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# Corporate Governance Group

# Client Alert

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## DELAWARE COURT RULES ON MANDATORY AND PERMISSIVE INDEMNIFICATION CLAIMS

*In determining whether officer was “successful on the merits,” Court refuses to look “behind the result” of criminal and regulatory proceedings*

In *Hermelin v. K-V Pharmaceutical Company*,<sup>1</sup> the Delaware Court of Chancery recently was asked to consider claims by a deposed CEO for mandatory and permissive indemnification under an expansive indemnification agreement. In its ruling, the Court provided helpful guidance on the “two boundaries for indemnification” and required elements of proof under Section 145 of the Delaware General Corporation Law (“DGCL §145”). The Court also explained the “dearth” of guiding case law by pointing out that the costs of litigating the availability of permissive indemnification generally outweigh the potential benefits to the parties.

### **Background**

Marc Hermelin was the CEO of K-V Pharmaceutical Company (“KV”) from 1975 through 2008, and served on KV’s board of directors from 1975 through 2010. In connection with his service with KV, Hermelin was provided with an Indemnification Agreement which stated that “the Company shall indemnify Indemnitee to the fullest extent permitted by the General Corporation Law . . . .” As such, the Indemnification Agreement contained “the primary source of KV’s indemnification obligations” to Hermelin.

In 2008, while Hermelin still served as CEO, two pharmacies alerted KV that they had received oversized morphine sulfate tablets manufactured by KV and distributed by one of its subsidiaries. After an internal investigation, KV discovered that it also had produced other oversized tablets. KV notified the Food and Drug Administration (“FDA”) regarding the oversized morphine sulfate tablets, but not the other oversized pills.

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<sup>1</sup> Civil Action No. 6936-VCG (Del. Ch. February 7, 2012).

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Following this investigation and receipt of complaints from KV employees that Hermelin had failed “to take appropriate action in response to the discovery that KV’s manufacturing process had produced several oversized tablets,” the Audit Committee of the KV board of directors conducted its own internal investigation. Hermelin retained personal counsel to represent his interests in this investigation, and subsequently claimed that he was entitled to reimbursement from KV for his attorney’s fees under his Indemnification Agreement.

As a result its investigation, the Audit Committee decided to terminate Hermelin “for cause.” KV’s public announcement of these actions drew the attention of various governmental investigators, who brought the following proceedings:

#### *Criminal Proceeding*

Because Hermelin was a “responsible corporate officer” of KV and the subsidiary that distributed the oversized tablets, the U.S. Attorney’s Office for the Eastern District of Missouri (“*USAO*”) charged him with two federal strict liability misdemeanors. Hermelin pled guilty, was ordered to pay \$1.9 million in penalties and spent 15 days in jail.

#### *HHS Exclusion*

The Office of Inspector General (“*OIG*”) of the U.S. Department of Health and Human Services (“*HHS*”) moved to exclude Hermelin from all federal healthcare programs for 20 years due to his relationship to the KV subsidiary that distributed the oversized tablets. To prevent KV from suffering a similar fate, Hermelin agreed with the *OIG* to sell his stake in KV and waive any rights he had to appeal his own exclusion.

#### *FDA Consent Decree*

In connection with its investigation of KV’s compliance with current “Good Manufacturing Practices,” the FDA sought an injunction barring KV, Hermelin and other related parties from producing or distributing any drug until certain quality control measures were implemented. Both KV and Hermelin entered into a consent decree under which KV agreed to destroy certain drugs and cease production of others until completion of various remedial measures. The provisions of the consent decree were not applicable “to Hermelin so long as (1) KV’s Board’s resolutions to terminate Hermelin’s employment remain in effect and (2) Hermelin ‘has no role in the decisionmaking, management, or operation of the Defendant KV that could affect the company’s compliance with’ ... [FDA rules and regulations].” If Hermelin later became re-involved with KV, however, he would become subject to the consent decree.

#### *Jail Records Proceeding*

While Hermelin was incarcerated following his guilty plea deal in the *USAO*’s criminal proceeding, his private conversations with visitors were recorded by prison officials “per the jail’s policy.” After a local reporter requested the recordings, Hermelin asked a state court to enjoin their release on the ground that they were “purely private matters.” The court entered a permanent injunction in Hermelin’s favor.

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In addition to seeking reimbursement of his expenses in connection with the Audit Committee investigation, Hermelin sought indemnification in respect of the various governmental proceedings under the Indemnification Agreement. KV disputed all of these claims.

### *The Court's Analysis*

The Court began its analysis of Hermelin's claims by explaining that the DGCL "sets two boundaries for indemnification." At one "end of the spectrum," DGCL §145(c) *requires* all Delaware corporations to indemnify any corporate director or officer who is made a party to a proceeding by reason of his or her service to the corporation *and* has achieved success on the merits. At the "other end," DGCL Sections §145(a) and (b) *prohibit* Delaware corporations from indemnifying any corporate director or officer who is *not* successful in the proceeding *and* has acted in *bad faith*. According to the Court, the purpose of DGCL §145 is to further "important public policy goals of encouraging corporate officials to resist unmeritorious claims and allowing corporations to attract qualified officers and directors by agreeing to indemnify them against losses and expenses they incur personally as a result of their service."

Between "the extremes of 'success' and 'bad faith'," a corporation's ability to provide indemnification under DGCL §145 is "permissive," such that "when a corporation has established by contract the indemnification rights of a corporate official, the agreement controls unless it conflicts with a mandatory statutory provision." In the case of Hermelin and his service with KV, the parties signed an Indemnification Agreement that both "tracks the language" of the mandatory provisions of DGCL §145(c) and otherwise "generally makes mandatory what are permissive provisions for indemnification under the DGCL." In framing Hermelin's entitlement to indemnification and advancement of expenses, the Indemnification Agreement stated that "where a proceeding to which Hermelin is a party 'is resolved in any manner other than by adverse judgment against [Hermelin] ... it shall be presumed that [Hermelin] has been successful on the merits or otherwise', ...." and placed the burden on KV to overcome this presumption.

The dispute between Hermelin and KV centered on whether Hermelin had "succeeded on the merits" of any of the proceedings brought against him, "thus entitling him to indemnification as a matter of law," or whether discovery was required to determine whether Hermelin had "acted in good faith, in which case he will be entitled to indemnification under the Indemnification Agreement."

### **Advancement of Expenses**

#### *Jail Records Proceeding*

Although his Indemnification Agreement contained "a key exception" for actions or portions thereof *initiated by him*, Hermelin sought to characterize his injunctive action as equivalent to a compulsory counterclaim in response to the reporter's requested release of the recorded jail conversations. On this basis, Hermelin argued that he was not the initiating party in the litigation and therefore was entitled to advancement of his expenses.

The Court rejected this argument after concluding that Hermelin was, despite his argument to the contrary, the initiator of the injunctive action. In this connection, the Court found that Hermelin's argument that another party initiated the matter "simply misconstrue[d] the language" of the Indemnification Agreement as it failed "to recognize the distinction between an act that gives rise to a [legal claim] and an act that actually initiates a proceeding ...." The Court explained that, "[u]nder Hermelin's interpretation, the

Indemnitee could never be seen as having ‘initiated’ a proceeding, even as a plaintiff, so long as he had in the first place a [legal claim] that he wished to vindicate.”

### **Mandatory Indemnification**

Next, the Court considered whether Hermelin was entitled to mandatory indemnification under the Indemnification Agreement, in respect of the criminal proceeding, the HHS proceeding or the FDA investigation. In this connection, the Court noted that the Indemnification Agreement supplied “additional clarification” of the concept “successful on the merits or otherwise” by providing that “a settlement or other disposition short of final judgment may be successful if it permits a party to avoid expense, delay, distraction, disruption and uncertainty.”

In determining whether Hermelin had been successful in any of these proceedings, the Court refused to look “behind the result,” emphasizing instead that “where the *outcome* of a proceeding signals that the indemnitee has avoided an adverse result, the indemnitee has succeeded ‘on the merits or otherwise,’ and further inquiry into the ‘how’ and ‘why’ of the result is unnecessary.” Consistent with this approach, the Court “examine[d] what Hermelin was charged with or formally accused of, and ... compare[d] that with the result Hermelin actually achieved.”

#### *Criminal Proceeding*

Despite pleading guilty to each charge against him in the criminal proceeding brought by the USAO, paying a significant fine and serving time in prison, Hermelin argued that he actually was “successful on the merits or otherwise” because, by pleading guilty, he avoided conviction on harsher charges. In the Court’s view, “[t]his was not a successful outcome.” Further, Hermelin’s argument that by pleading guilty he was able to “avoid expense, delay, distraction, disruption, and uncertainty” was “unpersuasive.” Otherwise, the Court explained, “[i]f an indemnitee could ‘succeed’ by pleading guilty on all counts, those indemnitees utterly without a defense ... would nonetheless be ‘successful’ on the merits ...”

Hermelin’s contention that his plea negotiations with the USAO dissuaded the USAO from charging him “with more serious claims” also fell on deaf ears. Simply put, “[t]he substance of these negotiations ... is beyond the scope of a determination of success on the merits under Section 145(c). ... The proper analysis instead considers the outcome achieved by the indemnitee in light of the formal charges or claims against him.”

#### *HHS Exclusion*

Hermelin contended that because his 20-year exclusion from all federal healthcare programs, as ordered by the OIG, was based on his association with KV’s subsidiary rather than his own misconduct, he was successful in that proceeding. Hermelin also argued that he should not be “punished” when he in fact voluntarily took actions that benefitted KV.

In view of Hermelin’s age, the Court saw no difference between the penalty initially sought by the OIG (a lifetime ban from federal healthcare programs) and the actual outcome of this proceeding (a 20-year ban). Hermelin’s settlement with the OIG, which benefitted KV but not him, was irrelevant to the Court’s inquiry into entitlement to *mandatory* indemnification. While “good corporate policy may support the indemnification of officers [on a *permissive* basis] who, in good faith, ‘take one for the company’ to avoid

bringing down the whole enterprise,” the Court found that such consideration had no place in assessing entitlement to *mandatory* indemnification under DGCL §145(c).

#### *FDA Consent Decree*

Hermelin characterized the resolution of the FDA’s proceeding as a victory based on the facts that the FDA did not find him personally guilty of misconduct and the consent decree, at least initially, did not apply to him. In contrast to its analysis of the other proceedings, the Court found that because “the restrictions contained in the Consent Decree ... did not place any additional restrictions on Hermelin,” Hermelin was entitled to mandatory indemnification because he avoided “a personally negative result ....”

#### **Permissive Indemnification**

Finally, the Court was called upon to determine whether Hermelin was entitled to *permissive* indemnification under his Indemnification Agreement in connection with those proceedings for which the Court ruled he was not entitled to *mandatory* indemnification. In this regard, because the Indemnification Agreement entitled Hermelin “to the fullest extent not prohibited by law,” the key question was whether Hermelin had “acted in *good faith* and in a manner ... reasonably believed to be in or not opposed to the best interest of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person’s conduct was unlawful.”

Although this inquiry “requires additional discovery,” according to the Court, “no Delaware court has squarely addressed what evidence is relevant” for this purpose. However, the Indemnification Agreement did provide “a starting point” for the Court’s analysis by providing that:

“The termination of any Proceeding ... by judgment, order, settlement or conviction, or upon a plea of *nolo contendere* ... shall not ... *of itself* adversely affect the right of Indemnatee to indemnification or create a presumption that Indemnatee did not act in good faith and in a manner which Indemnatee reasonably believed to be in or not opposed to the best interests of the Company ....”

In other words, for purposes of the Indemnification Agreement, “the particular outcome of a proceeding does not itself create a presumption that the indemnitee had a ‘non-indemnifiable state of mind’” *unless* “the underlying proceeding established that the indemnitee acted in bad faith ....” Absent such a finding, “additional discovery – in some instances mimicking the very litigation avoided by the settlement – may be required to permit a determination on whether the indemnitee acted in good faith.”

Based on the “scant evidence” before it, the Court ordered a “plenary trial” on the question whether Hermelin had acted in good faith in connection with the various matters at issue. This was not to be an open-ended proceeding, however, but rather one “limited to Hermelin’s conduct underlying the proceedings for which Hermelin seeks indemnification.” On the other hand, the Court rejected Hermlin’s attempt to restrict the fact-finding to “the records established in the matters for which he seeks indemnification.” A determination that “the indemnitee did not act in bad faith [is] a fact-intensive inquiry that will most likely require a trial and credibility determinations.”

### *Conclusion*

As the *Hermelin* decision makes clear, there are any number of circumstances “between the extremes of ‘success’ and ‘bad faith’” for which the DGCL grants corporations wide latitude in determining whether and how to indemnify its directors and officers. However, when *mandatory* indemnification is not available because the indemnitee was not successful on the merits, the determination whether he or she acted in good faith – and therefore was entitled to *permissive* indemnification under an expansive bylaw or indemnification agreement – can lead to protracted litigation if the company disputes its obligation to provide indemnity.

The “dearth” of judicial precedent for these determinations, the Court explained, stems from the fact that “companies never face claims for permissive indemnification and ... where, as here, it is clear that the employee’s right to indemnification turns on ‘good faith,’ economics militate in favor of resolving the matter outside of court, given the costs associated with a plenary trial on the indemnitee’s conduct.” From the Court’s point of view, in any such litigation, “we will essentially be conducting the litigation that the parties have thus far avoided through settlements, consent decrees, and plea agreements.” In a warning to KV and Hermelin that they might not “want to go there,” the Court offered that “I leave it to the parties to determine whether the elusive joys and potential benefits of such litigation outweigh the substantial costs that will result.”

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