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WHITE COLLAR CRIME

Corporate Bylaws May Provide Unintended Support For Employees

By Jack L. Gruenstein

Opinions issued in a white-collar criminal case shed light on the need for corporations to adjust their by-laws to avoid indemnification or advancement of legal expenses for employees who may become involved in white-collar crime legal proceedings.

In three opinions issued between December 2012 and October 2013, the New Jersey district court liberally construed Delaware General Corporate Law (DGCL) § 145, and granted summary judgment requiring Goldman Sachs Group, Inc. (GSI), a Delaware corporation, to advance expenses and attorney fees to the plaintiff, an officer of Goldman Sachs Co. (GSCo), a noncorporate subsidiary, to defend against New York state criminal charges related to the alleged theft of trade secrets which he provided to a competitor. GSI refused, claiming the plaintiff was not an officer of GSCo. The court concluded that advancement was an interim remedy not

Gruenstein chairs the white-collar crime practice group at Marshall Dennehey Warner Coleman & Goggin in Philadelphia.

requiring a decision on the merits of the plaintiff's claim to be an officer. The court was influenced by GSI's failure to draft its by-laws with sufficient clarity to identify any formalized appointment process by which GSCo employees were designated as officers, and the lack of any evidence that a process existed for GSI's noncorporate subsidiaries.

The plaintiff also sought summary judgment requiring GSI to indemnify him for all fees and expenses incurred in successfully defending an earlier federal indictment based on the same conduct as the state prosecution. The court refused, finding this dispute, including a challenge by GSI to the reasonableness of the fees and expenses paid, should await full discovery.

GSCo was a limited partnership in which it was the general and GSI was the limited partner. The plaintiff, Sergi Aleynikov, a GSCo vice president, was a computer programmer who helped develop "source code" software used by GSCo for high-frequency trading. After Aleynikov accepted a job with a competitor and allegedly supplied it with the source code, he was charged federally with the theft of trade secrets, convicted at trial and sentenced to 97

months' incarceration. He was acquitted on appeal to the Second Circuit because the evidence did not support the crimes charged. Thereafter, the state of New York relied on the same facts to indict him.

Aleynikov demanded indemnification of more than \$2 million from GSI to pay his attorneys in the federal case, and demanded an advance against fees and expenses anticipated in the state case. Pursuant to the bylaws, he provided GSI with an unsecured written undertaking to repay the advance if his state case defense was unsuccessful. He relied on DGCL § 145, and § 6.4 of GSI's bylaws. Section 145 embodies Delaware's policy of encouraging qualified individuals to assume corporate responsibilities without fear of personal economic loss for doing so, and allows a corporation to indemnify and/or advance funds to one involved in legal proceedings by reason of his status, inter alia, as a corporate officer. Section 145 is not mandatory; the final decision rests with the corporation.

Indemnification requires a favorable resolution of the underlying proceeding, although it's not limited to a "not guilty" verdict in a criminal matter. Advancement provides interim relief while charges are pending and success on the merits of the underlying case is unnecessary. Rather, if one becomes involved in a proceeding because of his particular status, and undertakes to repay the funds if unsuccessful, advancement is required.

Section 6.4 of the GSI's bylaws provided that it shall indemnify or advance funds to a GSI officer elected or

appointed by its board of directors; to an officer of a corporate or foreign subsidiary elected or appointed by their boards of directors; and, to a noncorporate subsidiary officer. Unlike the first two provisions describing the appointment process, the final provision, characterized by the court as circular, defined an officer as “any officer of such entity.”

As a GSCo vice president, Aleynikov claimed he was an officer, who had been twice charged by reason of that status, and was entitled to indemnification and advancement. When GSI denied his demands, he sought a preliminary injunction to force GSI to indemnify him for the federal criminal case expenses, and to advance \$500,000 against the expenses anticipated in the state court criminal case, and to fund the preliminary injunction litigation. GSI moved to dismiss.

Although acknowledging that the definition of a noncorporate subsidiary officer as “any officer” was circular, GSI asserted that its noncorporate subsidiaries had an established practice of appointing officers by a “formal resolution.” Because no resolution existed for the plaintiff, GSI contended he was not an officer of GSCo. It dismissed his vice-president title as an industry-wide courtesy title which did not vest him with the normal powers of an officer. Aleynikov claimed he had relied upon § 6.4 (3) in accepting employment, and that GSI was contractually obligated to provide indemnification and advancement. Even though he had not read the bylaws prior to joining GSCo, he supported his contract argument with the presumption contained in the bylaws that one serving as an officer had relied upon the bylaws in agreeing to do so. Finally, he asserted that the definition of “officer” at issue was ambiguous, and under Delaware law should be construed against GSI as the drafter.

The essential issue was whether Aleynikov was a GSCo officer. Since neither party sought an evidentiary hearing on this question, the court found that a preliminary injunction was not warranted because the record was insufficient to support the likelihood of success on the merits of the plaintiff’s claim to be an officer. However, in denying GSI’s motion to dismiss, the court found that other than an affidavit from an assistant general counsel, GSI had presented no

evidence that: the plaintiff was not an officer; that noncorporate subsidiary officers were appointed only by formal resolution; or that the vice-president title was merely an industry-wide courtesy.

The court found no irreparable harm from denial of a preliminary injunction on the request for indemnification. The federal prosecution had ended, and even if the plaintiff was an officer, his request for indemnification was one for monetary damages. The court further concluded that allowing GSI an opportunity to contest the reasonableness of the plaintiff’s indemnification demand would not cause him irreparable harm, but would provide procedural fairness to GSI. Such a challenge appears contemplated in DGCL § 145 (a), which provides for the indemnification of all expenses “actually and reasonably incurred.”

The court was less sanguine that no irreparable harm would result from denying the advancement request. While denial would not deprive the plaintiff of counsel, since even an indigent defendant had a right to court-appointed counsel, it could deprive the plaintiff of his counsel of choice. Here, the same firm had represented the plaintiff for more than two years, and was well-versed in the factual and legal issues involved in the ongoing state prosecution. Without funding, that firm might be unwilling or unable to continue, and the plaintiff might be irreparably harmed. The court recognized, however, that if funds were advanced, and the plaintiff ultimately was unsuccessful, he would not be entitled to indemnification, and his “undertaking” to repay the funds would be meaningless because he was impecunious. With these conflicting concerns, the court denied advancement, but ordered expedited discovery regarding the plaintiff’s officer status as it related to that claim.

When discovery ended, the parties each sought summary judgment. By that point, GSI had counterclaimed as to reasonableness of the indemnification claim. Because the reasonableness of those fees was not part of the expedited discovery, the court granted summary judgment to Aleynikov only as to advancement, ordering GSI to pay: the reasonable fees already incurred in the state case; any reasonable future expenses; and any fees reasonably attributed to the advancement

claim. The court denied the indemnification claim, finding it procedurally unfair to grant summary judgment to the plaintiff without permitting GSI an opportunity to develop the reasonableness counterclaim.

The court was influenced by the statutory policy of DGCL § 145 favoring advancement, and read the bylaws in a manner effectuating this policy. The court saw advancement as an “emergent” and “provisional” remedy not dependent upon the plaintiff’s guilt or innocence in the state criminal case. Rather, if convicted, then the plaintiff would not be entitled to indemnification and would be required to repay the funds advanced to him, even if he was an officer. The court also focused on the careless, circular, drafting of GSI’s definition of officer, and its failure to identify a written procedure describing the appointment process for officers of noncorporate subsidiaries. Because the bylaws defined such an officer as “any officer,” and under Delaware law a vice president was deemed an officer, the court granted summary judgment to the plaintiff for advancement.

Aleynikov challenged the definition of an officer as ambiguous, asserting it had to be construed against the drafter, GSI. The court disagreed. There was no ambiguity since the bylaws described no appointment process for noncorporate subsidiary officers, and Delaware case law held that a vice president was an officer. If an ambiguity did exist, then it would be construed against GSI under *contra proferendum*, a principle protecting one who joins an organization after the constitutive documents have been prepared. Because that person was not able to participate in drafting the documents, but relied on them in joining the organization, any ambiguity in the documents would be construed against the drafter.

GSI appealed the court’s decision to the Third Circuit, and then sought a stay from the district court of the advancement order. Although the stay request procedurally was improper, the court granted a seven-day stay to allow GSI to pursue that request on appeal.

Although *Aleynikov* involved two criminal cases, the reach of DGCL § 145 is much broader, providing for indemnification or advancement to any person

“[made] a party...to any...action...civil, criminal, administrative or investigative [because] the person is or was a director, officer, employee or agent....” Many investigations brought by federal, state and local authorities will implicate issues of indemnification and advancement, and a corporation must understand its potential obligations, and correct deficiencies in its bylaws that might provide unintended support for an employee seeking indemnification or advancement. ■