapter 11 bankruptcy case, the debtor in possession's lender often "suggests" one or more management companies or financial advisors that would be acceptable to the lender. The debtor in possession may be precluded from selecting other professional persons because the lender will not agree to provide financing if the debtor in possession does not select an acceptable professional person. In that situation, a court may take into account the debtor in possession's relative lack of

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*e.g.*, *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972) ("A contractual choice-of-forum clause should be held unenforceable if enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or judicial decision."); *Durrell v. Parachutes Are Fun, Inc.*, 1987 WL 18117, at \*2 (Del. Super. Oct. 8, 1987) (enforcing exculpation provision under Maryland law even though provision may have been contrary to public policy); *In re Healthco Int'l, Inc.*, 195 B.R. 971, 988 n.67 (Bankr. D Mass. 1996) (applying Delaware law to exculpation provision under contractual choice of law provision and where "[t]rustee offers no reason why that choice of law should not be given effect"); *In re United Artists Theatre Co.*, Case No. 00-3514(SLR), (mem) at para. 2 (D. Del Dec. 1, 2000) ("[I]t is the court's conclusion that the state laws of corporate governance should control the question of whether it is appropriate to provide the protection of indemnification to such a fiduciary").

<sup>51</sup> *James v. Getty Oil Co.*, 472 A.2d 33, 38 (Del. Super. 1984)

The paragraph in question also purports to provide indemnification for injuries or death which are caused by or arise out of a 'willful act' of Getty. A contract to relieve a party from its intentional or willful acts is invariably held to be unenforceable as being against clear public policy. 15 Williston Contracts, 3d Ed. § 1750A. Therefore, to the extent that paragraph 6 seeks to indemnify Getty against its willful acts, as opposed to its negligence, the agreement is void and unenforceable.

*Id.*; see also *Riggs Nat. Bank v. Zimmer*, No. CIV.A.3866, 1977 WL 5316, \*12 (Del. Ch. Nov. 30, 1977) ("In the absence of a statute, however, such (exculpatory) provisions are not regarded as against public policy if they merely relieve the trustee from liability for ordinary negligence.") (quoting SCOTT ON TRUSTS (2d ed.) section 222.3).

<sup>52</sup> See, *e.g.*, *Riggs Nat'l Bank*, 1977 WL 5316, at \*12 (Del. Ch. Nov. 30, 1977) (distinguishing negligence from gross negligence); see also *In re Healthco Internat'l, Inc.*, 195 B.R. at 987-88 n.67 (stating that exculpation clause in favor of financial advisors was "tacky, to say the least," and "unseemly" but enforceable under Delaware law for negligence). But see *Durrell*, 1987 WL 18117 at \*2 ("[C]ontractual provisions purporting to relieve a party for his own negligence are against Delaware public policy").

<sup>53</sup> See *Blum v. Kauffman*, 297 A.2d 48, 49 (Del. 1972) (describing how court looks unfavorably upon clauses which exonerate party from own negligence or that of agent and will narrowly construe such clauses); see also *Hercules Inc. v. AMEC Va.*, No. CIV.A.96C-10-153-JOH, 1999 Del. Super. LEXIS 102, at \*20 (Del. Super. Feb. 12, 1999) (acknowledging that courts are wary about exculpatory clauses where parties are unequal in bargaining power and/or sophistication); *Tandy Corp. v. Fusco Props., Ltd. P'ship*, C.A. No. 95C-03-085-JOH, 1996 Del. Super. LEXIS 168, at \*6-10 (Del. Super. Apr. 10, 1996) (upholding exculpatory clause between commercially sophisticated parties where no indication of unequal bargaining power and where transaction arms' length); *Donegal Mut. Ins. Co. v. Tri-Plex Sec. Alarm Sys.*, 622 A.2d 1086, 1089-90 (Del. Super. 1992) (upholding liability limitation clause in security alarm contract where clause was in plain and explicit terms).

bargaining power when scrutinizing an exculpation provision in favor of the professional person.<sup>54</sup>

Pursuant to section 379 of the Restatement (Second) of Agency, "[u]nless otherwise agreed, a paid agent has a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has."<sup>55</sup> The comment to section 379 provides "[a]n agreement with the principal that the agent is not to be liable to him for negligence not of a gross character is legal, except in the performance of a public duty."<sup>56</sup> Similarly, section 195 of the Restatement (Second) of Contracts provides that "[a] term exempting a party from tort liability harm caused intentionally or recklessly is unenforceable on grounds of public policy", although a term exempting a party from tort liability for harm caused "negligently" is unenforceable if, *inter alia*, "the term exempts one charged with a duty of public service from liability to one whom that duty is owed for compensation for breach of that duty."<sup>57</sup>

Under the test set forth in the Restatement (Second) of Agency and the Restatement (Second) of Contracts,<sup>58</sup> it is doubtful that the duties of a management

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<sup>54</sup> *In re Halpern, Inc.*, 248 B.R. 43, 47 (Bankr. S.D.N.Y. 2000), *aff'd*, 2000 WL 1800690 (S.D.N.Y. Dec. 6, 2000) (stating court should consider "whether the terms of the agreement were negotiated at arm's length by all interested parties"); *see also In re DEC Int'l, Inc.*, 282 B.R. 423, 429 (W.D. Wis. 2002) ("If the largest financial advisers include such clauses routinely and bankruptcy courts do not question them, hard-pressed debtors, trustees and creditors' committees will have little option but to accept them as a cost of doing business."); *In re Comdisco, Inc.*, No. 02 C 1174, 02 C 1397, 2002 WL 31109431, at \*5 (N.D. Ill. Sept. 23, 2002) ("[T]he Code is also designed to 'protect against the danger that a prospective debtor, willing to do whatever necessary to secure the counsel of its choice, may bargain away more than is reasonable . . . knowingly or otherwise'" (quoting *In re Gillett Holdings, Inc.*, 137 B.R. 452, 460 (Bankr. D. Colo. 1991))).

<sup>55</sup> RESTATEMENT (SECOND) OF AGENCY § 379 (1958); *see, e.g.*, *Kramer v. Nowak*, 908 F. Supp. 1281, 1288–89 (E.D. Pa. 1995) (discussing duties owed by associate to partner at law firm in context of section 379 of Restatement); *Karby v. Standard Prods. Co.*, C.A. No. 3:90-2918-17, U.S. Dist. LEXIS 22002, at \*23 (D. S.C. June 22, 1992) (enumerating specific duties that agent owes principal).

<sup>56</sup> RESTATEMENT (SECOND) OF AGENCY § 379 cmt. b (1958); *see also id.* section 419 ("An agent who has committed a breach of duty to the principal is discharged from liability by . . . a contract with the principal having the effect of a discharge."); *Maurer v. Cerkvenik-Anderson Travel, Inc.*, 890 P.2d 69, 73–74 (Ariz. Ct. App. 1994) (stating agent who is discharged from liability by effective contract is still under duty of disclosure and fair dealing with principal).

<sup>57</sup> RESTATEMENT (SECOND) OF CONTRACTS § 195(1), (2)(b) (1981); *see, e.g.*, *Valhal Corp. v. Sullivan Assocs., Inc.*, 44 F.3d 195, 206 (3d Cir. 1995) (discussing section 2(b) of Restatement as correct statement of law in Pennsylvania); *Aldoo v. H.T. Brown Real Estate, Inc.*, 686 A.2d 298, 301 (Md. 1996) (identifying circumstances when exculpatory clauses in contracts are invalid and unenforceable).

<sup>58</sup> At least two courts have considered the fact that a fiduciary may be exculpated and indemnified under the RESTATEMENT (SECOND) OF TRUSTS §§ 222, 247 (1959) as support for the proposition that a financial advisor may receive similar benefits. *In re DEC Int'l, Inc.*, 282 B.R. at 428; *In re Halpern*, 248 B.R. at 45–46. The author believes that the RESTATEMENT (SECOND) OF AGENCY and the RESTATEMENT (SECOND) OF CONTRACTS are clearly more applicable. First of all, section 145 of the DGCL specifically deals with indemnification of "agents." DEL. CODE ANN. tit. 8, § 145(a)–(b). Second, the bankruptcy courts are considering contractual indemnification provisions. Third, financial advisors are not "trustees" with respect to a debtor in possession. As agents, however, financial advisors may owe a fiduciary duty to a debtor in

company or financial advisor rise to the level of public duties or constitute public services. Thus, under that test, a Delaware corporation may be permitted to exculpate its management company or financial advisor for mere negligence.<sup>59</sup>

Together, sections 145 and 102(b)(7) of the DGCL and Delaware public policy indicate that officers or corporate agents, such as management companies or financial advisors, should not be indemnified (except upon a showing in certain instances with respect to attorneys' fees and expenses) or exculpated with respect to at least certain breaches of fiduciary duties owing to a Delaware corporation. A bankruptcy court should not approve proposed retention of a management company or financial advisor where the terms of the retention include an indemnification or exculpation provision contrary to section 145 of the DGCL or Delaware public policy.

#### V. INDEMNIFICATION AND EXCULPATION IN THE BANKRUPTCY COURTS

Initially, indemnification and exculpation of professional persons under section 327(a) were met with hostility from the bankruptcy courts. For example, in *In re Glosser Brothers, Inc.*,<sup>60</sup> the bankruptcy court rejected the proposed indemnification and limited exculpation clause in a retention agreement with Bear Stearns, the debtor in possession's proposed investment bankers. The debtor in possession proposed to indemnify Bear Stearns from all actions excluding those involving gross negligence or willful misconduct.<sup>61</sup> The debtor in possession also sought to limit Bear Stearns' liability for any misconduct to the disgorgement of fees received by Bear Stearns.<sup>62</sup> The bankruptcy court held that such provisions bore all the signs of an "adhesion contract."<sup>63</sup> The court refused to approve the engagement of Bear

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possession. See *Official Committee of Unsecured Creditors v. Donaldson, Lufkin & Jenrette Sec. Corp.*, No. 00 Civ. 8688(WHP), 2002 WL 362794, at \*9 (S.D.N.Y. March 6, 2002) (declaring that several courts have acknowledged that a financial advisor may owe a fiduciary duty to its client). Thus, the RESTATEMENT (SECOND) OF TRUSTS may also provide some analogous support for the proposition that financial advisors, management consultants or other professionals may be indemnified and exculpated by debtors in possession.

<sup>59</sup> See *In re Healthco Int'l, Inc.*, 195 B.R. 971, 988 (Bankr. D. Mass. 1996) (stating that under Delaware law, contract clauses exempting parties from liability for negligence are enforceable, although not favored); see also *In re Halpern*, 248 B.R. at 47. But see *Robertson v. Central Jersey Bank & Trust Co.*, 47 F.3d 1268, 1278 (3d Cir. 1995) (discussing New Jersey law which prohibited exculpation of financial advisor) (citing *Erllich v. First Nat'l Bank of Princeton*, 505 A.2d 220, 232 (N.J. Super. 1984)); *In re WCI Cable, Inc.*, Bankruptcy Case No. 301-38242-rld11, 2002 Bankr. LEXIS 925, at \*52-55 (Bankr. D. Or. Jun. 27, 2002) (describing how Ninth Circuit disfavors exculpation or indemnification provisions that limit liability for negligence or breaches of fiduciary duties).

<sup>60</sup> 102 B.R. 38, 42-43 (Bankr. W.D. Pa. 1989).

<sup>61</sup> *Id.* at 42.

<sup>62</sup> *Id.* at 42.

<sup>63</sup> *Id.* at 42 ("Debtors seem to lack any bargaining power . . ."); see also BLACK'S LAW DICTIONARY 318-19 (7th ed. 1999) (defining "adhesion contract" as "standard-form contract prepared by one party, to be signed by another party in a weaker position, usu. a consumer, who has little choice about the terms . . .").

Stearns.<sup>64</sup> Similarly, in *In re Drexel Burnham Lambert Group, Inc.*,<sup>65</sup> the bankruptcy court refused to recognize any form of permissible indemnification for financial advisors: "Simply stated, indemnification agreements are inappropriate."<sup>66</sup>

In *In re Mortgage & Realty Trust*, the debtor in possession sought to engage an investment advisor pursuant to an agreement that provided for the indemnity of the investment advisor against liability for acts other than negligence, gross negligence or willful misconduct.<sup>67</sup> The court noted that section 328 required the terms of the proposed engagement to be "reasonable."<sup>68</sup>

The bankruptcy court stated, the reason for hiring a professional person is the person has special expertise that is beneficial to the estate.<sup>69</sup> The court stated, it expected a professional person to be "especially diligent" in discharging its duties and satisfying its standard of care.<sup>70</sup> The court declared, "[i]ndemnification is not consistent with professionalism."<sup>71</sup>

The debtor claimed the investment advisor "has a management policy that it will not accept employment as an investment advisor without an indemnity agreement."<sup>72</sup> The debtor further claimed the investment advisor would withdraw absent the indemnity provision and such withdrawal would cause "great harm" to

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<sup>64</sup> *In re Glosser Bros., Inc.*, 102 B.R. at 42. See generally *In re Gillett Holdings, Inc.*, 137 B.R. 452, 458–59 (Bankr. D. Colo. 1991) (refusing to approve indemnification of investment banker for negligence labeling such indemnification "entirely improper and unacceptable" and refusing to approve damage limitation cap set at amount of fees received by professional person, but declaring that such provisions must be analyzed "case by case"); *In re Allegheny Int'l, Inc.*, 100 B.R. 244, 246–47 (Bankr. W.D. Pa. 1989) (declining to approve indemnification of investment advisor against claims for negligence or violation of fiduciary duty).

<sup>65</sup> 133 B.R. 13 (Bankr. S.D.N.Y. 1991).

<sup>66</sup> *Id.* at 27.

<sup>67</sup> 123 B.R. 626, 628 nn. 2 & 3 (Bankr. C.D. Cal. 1991).

<sup>68</sup> *Id.* at 630; 11 U.S.C. § 328(a) (2000) (stating trustee may employ professional person with court's approval "on any reasonable terms and conditions of employment . . ."). See generally *In re Allegheny Int'l, Inc.*, 100 B.R. at 246 (interpreting section 328(a) of Bankruptcy Code as requiring reasonable terms in engagements of professional persons).

<sup>69</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 630–31 (stating professional person possesses special expertise beneficial to estate); see also *In re Office Prods. of Am., Inc.*, 136 B.R. 675, 681 (Bankr. W.D. Tex. 1992) (requiring that investment bankers have specialized skills); *In re Drexel Burnham Lambert Group, Inc.*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) (stating reason for hiring professional person is special expertise).

<sup>70</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 631; see also *In re Metricom, Inc.*, 275 B.R. 364, 370 (Bankr. N.D. Cal. 2002) (quoting same); *In re Allegheny Int'l, Inc.*, 100 B.R. at 247 ("Holding a fiduciary harmless for its own negligence is shockingly inconsistent with the strict standard of conduct for fiduciaries.").

<sup>71</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 631; see also *In re Halpern, Inc.*, 248 B.R. 43, 45 (Bankr. S.D.N.Y. 2000) (quoting same), *aff'd*, 2000 WL 1800690 (S.D.N.Y. Dec. 6, 2000); *In re Allegheny Int'l, Inc.*, 100 B.R. at 247 (applying same principle).

<sup>72</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 631.



the estate.<sup>73</sup> The court rejected the debtor's argument and declared it was not a legitimate basis for authorizing an indemnity provision.<sup>74</sup>

The court further declared that whether an estate should indemnify a professional person should be determined "after the facts giving rise to the claim are known" on a "case by case" basis when the claim has been asserted.<sup>75</sup> The court questioned whether such a blanket indemnity provision was even legitimate as a matter of contract law outside of bankruptcy.<sup>76</sup>

The court answered that California common law provided for the indemnity of an agent only in certain instances.<sup>77</sup> The court held there was no reason to approve indemnification to the extent that it is already available at common law and no reason to approve an indemnity provision that exceeded the scope of an agent's right to indemnity under California's common law.<sup>78</sup>

The bankruptcy court's analysis in *Mortgage & Realty Trust* is instructive. The court considered the permissible scope of indemnity available under state law and refused to permit the debtor to exceed that scope.

Similarly, addressing the appropriateness of indemnification provisions shortly after the *In re Merry-Go-Round Enterprises, Inc.* settlement, Chief Judge Peter J. Walsh of the United States Bankruptcy Court for the District of Delaware also rejected broad indemnity and exculpation provisions in *In re Dailey International, Inc.*<sup>79</sup>

In *Dailey*, the agreement between the debtors in possession and the proposed financial advisor, Ernst & Young, provided the advisor's liability "shall be limited to the fees paid" to Ernst & Young.<sup>80</sup> The agreement provided "[i]n no event will E & Y be liable to the [debtors in possession] for consequential, incidental, indirect, punitive or special damages . . . regardless of whether such liability is based on breach of contract, tort, strict liability, breach of warranties, failure of essential purpose or otherwise . . . ."<sup>81</sup> The agreement further provided that the debtor in

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<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 631; *see also In re Gillett Holdings, Inc.*, 137 B.R. 452, 458–59 (Bankr. D. Colo. 1991) ("Indemnity provisions must be analyzed on a case-by-case basis . . . ."); *In re Allegheny Int'l, Inc.*, 100 B.R. at 246 (explaining only certain indemnity provisions, which are not blanket, will be allowed by court).

<sup>76</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 631 ("[I]t is questionable whether blanket indemnity at the outset of a case is even legitimate as a matter of contract law outside of a bankruptcy case."); *see also* E. ALLAN FARNSWORTH, *CONTRACTS* § 5.2 (3d ed. 1999) (discussing party may not exempt itself from liability if harm caused is intentional or reckless, but it can limit its liability for harm caused negligently).

<sup>77</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 631 (citing 2 B. WITKIN, *SUMMARY OF CALIFORNIA LAW* 72 (9th ed. 1987); *see, e.g., In re Metricom, Inc.*, 275 B.R. 364, 374–75 (Bankr. N.D. Cal. 2002) (holding indemnity provisions must be reasonable).

<sup>78</sup> *In re Mortgage & Realty Trust*, 123 B.R. at 631–32.

<sup>79</sup> Case No. 99-1233 (PJW), Letter Ruling (Bankr. D. Del. July 1, 1999) (Walsh, J.).

<sup>80</sup> *Id.* at 3.

<sup>81</sup> *Id.*

possession "shall have no recourse against, and shall bring no claim . . . against E & Y with respect to (i) any third party claim . . . or (ii) any losses, liabilities, damages or expenses . . . incurred" by the debtors in possession as a result of any such claim.<sup>82</sup> Finally, the agreement required the debtors in possession to indemnify Ernst & Young against "all claims and causes of action of any kind, including contract, tort or otherwise, by any third party" and "any losses, liabilities, damages and expenses . . . that are incurred . . . as a result of any such claims or causes of action."<sup>83</sup>

The court in *Dailey* found Ernst & Young's efforts to limit liability exposure "understandable," in light of the multi-million dollar settlement to which the company recently agreed with the chapter 7 trustee in the *In re Merry-Go-Round Enterprises, Inc.* litigation.<sup>84</sup> In assessing the agreement between the debtors in possession and Ernst & Young, the court stated the exculpation and indemnity provisions presented "a matter of first impression" for the court.<sup>85</sup> The financial advisors' counsel stated the United States Bankruptcy Court for the District of Delaware was the first court to address the proposed agreement as "the standard form of engagement letter going forward."<sup>86</sup> Although counsel maintained such provisions were standard in the marketplace outside of bankruptcy cases, the court concluded the financial advisors' affidavit under Federal Rule of Bankruptcy Procedure 2014 failed to provide credible evidence to support that assertion.<sup>87</sup>

The bankruptcy court held that the proposed "risk allocation provisions" were not appropriate terms and conditions for the retention of professionals in bankruptcy pursuant to sections 327 and 328 of the Bankruptcy Code. The court reasoned that the proposed indemnification "without regard to the nature of the claim that might be asserted or the wrongdoing . . . that contributed to or gave rise to the claim" was overreaching.<sup>88</sup> The court, however, noted it had previously approved engagement agreements for investment bankers and financial advisors with limited indemnification provisions excepting claims for gross negligence or willful misconduct.<sup>89</sup>

Analogizing the proposed damage limitation provisions to the all-encompassing damage limitation provisions utilized by photo film developers, the court refused to approve the exculpation provisions as "inappropriate in the arena of professional

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<sup>82</sup> *Id.* at 3–4.

<sup>83</sup> *Id.* at 4.

<sup>84</sup> *In re Dailey Int'l, Inc.*, Letter Ruling at 17.

<sup>85</sup> *Id.* at 4.

<sup>86</sup> *Id.* at 5.

<sup>87</sup> *Id.* at 7. See generally 5 COLLIER ON BANKRUPTCY ¶ 2014 at 1 (Lawrence P. King et al. eds., 15th ed. Rev. 1997) (stating application to court must contain affidavit stating connection between employee and debtor); *In re Neidig Corp.*, 113 B.R. 696, 697 (Bankr. D. Colo. 1990) (indicating debtor and attorney for debtor must file affidavit with court under Federal Rule of Bankruptcy Procedure 2014).

<sup>88</sup> *In re Dailey Int'l, Inc.*, Letter Ruling at 12.

<sup>89</sup> *Id.*

services."<sup>90</sup> The court stated, requiring a waiver of all claims "regardless of the nature of the claims asserted" and limiting the damages to the fees paid to the financial advisors went "*far beyond*" the provisions the court had previously approved.<sup>91</sup>

The financial advisor argued the proposed risk allocation provisions were "enforceable under state law" and, therefore, in bankruptcy cases.<sup>92</sup> The court, however, responded that the issue is whether such provisions should be approved in the bankruptcy forum.<sup>93</sup> The court further declared it was "patently clear" under sections 327 and 328 that "sophisticated parties are not entitled to dictate the terms and conditions of the engagement of professionals."<sup>94</sup>

The court declared there was "no benefit to the administration of reorganization cases resulting from the adoption of such provisions."<sup>95</sup> Although the court understood the financial advisor's efforts to limit their exposure after the *In re Merry-Go-Round Enterprises, Inc.*, settlement, the court concluded their efforts were "overreaching and not consonant with the public policy" embodied in the Bankruptcy Code.<sup>96</sup> Thus, the court denied the application to retain the financial advisor.<sup>97</sup>

In the *In re United Artists Theatre Co.*, Memorandum Order dated December 1, 2000, Judge Sue L. Robinson of the United States District Court for the District of Delaware considered more limited proposed indemnification provision in favor of the proposed financial advisor.<sup>98</sup> At the outset, the court held there was no authority to support the United States Trustee's position that indemnification of fiduciaries is *per se* impermissible.<sup>99</sup>

The district court acknowledged that state corporation law governed the appropriateness of the proposed indemnification.<sup>100</sup> The court then turned to section 145 of the DGCL. The court concluded, without further discussion, that the "record

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<sup>90</sup> *In re Dailey Int'l, Inc.*, Letter Ruling at 12.

<sup>91</sup> *Id.* See generally *In re Allegheny Int'l, Inc.*, 100 B.R. 244, 247 (Bankr. W.D. Pa. 1989) (indicating permitting indemnification for gross negligence is inconsistent with expected behavior of fiduciaries).

<sup>92</sup> *In re Dailey Int'l, Inc.*, Letter Ruling at 15.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at 13; see also *In re Metricom, Inc.*, 275 B.R. 364, 371 (Bankr. N.D. Cal. 2002) (stating proponent of indemnification provision "bears the burden of establishing that such terms of employment are reasonable in the context of this case as required by § 328(a), and that showing has not been made."); *In re Allegheny Int'l, Inc.*, 100 B.R. at 246 (noting section 328(a) requirement of court approval for employment of professionals).

<sup>95</sup> *In re Dailey Int'l, Inc.*, Letter Ruling at 15.

<sup>96</sup> *Id.* at 17.

<sup>97</sup> *Id.*

<sup>98</sup> See Debtors' Response, and Memorandum in Support Thereof, to United States Trustee's Objection to Application for Order Pursuant to 11 U.S.C. §§ 327(a) and 328 Authorizing the Employment and Retention of Houlihan, Lokey, Howard & Zukin Capital as Investment Bankers for the Debtors at 4 n.5, (No. 00-03514) (SLR) [hereinafter Debtors' Response and Memorandum].

<sup>99</sup> *In re United Artists Theatre Co.*, Case No. 00-3514 (SLR) (mem.) at para. 1 (D. Del. Dec. 1, 2000).

<sup>100</sup> *Id.* at para. 2.

as developed thus far does not demonstrate that the indemnification provision at bar is inconsistent with Section 145."<sup>101</sup>

The court also relied upon the Third Circuit's decision in *In re PWS Holding Corp.*<sup>102</sup> In *In re PWS Holding Corp.*, the Third Circuit held that professionals retained by a debtor in possession or creditors' committee are liable only for willful misconduct or gross negligence.<sup>103</sup> Accordingly, the court approved the debtor in possession's indemnification of professionals with respect to all claims, except those arising "solely" from the gross negligence or willful misconduct of the financial advisor.<sup>104</sup>

The court in *In re United Artists Theatre Co.*, did not specifically address several troubling issues with respect to the proposed indemnification agreement, that arguably, were not squarely before the court. First of all, the language limiting the debtor in possession's duty to indemnify the financial advisor provided that the debtor in possession did not have a duty to indemnify the financial advisor where the financial advisors' gross negligence or willful misconduct was the "sole" cause of the damages.<sup>105</sup> Thus, the proposed indemnity agreement implicitly required the debtor in possession to indemnify the financial advisor from claims that were caused "in part" by the financial advisor's gross negligence or willful misconduct. A debtor in possession should not be permitted to indemnify a professional person that has acted in a grossly negligent, willful or bad faith manner where such conduct was a contributing, but not the sole, factor upon which a claim against the professional person was based. Permitting indemnification of such actions, particularly where the professional person has been adjudicated liable, or agreed to make a settlement payment, would violate section 145 of the DGCL and public policy.<sup>106</sup> Such indemnification is unreasonable and, therefore, inappropriate under section 328 of the Bankruptcy Code.<sup>107</sup>

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<sup>101</sup> *Id.* at para. 5.

<sup>102</sup> 228 F.3d 224, 224 (3d Cir. 2000); *see also In re United Artists Theatre Co.*, No. 00-3514 para. 2 n.1.

<sup>103</sup> *In re PWS Holding Corp.*, 228 F.3d at 246

[M]embers of the Committee and professionals who provided services to the Debtors remain liable for willful misconduct or gross negligence. Because we conclude that this standard of liability is the standard that already applies in this situation, we believe that [the release in] Paragraph 58 affects no change in liability.

*Id.* *See generally In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 605-06 (Bankr. D. Del. 2001) ("Under 11 U.S.C. § 1103(c), the liability of committee members and their professionals are limited to willful misconduct or *ultra vires* acts."), *appeal dismissed*, 280 B.R. 339 (D. Del. 2002).

<sup>104</sup> *In re PWS Holding Corp.*, 228 F.3d at 245-47; *see also In re Halpern, Inc.*, 248 B.R. 43, 47 (Bankr. S.D.N.Y. 2000) (approving indemnification of financial advisor where provision was limited to mere negligence and supported by creditors' committee), *aff'd*, 2000 WL 1800690 (S.D.N.Y. Dec. 6, 2000).

<sup>105</sup> *See Debtors' Response and Memorandum*, *supra* note 98, at 4 n.5.

<sup>106</sup> *See Vonfeldt v. Stifel Fin. Corp.*, No. Civ. A. 15688, 1999 WL 413393, at \*2 (Del. Ch. June 11, 1999) ("[A]s a matter of public policy it simply would not make sense for a corporation to have the power to indemnify agents who do not act in its best interests."); *see also U.S. v. Lowe*, 29 F.3d 1005, 1007 (5th Cir. 1994) (discussing clause that does not indemnify with respect to matters that are against public policy); Micah John Schreurs, *Vonfeldt v. Stifel Financial Corp.: Clarifying the Scope of Delaware Corporate*

Secondly, the indemnification of agents under section 145(a) and (b) of the DGCL is limited to claims asserted against the agent "by reason of the fact that he is or was . . . [an] agent."<sup>108</sup> The indemnification provision in cases such as *In re United Artists Theatre Co.*, is not so limited. Thus, such indemnification provisions are overly broad in that they even require a debtor in possession to indemnify a professional person with respect to claims for breaches of its contract with the debtor in possession. As the Delaware Chancery Court held in *Cochran*, such claims are not subject to indemnification because they are not asserted "by reason of the fact" that the professional person was serving as a corporate agent.<sup>109</sup> The indemnification of a professional person with respect to a breach of contract claim would render the professional's contractual promises illusory.<sup>110</sup>

Where the pre-petition negligence claim is asserted by or on behalf of the debtor against its agent, section 145(b) prohibits the debtor from indemnifying the agent against a judgment or settlement payment.<sup>111</sup> Section 145(b) only authorizes the debtor to indemnify the agent against its attorney's fees where the agent successfully defended against the claim or where, *inter alia*, the agent acted in good

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*Indemnification Law*, 25 IOWA J. CORP. L. 161, 177 (1999) (explaining how even though proper boundaries of corporate indemnification law are yet to be defined, duties owed by corporate directors, officers, and employees to corporations they serve must outweigh their "entitlement" to indemnification).

<sup>107</sup> See 11 U.S.C. § 328(a) (2000) (authorizing trustee, with court's approval, to employ professional persons on reasonable terms); see also *In re Metricom, Inc.*, 275 B.R. 364, 371 (Bankr. N.D. Cal. 2002) (holding that determination regarding whether particular terms are reasonable under section 328(a) is made on case by case basis); *In re Hathaway Ranch P'ship*, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990) (explaining that any agreement concerning employment of professional by debtor in possession under section 328(a) is subject to court's review and approval that such agreement is reasonable).

<sup>108</sup> DEL. CODE ANN. tit. 8, §§ 145 (a)–(b) (2001); see also *Perconti v. Thornton Oil Corp.*, No. Civ.A. 18630-NC, 2002 WL 982419, at \*13 (Del. Ch. May 3, 2002) (holding suit is brought "by reason of" defendant's corporate function when conduct resulting in prosecution was done in capacity as corporate officer); *Tilden of N.J., Inc., v. Regency Leasing Sys., Inc.*, 237 A.D.2d 431, 431 (N.Y. App. Div. 1997) (affirming denial of motion seeking indemnification because action was not brought against defendant "by reason of the fact that he . . . was a director or officer of the corporation" within meaning of phrase employed in New York indemnification statute).

<sup>109</sup> *Cochran v. Stifel Fin. Corp.*, No. Civ.A.17350, 2000 WL 1847676, at \*7 (Del. Ch. Dec. 13, 2000) (stating one is not entitled to indemnification for alleged breach of personal contractual obligation), *aff'd in relevant part, rev'd in part on other grounds*, 2002 WL 1316240 at \*8 (Del. Jun. 13, 2002) ("We agree that the claims litigated in the arbitration action were properly characterized as personal, not directed at Cochran in his 'official capacity' as an officer and director.").

<sup>110</sup> See *Cochran*, 2000 WL 1847676, at \*6 (arguing it is problematic to conclude that suit has been rendered "official capacity" suit subject to indemnification if corporation alleges officer breached individual obligations); see also *Ridge Runner Forestry v. Veneman*, 287 F.3d 1058, 1061 (Fed. Cir. 2002) (defining illusory promise as words that "promise nothing; they do not purport to put any limitation on the freedom of the alleged promisor, but leave his future action subject to his own future will, just as it would have been had he said no words at all."); *Reddy v. Elec. Data Sys. Corp.*, No. 19467, 2002 WL 1358761, at \*7 (Del. Ch. June 18, 2002) (indicating employees would seek escape from personal responsibilities they owe to corporation if they were allowed entitlement to indemnification despite fact they were not acting by reason of official capacity).

<sup>111</sup> DEL. CODE ANN. tit. 8, § 145(b) (2001).

faith and "reasonably" believed that its conduct was in or not opposed to the best interests of the corporation.<sup>112</sup>

The indemnification provisions approved in *In re United Artists Theatre Co.* are not inconsequential as was the release in *In re PWS Holding Corp.* The indemnification provision approved in *In re United Artists Theatre Co.* appears to require a debtor to indemnify an agent beyond its corporate authority under section 145 of the DGCL. Thus, while the exculpatory release in *In re PWS Holding Corp.* affected "no change in liability," the indemnification provisions in *In re United Artists Theatre Co.* expanded the authority of the debtor in possession to indemnify its agents beyond the authority granted to corporations in section 145 of the DGCL.<sup>113</sup>

In *In re Comdisco, Inc.*,<sup>114</sup> the district court considered whether indemnification provisions for professional advisors were *per se* unreasonable under section 328. The debtor in possession and the creditors' committee sought to employ financial advisors pursuant to engagement agreements that required the estate to indemnify the financial advisors from all losses, claims or other liability except any such loss, claim or other liability determined by a court of competent jurisdiction to have resulted "primarily" from the indemnified party's gross negligence, willful misconduct, bad faith, or fraud.<sup>115</sup>

The United States Trustee argued that such indemnification provisions were *per se* improper in chapter 11 cases although the evidence presented in the bankruptcy court tended to demonstrate that such provisions were the norm in the marketplace for financial advisors.<sup>116</sup> In upholding the bankruptcy court's approval of the indemnification provisions, the district court declared that such provisions are "arguably distasteful and potentially could excuse substandard performance."<sup>117</sup> The district court, however, noted that fiduciaries, such as investment advisors, may be indemnified under the common law, except for breach of trust, bad faith, or intentional or reckless indifference to the beneficiaries' interests.<sup>118</sup>

The district court stated, "whether a particular indemnity clause is reasonable in a particular case depends on the facts of the case and can properly be determined

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<sup>112</sup> *Id.*

<sup>113</sup> The district court's decision in *In re United Artists Theatre Co.* has been appealed to the United States Court of Appeals for the Third Circuit. See *In re United Artists Theatre Co.*, No. 00-3514 (D. Del. 2000), *Appeal docketed*, No. 01-1351 (3d Cir. 2002).

<sup>114</sup> 2002 WL 31109431 (N.D. Ill. Sept. 23, 2002).

<sup>115</sup> *Id.* at \*1.

<sup>116</sup> *Id.* at \*2,\*5.

<sup>117</sup> *Id.* at \*5.

<sup>118</sup> *Id.* at \*4 (citing RESTATEMENT (SECOND) OF TRUSTS § 222 (1959) regarding exculpation of fiduciaries and RESTATEMENT (SECOND) OF TRUSTS § 247 cmt. h regarding indemnification); see also *In re Halpern*, 248 B.R. 43, 45-46 (Bankr. S.D.N.Y. 2000) (stating same), *aff'd*, 2000 WL 1800690 (S.D.N.Y. Dec. 6, 2000).

only on an individual basis."<sup>119</sup> The district court held the following factors are among the factors that should be considered in determining whether an indemnity provision is reasonable under section 328(a):

- a. the extent of the debtor's need for a financial advisor;
- b. the financial advisor's experience and level of expertise;
- c. whether and on what terms the financial advisor would agree to remove the indemnity clause;
- d. whether comparable services are available from another financial advisor without an indemnity clause;
- e. whether the terms of the agreement were negotiated at arms' length by all interested parties; and
- f. whether the creditors support the retention notwithstanding the indemnity clause.<sup>120</sup>

Notably, the district court in *In re Comdisco* did not address the applicability of any relevant state law concerning a corporation's authority to indemnify agents. As the United States Trustee did not object to the reasonableness of the particular indemnification provisions, the district court affirmed the bankruptcy court's approval of those provisions.<sup>121</sup>

Similarly, in *In re DEC International, Inc.*,<sup>122</sup> the Office of the United States Trustee involved in *Comdisco* raised the same argument that indemnification of professional advisors was *per se* unreasonable under section 328(a). The debtor in possession's retention agreement with KPMG provided that the debtor in possession would indemnify KPMG for any damages arising out of KPMG's role as investment advisor, except for losses caused by KPMG's bad faith, gross negligence, or willful misconduct.<sup>123</sup>

The district declared there was "something distinctly unpalatable" about the idea of indemnifying professional advisors for their own negligence.<sup>124</sup> The district court questioned why the proposed indemnification of KPMG was not limited to claims arising out of action taken in good faith and with a reasonable belief that the actions are in the debtor in possession's best interests.<sup>125</sup> The district court also noted the absence of any evidence to support the reasonableness of the proposed indemnification, to estimate the potential cost to the creditors, or to show that the

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<sup>119</sup> *In re Comdisco, Inc.*, 2002 WL 31109431, at \*5.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.* at \*6.

<sup>122</sup> 282 B.R. 423 (W.D. Wis. 2002).

<sup>123</sup> *Id.* at 424.

<sup>124</sup> *Id.* at 426.

<sup>125</sup> *Id.* at 426.

debtor in possession had the financial ability to make any indemnification payments if necessary.<sup>126</sup>

As in *Comdisco*, however, the court rejected the Trustee's narrow contention that indemnification provisions were *per se* impermissible in bankruptcy cases.<sup>127</sup> Although the district court affirmed the bankruptcy court's approval of the KPMG indemnification provision, the court declared that such provisions need to be

scrutinized with care to protect creditors, to preserve the public's perception of fairness and integrity of the bankruptcy system, to ensure that debtors, trustees, and creditors' committees have true freedom of choice in retaining financial advisers and to guard against breaches of the fiduciary duty that professional investment advisers owe to the bankruptcy estate.<sup>128</sup>

Neither district court in *Comdisco* nor *DEC International* addressed whether there were any limitations imposed by applicable state law on the debtor in possession's right to indemnify. Rather, the courts scrutinized the provisions solely under the "reasonableness" standard under section 328(a). As indicated above, however, section 328(a) should not be interpreted as superseding any state law restrictions on a corporation's power to indemnify its agents.

Conversely, in *In re Metricom, Inc.*,<sup>129</sup> the bankruptcy court refused to approve a bondholders committee's proposed retention of its financial advisers under an agreement indemnifying the financial advisers for their negligence.<sup>130</sup> Although the bankruptcy court held that indemnification is not *per se* impermissible, the court held the bondholders failed to satisfy their burden of proving that the proposed terms were "reasonable" under section 328, particularly in light of the fact that other professionals (including Ernst & Young) were employed in the case without indemnification or exculpation provisions.<sup>131</sup> The court declared determinations of "reasonableness" should be made on a case-by-case basis, including a consideration of factors such as the availability of insurance to the financial advisor, whether comparable services for the same price were available from another financial advisor without indemnification or exculpation, and whether the financial advisor would provide its services without indemnification or exculpation.<sup>132</sup> Although the financial advisor claimed Delaware law applied and permitted the proposed

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<sup>126</sup> *Id.* at 425.

<sup>127</sup> *In re DEC Int'l, Inc.*, 282 B.R. at 424.

<sup>128</sup> *Id.* at 423.

<sup>129</sup> 275 B.R. 364 (Bankr. N.D. Cal. 2002).

<sup>130</sup> *Id.* at 371.

<sup>131</sup> *Id.* at 371–72.

<sup>132</sup> *Id.* at 372.



indemnification and exculpation provisions,<sup>133</sup> the bankruptcy court did not consider whether Delaware law permitted such provisions, and if so, the limitations under Delaware law.

In *Unsecured Creditors' Comm. v. Joel Pelofsky (In re Thermadyne Holdings Corp.)*,<sup>134</sup> the bankruptcy appellate panel considered whether the bankruptcy court abused its discretion in refusing to approve a creditors' committee's proposed engagement agreement providing for indemnification and exculpation of its financial advisors. The proposed terms of engagement provided that the debtor in possession would indemnify and exculpate the financial advisors from all losses and claims except those arising from the financial advisor's gross negligence, willful misconduct, breach of fiduciary duty, bad faith or self-dealing.<sup>135</sup> The bankruptcy court refused to approve the proposed indemnification and exculpation provision because it presented a "potentially unlimited" impact on the estate.<sup>136</sup>

On appeal, the bankruptcy appellate panel declared that the Bankruptcy Code did not prohibit indemnification or exculpation of professionals.<sup>137</sup> The bankruptcy appellate panel, however, affirmed the bankruptcy court's refusal to approve the employment of the financial advisor. The appellate panel held the availability of indemnification and exculpation provisions outside of bankruptcy was only one factor to consider.<sup>138</sup> The appellate panel concluded the bankruptcy court was not clearly erroneous in finding the potentially unlimited impact on the estate outweighed the higher, but certain, fees the estate may have to bear in the absence of the indemnification and exculpation provisions.<sup>139</sup> The appellate panel did not consider the extent to which the challenged provisions were authorized or prohibited under applicable state law.

In *In re Joan and David Halpern Inc.*,<sup>140</sup> the bankruptcy court conducted a thoughtful analysis of applicable state law in determining whether to approve a proposed indemnification provision in the debtor in possession's application to employ its financial advisor. The United States Trustee objected to the proposed terms of the engagement requiring the debtor in possession to indemnify the

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<sup>133</sup> *Id.* at 373 n.14.

<sup>134</sup> 283 B.R. 749 (B.A.P. 8th Cir. 2002).

<sup>135</sup> *Id.* at 752.

<sup>136</sup> *Id.* at 758.

<sup>137</sup> *Id.* at 756.

<sup>138</sup> *Id.* at 757.

<sup>139</sup> *In re Thermadyne Holdings Corp.*, 283 B.R. at 758. The court noted that there was no evidence regarding the financial advisor's ability to obtain insurance to protect against any claims. *Id.* The court added that it was unusual for the creditors' committee to bind the debtor in possession, a non-party to the engagement, to indemnify and exculpate the committee's financial advisor. *Id.* at 758-59. Where a debtor in possession seeks to indemnify or exculpate its own professionals, however, a court should consider the debtor in possession's unwillingness to indemnify or exculpate the committee's professionals when determining whether the exculpation of the debtor in possession's professionals is "reasonable" under section 328(a).

<sup>140</sup> 248 B.R. 43 (Bankr. S.D.N.Y. 2000), *aff'd*, 2000 WL 1800690 (S.D.N.Y. Dec. 6, 2000).

financial advisors and, *inter alia*, its affiliates, shareholders, members, officers, directors, employees and other agents, for liability relating to its engagement, excluding only liability determined by a court to have "primarily resulted from the bad faith, gross negligence or willful misconduct" of the financial advisors.<sup>141</sup>

Although the bankruptcy court noted that section 328 required the terms of employment to be "reasonable," the court then turned to state law.<sup>142</sup> The court acknowledged section 145 of the DGCL authorized a corporation to indemnify an "officer or director" from liability provided he acted in good faith and with a reasonable belief that his actions were in or not opposed to the corporation's best

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<sup>141</sup> *Id.* at 44 n.1.

<sup>142</sup> Although the court cited provisions of both Delaware and New York law, the court did not conclude which state's law governed its analysis of a corporation's authority to indemnify or exculpate its agents. *See In re Halpern*, 248 B.R. at 46. The law of the state of incorporation should govern that analysis as a corporation should not be able to escape the limitations of the law of its state of formation by choosing another state's law. *See Teren v. Howard*, 322 F.2d 949, 950 (9th Cir. 1963); *In re Metricom*, 275 B.R. at 373 n.14 (noting financial advisor "contends that Delaware law is the applicable non-bankruptcy law here because Debtor is a Delaware corporation"); *In re United Artists Theatre Co.*, Case No. 00-3514(SLR), (mem) at para. 2 (D. Del. Dec. 1, 2000) ("[I]t is the court's conclusion that the state laws of corporate governance should control the question of whether it is appropriate to provide the protection of indemnification to such a fiduciary"). The *In re Halpern* court did cite sections of the DGCL and New York Business Corporation Law ("NY BCL") as support for the proposition that corporations may indemnify financial advisors. The court stated that the NY BCL may provide for broader indemnity than is available under the DGCL. *In re Halpern*, 248 B.R. at 46. Specifically, the court declared that a Delaware corporation may indemnify an officer or director who acted "in good faith and in the reasonable belief that his actions were in or not opposed to the best interests of the corporation," while a New York corporation may provide for broader indemnity excluding only liability based on bad faith, active or deliberate honesty or self-dealing." *Id.* (citing DEL. CODE ANN. title 8, § 145(a) and N.Y. BUS. CORP. LAW § 721 (McKinney 1986)). Although sections 722(a) and (c) of the NY BCL contain a similar requirement to sections 145(a) and (b) of the DGCL in that an officer or director must act "in good faith, for a purpose which he reasonably believed to be in, or, . . . not opposed to, the best interests of the corporation." *Compare* N.Y. BUS. CORP. LAW §§ 722(a), (c), *with* DEL. CODE ANN. tit. 8, §§ 145(a)–(b). Section 721 of the NY BCL provides that a corporation may indemnify an officer or director by agreement provided that the officer or director did not act "in bad faith" or with "deliberate dishonesty" that is material to the cause of action adjudicated or did not personally gain a financial profit or other advantage to which he was not legally entitled. N.Y. BUS. CORP. LAW § 721 (McKinney 1986). Although section 721 of the NY BCL may be broader than section 145 of the DGCL in that respect, section 721 appears to apply only to "officers" or "directors." N.Y. BUS. CORP. LAW § 721 (referring to "director or officer" but not "agent"). Section 145 of the DGCL specifically authorizes a corporation to indemnify its "agents." DEL. CODE ANN. tit. 8, §§ 145(a), (c). In that respect, section 722 of the NY BCL is arguably narrower than section 145 of the DGCL. *See* Robert H. Roshe, *New York's Response to The Director and Officer Liability Crisis: A Need to Reexamine the Importance of D&O Insurance*, 54 BROOK. L. REV. 1305, 1323 (Winter 1989) (stating in New York, non-officer employees and agents are not included within corporate indemnification statute). Indeed, section 721 of the NY BCL specifically provides that "[n]othing contained in this article shall affect any rights to indemnification to which corporate personnel other than directors and officers may be entitled by contract or otherwise under law." N.Y. BUS. CORP. LAW § 721. Thus, non-officer employees and other corporate agents must seek indemnification in New York pursuant to common law principles of agency and contract. Roshe, at 1323; Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1996 (1978).

interests.<sup>143</sup> The court, however, apparently did not recognize that section 145 of the DGCL also specifically authorized a corporation to indemnify an "agent."<sup>144</sup>

Turning to the proposed indemnification provision at issue, the court concluded that it was permissible if modified.<sup>145</sup> Specifically, the court required the parties to modify the indemnity provision to make it explicit that the financial advisors were not entitled to indemnification for "bad faith, breach of fiduciary duty (other than ordinary negligence), breach of trust, self-dealing, willful or reckless misconduct or gross negligence."<sup>146</sup>

The court's modification to the exclusions in the indemnification provision is a better formulation of the extent of permissible indemnification under Delaware law than is the language employed in other cases. For example, in *In re United Artists*, the exclusionary language referred to losses arising "solely from [advisor's] gross negligence or willful misconduct."<sup>147</sup> The *United Artists*' language is much less explicit and clear as to the exclusions as is the language approved in *In re Halpern*.

The court's modification in *In re Halpern* stopped short in several respects, at least with respect to Delaware corporate law. First, the court did not address the fact that the exclusion to the indemnification provision required the financial advisors' conduct to have been "primarily" the result of bad faith, breach of fiduciary duty (other than ordinary negligence), breach of trust, self-dealing, willful or reckless misconduct, or gross negligence. Although Delaware case law has not addressed the issue, it would seem to violate Delaware public policy and the legislative intent behind section 145 of the DGCL to permit indemnification where a party's "bad faith" conduct was determined to be a significant, but not primary, factor in harming the estate. Second, the court should have denied the financial advisors' indemnity claim if the financial advisor did not act in good faith *and* with a reasonable belief that his actions were in or not opposed to the corporation's best interests. Third, the indemnity provision in *Halpern* apparently requires the debtor in possession to indemnify the financial advisors for claims by the debtor in possession for breach of the engagement agreement. Such a right of indemnity would render the financial advisor's contractual promises to the debtor in possession wholly illusory.<sup>148</sup> Fourth, the indemnity provision apparently requires the debtor in possession to indemnify the financial advisor against (i) liability on any claim asserted by or on behalf of the debtor in possession, contrary to section 145(b) of

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<sup>143</sup> *In re Halpern*, 248 B.R. at 46.

<sup>144</sup> DEL. CODE ANN. tit. 8, § 145(a)–(b) (referring to "agent").

<sup>145</sup> *In re Halpern*, 248 B.R. at 47.

<sup>146</sup> *Id.* at 47.

<sup>147</sup> See Debtors' Response and Memorandum, *supra* note 98, at 4 n.5.

<sup>148</sup> See *Cochran*, No. Civ. A. 17350, 2000 WL 1847676, at \*6 (Del. Ch. Dec. 13, 2000) (declaring that to find breach of contract action against officer for failure to perform his duties under employment contract would render illusory officer's duty to perform), *aff'd in relevant part, rev'd in part on other grounds*, 2002 WL 1316240, at \*1 (Del. Jun 13, 2002).

the DGCL and (ii) expenses in such a claim for which the financial advisor is adjudged liable without the showing required by section 145(b).<sup>149</sup> Fifth, it is doubtful whether a Delaware corporation can indemnify the affiliates, shareholders, employees, officers, directors or other agents of the financial advisor, particularly where such liability is not simply derivative of the financial advisors liability as the "agent" under section 145 of DGCL.<sup>150</sup>

There may be differences from state to state concerning the permissibility of indemnification or exculpation provisions as their corporate law statutes or applicable common law may differ. Accordingly, it may be more appropriate for a court unfamiliar with a particular state's law on indemnification to permit indemnification to some extent "permissible under applicable state law."

A court should strictly scrutinize a debtor in possession's agreement to indemnify a professional "to fullest extent" permissible under applicable state law.

Courts considering the appropriateness of indemnification provisions in an engagement agreement between a debtor and a professional person should consider whether the provision is "reasonable" under section 328 of the Bankruptcy Code, with due consideration of the reasonable views of the debtor's creditors (particularly in a liquidating case) – who are likely to bear the financial effects of any professional's negligence.<sup>151</sup> The availability of insurance, either to the professional or to the debtor in possession,<sup>152</sup> should also be considered. The cost of obtaining such insurance, if appropriate and available, may be more acceptable to parties in interest than the potentially unlimited indemnity obligation. Indemnification of

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<sup>149</sup> Section 145(b) of the DGCL does not authorize a corporation to indemnify an agent against judgments or settlement payments in actions brought by or on behalf of a corporation. *See* BALOTTI & FINKELSTEIN, *supra* note 19, at 4-83 (construing title 8, § 145(b)). Moreover, pursuant to section 145(b) of the DGCL, an agent is only entitled to indemnification of expenses in an action brought by or on behalf of the corporation where the agent is adjudged liable after showing that in "view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper." DEL. CODE ANN. tit. 8, § 145(b) (2001).

<sup>150</sup> DEL. CODE ANN. tit. 8, § 145(a)–(b) (referring only to officer, director or "agent").

<sup>151</sup> *See In re Comdisco*, 2002 WL 31109431, at \*5 ("[W]hether the creditors support the retention notwithstanding the indemnity clause" is a factor that courts should consider). *Compare In re Halpern*, 248 B.R. at 47 ("The Committee's support is entitled to weight. After all, it is the creditors' money that is placed at risk by the indemnity provision.") with *In re Metricom, Inc.*, 275 B.R. 364, 373 (Bankr. N.D. Cal. 2002) (stating "financial advisor does not claim to have negotiated with the estate, which is the entity that would bear the burden of the provisions for indemnity/contribution and exculpation" although certain committee's did not object to those provisions).

<sup>152</sup> *Unsecured Creditors' Comm. v. Joel Pelofsky (In re Thermadyne Holdings Corp.)*, No. 02-6031EM, 2002 WL 31190927, at \*6 (B.A.P. 8th Cir. Sept. 17, 2002) ("[T]here is not sufficient evidence that indemnity insurance would be unavailable to [financial advisor] or is too expensive to procure."); *In re Metricom*, 275 B.R. at 372 (noting that "[t]here is no evidence that insurance is either unavailable or prohibitively expensive" and there is no evidence of any increase in the professional's fees that would be necessary to offset the cost of such insurance); *In re Drexel Burnham Lambert Group, Inc.*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) ("[W]e know that investment bankers carry coverage to protect themselves from malpractice liability").

professional persons should not be lightly approved due to the potential depletion of the estate that may occur in the event a claim is asserted against the indemnitee. Courts should similarly scrutinize exculpation provisions in engagement agreements between a debtor in possession and its professional persons where such provisions would purport to effect any change in liability under the *In re PWS Holding Corp.* standard.

#### CONCLUSION

In the wake of the *In re Merry-Go-Round Enterprises, Inc.* settlement, engagement agreements between the chapter 7 trustee and the debtor in possession's financial advisors, professionals, including management companies and financial advisors, have routinely sought bankruptcy court approval of broad indemnification and exculpation provisions, with little or no discussion concerning the permissible scope of indemnification under applicable state corporation law. Courts have disagreed on the permissibility of such provisions and their scope in bankruptcy cases.

In appropriate instances, a debtor in possession may agree to indemnify or exculpate a professional person with respect to certain conduct. The Bankruptcy Code does not *per se* prohibit such indemnification or exculpation of corporate agents. Such provisions, however, should be scrutinized under the Bankruptcy Code *and* applicable state corporation law. A corporate debtor in possession should not be able to force creditors to bear the risk of such provisions where they are not in the best interests of the estate, where the indemnification provisions are unauthorized under the applicable state corporation law, where the exculpation provisions purport to rewrite the applicable standard of care owed to the debtor in possession in a bankruptcy case or where such provisions are otherwise unreasonable under section 328(a) in a particular case under the totality of the circumstances.

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