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## Future Of Advancement And Indemnification Rights

*Law360, New York (July 10, 2009)* -- Recently, in *In re HealthSouth Corp. Securities Litigation*, -- F. 3d --, 2009 WL 1675398 (11th Cir. June 17, 2009), the Eleventh Circuit held that companies settling securities class actions can include bar orders under the Private Securities Litigation Reform Act (the "Reform Act") that extinguish their former officers' statutory and contractual rights to advancement and indemnification of legal fees.

Issuers defending securities fraud class actions and their indemnified executives, along with the lawyers representing these defendants, should take note of the HealthSouth opinion and what it could mean for settlement negotiations and litigation strategy.

### Reform Act Bar Orders

The Reform Act requires a court approving a settlement of a securities fraud class action to issue a contribution "bar order." Bar orders allow settling parties to buy peace, because they foreclose nonsettling defendants from bringing future contribution claims against the settling defendants.

The Reform Act provides that bar orders are reciprocal in that nonsettling defendants are barred from seeking contribution from settling defendants, and settling defendants are similarly barred from seeking contribution against nonsettling defendants.

Nonsettling defendants are also protected under the Reform Act by a judgment credit for the higher of the proportionate liability of the settling defendant or the amount actually paid by the settling defendant.

Thus, a nonsettling defendant will only be held liable for any judgment against her exceeding the amount paid by the settling defendants or the amount for which the jury deems the settling defendants culpable. And the securities plaintiff bears the risk of a cheap partial settlement.

## Indemnification and Advancement Rights

Most public companies, including HealthSouth, are Delaware corporations. Section 145 of the Delaware General Corporate Law (and many other state laws) provides that a corporation may include in its bylaws “indemnification” and “advancement” provisions, and it is common for companies to do so.

Thus, most corporations agree in their bylaws to indemnify their officers and directors for judgments, settlement payments, and reasonable defense costs for lawsuits brought against the executives in their corporate capacity.

Indemnification for defense costs is usually a promise to advance them during the pendency of the action, subject to an undertaking by the individual to repay those advances if it is determined that the executive is ultimately not entitled to indemnification.

Corporations may, and often do, also make these commitments to officers in their employment contracts.

Whether created by the bylaws or an employment contract, Delaware courts do not hesitate to enforce broadly a corporation’s advancement obligation.

Companies can be required to advance several millions of dollars in defense costs for even convicted criminals, when everyone knows the executive will not be able to return the money if he is ultimately found not to be entitled to indemnification.

Delaware courts have spoken rather harshly of companies who “are being forced to search even harder for increasingly strained arguments that will allow them to delay living up to seemingly clear advancement obligations.” *Sun-Times Media Group Inc. v. Black*, 954 A.2d 380, 400 n.75 (Del. Ch. 2008).

Under Delaware law, companies must advance defense costs until the executive’s liability is fully resolved, i.e., not subject to further appeals by the executive. Only if the action is resolved adversely to the executive can the corporation use the undertaking to clawback the amounts advanced.

The executive must then demonstrate that he is entitled to indemnification because he “acted in good faith and in a manner [he] reasonably believed to be in or not opposed to the best interests of the corporation.” 8 Del. Code § 145(a).

The verdict against him cannot serve as a presumption that he cannot meet this standard. *Id.* Until the executive’s right to indemnification is resolved, the company’s obligation to advance is absolute.

Indeed, if the company sues the executive to clawback the advanced defense costs, the company must advance the executive’s costs in defending the clawback suit.

## The HealthSouth Decision

Despite Delaware's presumption in favor of defense-cost indemnification and advancement, in HealthSouth the Eleventh Circuit affirmed a settling company using a Reform Act bar order to extinguish its obligation to advance defense costs to its non-settling former CEO.

HealthSouth and the class action plaintiffs had reached a settlement in which HealthSouth and its insurers agreed to pay \$445 million. Richard Scrushy, HealthSouth's former chairman and CEO, was named as a defendant but not included in the settlement.

The settlement agreement called for a bar order that extinguished not only Scrushy's right to seek contribution from HealthSouth for any liability he had to plaintiffs, but also foreclosed any further indemnification obligations HealthSouth had for defense costs.

The district court approved the settlement and bar order over Scrushy's objections, and he appealed to the Eleventh Circuit. He argued, among other things, that the bar order impermissibly extinguished his contractual claims against HealthSouth for advancement of defense costs. Scrushy presented three arguments in support of his objection, and the court rejected all of them.

First, Scrushy argued that the order was not appropriate under the Reform Act or case law interpreting it, because his advancement claim against HealthSouth was independent of the plaintiffs' securities fraud claim and therefore could not be settled between plaintiffs and HealthSouth.

The court found a sufficient relationship between Scrushy's advancement claim and the underlying securities claim because Scrushy would have no need to claim defense costs if he were not being sued by plaintiffs.

As the court put it, "the attorneys' fees for which Scrushy seeks advancement were incurred on account of Scrushy's liability or the risk thereof to the underlying plaintiffs."

Plaintiffs were therefore allowed to agree with HealthSouth that Scrushy should no longer be entitled to advancement.

Second, Scrushy argued that public policy supported the advancement of attorneys' fees.

As explained above, Delaware law is very pro-advancement, and the reason often given is that Delaware corporations want the best individuals to serve on their boards and as their officers and to encourage them to do so needs to guarantee that they will be protected from meritless litigation.

The court held that this policy was outweighed by a policy favoring settlements, and HealthSouth would have been unlikely to settle if it continued to be liable to Scrusby for his defense costs.

The court suggested that these considerations might balance differently for an executive who could establish his innocence, but Scrusby had not.

Third, Scrusby argued that the bar order cutting off his advancement could not be justified like a typical bar order because he did not receive the consideration of reciprocity — he owed HealthSouth no contractual obligation to advance its defense costs.

The court held that precise reciprocity was not necessary; the bar order's protection for Scrusby from any claims by HealthSouth was sufficient compensation to him for losing his advancement rights.

Again the court suggested that the calculus might differ for a more innocent executive: "This constitutes very significant compensation to Scrusby, in light of the perception by the underlying plaintiffs and HealthSouth that Scrusby was a central figure in the violations."

## **Going Forward**

The HealthSouth decision should certainly draw attention from securities litigators. The Eleventh Circuit's willingness to permit issuers to extend Reform Act bar orders to block defense-cost advancement claims should tip the scales of bargaining power and encourage a change in behavior from each of the parties.

For their part, issuers will make such broad bar orders standard operating procedure in their settlement agreements if they intend to cut a former executive loose in the settlement.

And since an unrepresented (or lesser-represented) executive is more lucrative to plaintiffs, they will be happy to agree to the broad bar order.

The nonsettling defendant may or may not succeed in his objection to the bar order, but there is little harm in the parties including it.

The ability to "buy peace" with a bar order might also make companies more willing to settle without their former executives, rather than attempt to reach a global settlement.

And since plaintiffs know about this procedural maneuver, they might push for segregated settlements as a way to get more consideration from multiple defendants.

Companies will no longer be able to use the excuse that they cannot settle without everyone included because they still have liability in the form of defense costs.

To protect themselves, the director or officer might obtain a Delaware judgment immediately that they are entitled to advancement until the case is resolved against them.

Delaware provides for expedited proceedings in advancement cases, and at the first sign of trouble — e.g., the company is late paying the executive's submitted legal bill — the executive would have an excuse to file a summary proceeding in Delaware seeking such an order.

The issuer would have no interest in presenting bad facts at that stage, because such facts would hurt the issuer in the liability case against it.

But they would be irrelevant in any event, since the Delaware court would only determine whether the individual had been sued in his capacity as an officer or director, and then order the company to advance reasonable defense costs until the executive's right to indemnification was settled.

It is unlikely that the issuer could agree in a settlement with plaintiffs to avoid such a direct court order. And, presumably, the court in which the securities action is pending would want to avoid a direct conflict with the court of the state of the company's incorporation.

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