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Recent Developments in
**BUSINESS AND
CORPORATE LITIGATION**

Business and Corporate Litigation Committee



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CHAPTER 11

Director and Officer Indemnification and Advancement Rights

Francis G.X. Pileggi

Gary W. Lipkin

Aimee M. Czachorowski

Justin M. Forcier

Alexandra D. Rogin

Eckert Seamans Cherin & Mellott, LLC

222 Delaware Avenue, 7th Floor

Wilmington, DE 19801

(302) 574-7400

fpileggi@eckertseamans.com

glipkin@eckertseamans.com

aczachorowski@eckertseamans.com

jforcier@eckertseamans.com

arogin@eckertseamans.com

www.delawarelitigation.com

CHAPTER 11

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Director and Officer Indemnification and Advancement Rights

§ 11.1 Introduction

This chapter summarizes significant legislative and case law developments in 2016 concerning the indemnification of directors, officers, employees and agents by the corporations or other entities they serve, as well as the rights of such persons to the advancement of litigation expenses before final resolution of the litigation.¹

This chapter also refers to legislative developments under Delaware law and the Model Business Corporation Act.

§ 11.2 Indemnification and Advancement – 8 *Del. C.* § 145

Section 145 of the Delaware General Corporation Law (“DGCL”)² authorizes (and at times requires) a corporation to indemnify its directors, officers, employees, and agents for certain claims brought against them, and allows a corporation to advance funds to those persons for the expenses they incur while defending such claims. Specifically, Sections 145(a) and (b) broadly empower a Delaware corporation to indemnify its current and former corporate officials for expenses incurred in legal proceedings to which a person is a party “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 entity or enterprise.

1. The views reflected herein are those of the authors and may not reflect those of Eckert Seamans Cherin & Mellott, LLC, or its clients.

2. The DGCL is found in Title 8 of the Delaware Code.

If a present or former director or officer is successful in defending an action brought “by reason of the fact” that the person is or was a director or officer, Section 145(c) of the DGCL requires the corporation to indemnify that person for expenses (including attorneys’ fees) reasonably incurred in connection with that defense. Section 145(e) allows a corporation to advance to corporate officials the reasonable expenses (including attorneys’ fees) incurred in defending an investigation or lawsuit. The Model Business Corporation Act (MBCA) contains similar provisions regarding the indemnification and advancement of expenses to corporate officials and employees, and the alternative entity statutes of Delaware and many other jurisdictions similarly contain enabling provisions concerning indemnification and advancement.

Many corporations have charter or bylaw provisions, or are parties to agreements with directors, officers, or employees, that supplement statutory indemnification and advancement rights. Such provisions often make indemnification and advancement mandatory under specified circumstances.

§ 11.2.1 Legislative Developments

The Delaware General Assembly did not enact any amendments to 8 *Del. C.* § 145 in 2016. No changes were made to the indemnification and advancement provisions of the MBCA in 2016.

§ 11.2.2 Case Law Developments

§ 11.2.2.1 *Andrikopoulos v. Silicon Valley Innovation Co., Inc.*³

This case addressed an issue of first impression in Delaware: the priority of an advancement claim against a company that is in receivership. Borrowing concepts that are more common in bankruptcy law, the Delaware Court of Chancery ruled that the claims for advancement in this case were not entitled to administrative priority and should be treated as pre-petition, unsecured claims.

In a previous decision, the court appointed a receiver for Silicon Valley Innovation Company (“SVIC” or the “Company”). SVIC’s only assets were the contingent claims against its officers and directors. Two of those officers (the “Plaintiffs”) filed this case claiming that they were owed advancement for the contingent claims. The narrow issue decided in this case was whether the Plaintiffs’ advancement claims deserved priority over the Company’s other financial obligations.

The court held that no priority should be given to those advancement claims, and that the advancement claims should be treated the same as unsecured creditors’ claims are treated in bankruptcy. The court stated that the Company had no long-term horizon, and the purpose of the receivership was to wind up SVIC’s

3. 120 A.3d 19 (Del. Ch. 2016).

affairs. Additionally, any priority given to the advancement claims would hinder the Company's ability to pursue the contingent claims against the officers and directors. Furthermore, the court held that there is a substantial difference between a pre-receiver entity and a post-receiver entity—they are managed by different people, operate by different rules, and have different purposes. Therefore, the court held, the Plaintiffs' advancement claims were not entitled to a level of priority over the other obligations of the Company.

§ 11.2.2.2 *Dodge v. Stack*⁴

This action involves a dispute over pay between two co-owners and the sole shareholders of Lake Area Human Services, Inc. ("LAHS"). Co-owner, Gordon Dodge, brought suit over co-owner, Charlotte Stack's, entitlement to clinical earnings and administrative pay. The lower court determined that Stack was entitled to all of her clinical earnings and administrative pay, but the court denied Stack's request for indemnification. The parties appealed.

On appeal, Stack requested indemnification to the extent she responded to the lawsuit in her capacity as an officer of the corporation. Dodge opposed this request on the basis that he intended to bring the suit against Stack for her personal actions in, *inter alia*, allegedly disregarding the parties' personal agreements, failing to properly document expenditures, and managing the business in a way at odds with Dodge's instructions.

A Minnesota statute provided for mandatory indemnification of corporate directors and officers made a party to litigation in connection with their official capacities. The lower court did not analyze the statutory requirements because it found that the claims related to Stack in her personal capacity. The appeals court disagreed. The allegations in the complaint could not have occurred unless Stack was a corporate officer. Therefore, the court reversed and remanded the case back to the lower court to analyze Minnesota's statutory indemnification requirements.

§ 11.2.2.3 *Harrison v. Quivus Systems, Inc.*⁵

This case is important because the court discusses the more flexible advancement rights available to LLC members and managers under the Delaware LLC Act. Harrison joined Quivus in 2007 as the company's CEO. Quivus was formed under the Delaware LLC Act, which allows for advancement rights to LLC members and managers, as well as their heirs, estate, personal representative, or administrator. Harrison was removed from his position in 2014. One year later, Harrison was sued by his former business associate for mismanagement, incompetence, and corporate malfeasance for actions he took as CEO. Harrison sent a letter to Quivus demanding advancement to defend against the allegations, but Quivus refused.

4. No. A15-0968, 2016 WL 1724188 (Ct. App. Minn. May 2, 2016).

5. C.A. No. 12084-VCMR (Del. Ch. Aug. 5, 2016) (Transcript).

The court began its analysis by drawing a distinction between advancement for corporate officers and directors under the DGCL, and for LLC members and managers under the Delaware LLC Act. The significant difference between the two statutes is that advancement under the DGCL normally hinges on whether the defendant is being sued “by reason of the fact” that he took action in his official corporate capacity. Under the Delaware LLC Act, however, advancement and indemnification is available for “any and all claims and demands whatsoever.”

Quivus asserted that notwithstanding the Act’s broad language, advancement should be denied to Harrison because he had been removed from his position as CEO prior to being sued. The court rejected that argument because, “[i]f nothing else, Harrison was a present manager when he was the CEO of the company and when the events underlying the...action occurred.”

The court also reiterated Delaware’s public policy of respecting advancement rights to encourage qualified persons to serve as corporate directors without the ever-present threat of having to fund a lawsuit to defend themselves.

§ 11.2.2.4 *Hyatt v. Al Jazeera American Holdings II, LLC.*⁶

This is the latest in an ongoing series of rulings in Delaware involving a transaction in which the media company known as Al Jazeera, based in the Middle East, purchased a cable TV company in the U.S., which was owned in part by the former politician, Al Gore, as well as Joel Hyatt.

The court begins the opinion with the apt description of many advancement cases being indicative of “Hirer’s Remorse” to the extent that advancement is given to employees, officers, and directors as inducement for them to accept their positions for the benefit of a corporation. Yet afterwards, when those corporations need to make payments pursuant to those advancement obligations, they often resist and try to find reasons not to pay.

In large measure, the case turned on whether the counterclaims against Hyatt and Gore were made against them in their capacities as former officers and directors. The court analyzed each of the counterclaims separately, finding that most did assert allegations based on Gore’s and Hyatt’s actions as former officers and directors of the company. The analysis was based on the terms of the merger agreement, which incorporated the advancement provisions in the LLC operating agreement.

Notably, the court found that the fee shifting provision in the relevant agreement did not supersede the advancement obligation, and that the fee shifting provision was silent on the issue of advancement.

The court observed a basic counterintuitive principle: “Although indemnification and advancement rights are closely related, each are ‘distinct types of legal rights,’ and the ‘right to advancement is not ordinarily dependent upon a determination that the party in question will ultimately be entitled to be

6. C.A. No. 11465-VCG, 2016 WL 1301743 (Del. Ch. Mar. 31, 2016).

indemnified.”” The foregoing statement perhaps encapsulates the counterintuitive nature of the concept of advancement, and it is the aspect that most commonly frustrates many corporations who find it difficult to advance fees and expenses when they are at least personally convinced that the former officer or director will not be entitled to indemnification.

The court explained that it often applies the reasoning from cases interpreting Section 145 to the interpretation of language in an LLC operating agreement or other agreements that often incorporate the same statutory advancement language as Section 145.

The court referred to Section 18-108 of the Delaware LLC Act as giving broad authority to LLC’s to provide indemnification by contract. Specifically, the court found that the parties intended to import the “strictures” of Section 145 by using the same language in their agreement. The court also allowed for “fees on fees,” which is a well-established principle to cover the costs of litigation to the extent that a party prevails in establishing the right to advancement, as in this case.

§ 11.2.2.5 *Marino v. Patriot Rail Company LLC*⁷

This opinion is noteworthy for providing the most detailed historical analysis and doctrinal underpinning for the legislative scheme that requires corporations under certain circumstances to provide advancement to former directors and officers. The decision also explains why companies are barred from terminating such advancement for former directors and officers unless certain prerequisites are satisfied.

This opinion provides one of the “deepest dives” of any Delaware decision into advancement rights under Section 145(e), Section 145(f), and Section 145(j) of the DGCL. This opinion also provides practical assistance for those handling this common form of corporate litigation.

The distinction in Section 145(e) between current and former directors and officers was only intended to underscore the ability of current directors and officers to receive advancement if an undertaking is provided, and not to presume engagement in self-interested transactions.

The court refers to Section 145(j) as the “Continuation Clause,” which requires an explicit opt-out before the advancement rights of a former director and officer can be terminated. Accordingly, although Subsection (e) makes advancement permissive, once it is provided, advancement is mandatory to the extent Section 145(j) prohibits termination of coverage for former directors. The court explained that under the Continuation Clause, “the only way that a covered person loses coverage after having ceased to be a director is if the source of the coverage ‘otherwise provided when authorized or ratified.’”

By comparison, and consistent with the Continuation Clause, the court explained that Section 145(a) grants authority to a corporation to indemnify a person who “is or was” a director for actions they took while a director.

7. 131 A.3d 325 (Del. Ch. 2016).

The “was” compliments the default rule of the Continuation Clause, which states that unless the indemnification or advancement right specifies otherwise, coverage for actions taken while in a covered capacity continues after the person “has ceased” to serve in the covered capacity. Section 145(a) addresses whether an individual became involved in the litigation “by reason of” the individual’s service in a covered capacity.

Section 145(b) authorizes indemnification for actions by or in the right of a corporation and includes parallel usages of the words “is or was.”

Many parts of this opinion make it required reading for anyone interested in this area of Delaware corporate law. One of the key parts describes a detailed procedure that parties and their counsel must follow to address disputed claims for advancement. This procedure is similar to prior procedures used in Chancery. It will inevitably be needed to address disputes as this opinion is applied to specific bills received on a monthly basis, engendering disagreement about which bills are properly covered pursuant to this opinion.

§ 11.2.2.6 *Narayanan v. Sutherland Global Holdings Inc.*⁸

This Delaware Court of Chancery opinion addressed: (1) whether separate sources of indemnification, including the company’s bylaws and an indemnification agreement, must be read together or separately; (2) whether the plaintiff-director served the entity at the request of the company or for his own personal benefit; and (3) whether the court should delay granting the request for fees and fees-on-fees until after the court determines that the company is liable. Each of the issues was decided in favor of the plaintiff-director.

The three instruments on which the claims for advancement are based are the: (1) certificate of incorporation; (2) bylaws; and (3) indemnification agreement. After making a demand and attaching an undertaking, the complaint in this matter was filed on November 30, 2015. It is noteworthy that the trial was held within 70-days after the complaint was filed, and this 44-page opinion was issued promptly thereafter.

The court held that: (1) the bylaws are a separate and independent source of indemnification and advancement, which do not require cooperation even though other documents might have that as a condition; (2) that the controller of the company requested the plaintiff-director to serve in both entities involved in this matter satisfied any prerequisites for advancement; and (3) there is no reason to delay vindicating the right to advancement notwithstanding other issues that have yet to be adjudicated.

DGCL Section 145 governs the advancement issues in this case. The court observed the truism that a corporation has discretionary authority to provide indemnification under Subsections (a) and (b), as well as advancement under Subsection (e), but must provide indemnification in certain circumstances pursuant to Subsection (c).

8. C.A. No. 11757-VCMR, 2016 WL 3682617 (Del. Ch. July 5, 2016).

Section 145(f) makes clear that indemnification and advancement rights under the DGCL are not exclusive of any additional indemnification and advancement rights a corporation chooses to provide in a separate instrument.

The court addressed the principle that when multiple contracts are signed together as part of a single transaction, those contracts are often interpreted together, apart from any explicit incorporation by reference. Notwithstanding the foregoing principle, the court emphasized the exception to the rule for “absence of evidence to the contrary,” which applies in this case.

After reciting the basic principles of contract interpretation, the court held that under the circumstances, the bylaws and the separate indemnification agreement were independent sources of advancement rights. The court found that based on the testimony and evidence at trial, the plaintiff-director served at the request of the person who was the controlling stockholder, chairman, and CEO, which the court viewed as tantamount to a request by the corporation.

The court expressed the view oftentimes repeated in recent advancement decisions that a proceeding to determine the right to advancement is not the appropriate time to dispute the precise amount of fees, and that in an advancement proceeding, the court will not inject itself as a “monthly monitor of the precision and integrity of advancement requests.”

§ 11.2.2.7 *Pulier v. Computer Sciences Corporation*⁹

The outcome of this case was determined by whether, under the bylaws, the former officer was a “covered” or “indemnified” person subject to advancement and indemnification. Pulier was the founder and CEO of an acquired company, who stayed on to manage his former company as a division of the acquiring company. Although he essentially continued his previous CEO role, he was given the title of Vice President.

Computer Sciences’ bylaws provided that to be an officer, and therefore entitled to indemnification and advancement, one must be elected as such by the board of directors. Although other evidence of Pulier’s title and role within the company would lead to the belief that he was an officer, such as his responsibilities, title as vice president, and inclusion in the Company’s list of its “executive team,” the court found that Nevada law applied; Nevada law specified that one can only be a corporate officer in the manner specified in the company’s bylaws. Because the bylaws required election by the board of directors, the court found Pulier was not entitled to advancement and indemnification under Computer Sciences’ bylaws.

Despite that finding, the court held that Pulier was entitled to advancement and indemnification pursuant to the acquired company’s bylaws for acts taken as CEO of that company pre-closing. Because he was not entitled to indemnification or advancement for post-closing acts, the court awarded advancement for 70 percent of his defense costs related to pre-closing acts

9. C.A. No. 12005-CB (Del. Ch. May 12, 2016) (Transcript).

and 80 percent of his fees-on-fees incurred in bringing the Delaware action to enforce his advancement rights.

§ 11.2.2.8 *RoundPoint Mortg. Co. v. Florez*¹⁰

This action involves RoundPoint's claims against individual former directors, officers, and employees for allegedly taking improper actions in competition with the company. After RoundPoint filed its complaint, the defendants filed counterclaims for indemnification. Thereafter, the parties moved for summary judgment.

RoundPoint's bylaws provided for indemnification to the fullest extent of Florida law. Florida law required mandatory indemnification where the official, sued in his or her official capacity, was successful or otherwise on the merits of a claim. Florida law further allowed for permissive indemnification to the extent an official acted in good faith, in a manner reasonably believed to be in the best interests of the company. A dispute arose over whether the defendants were sued in connection with their official capacities, and thus, whether they were entitled to indemnification.

The court based its opinion on an interpretation of the Florida Supreme Court case of *Banco Industrial de Venezuela C.A., Miami Agency v. De Saad*, 68 So.3d 895 (Fla. 2011). Pursuant to *De Saad*, the court evaluated whether the individuals were sued because of their conduct, rather than solely because of their positions in the company. The court explained that if a defendant's position is incidental to the conduct that formed the claim, indemnification is not permitted. Thus, indemnification is not warranted for an individual made a party to litigation on the basis of conduct outside the scope of employment.

Ultimately, the court held that indemnification was not warranted, as the company's allegations did not arise out of any defendant's status as an officer, director, or employee.

§ 11.2.2.9 *Thompson v. Orix USA Corp.*¹¹

The court in this decision determined that a former CEO was entitled to advancement rights even though he was not named as a party in the underlying lawsuit.

Most arguments opposing advancement fail when challenging the satisfaction of the requirement that the underlying suit was brought "by reason of the fact" that the claimant was sued in his corporate capacity. However, the charter of Orix USA, one of the two entities involved, provided advancement not only for officers and directors, but also for employees who were sued "by reason of the fact" of that status. This is an unusually broad provision that made it easy for the court to avoid the more common issue of whether the claims were based on the status of the claimant as an officer or director. The court found

10. No. 13 CVS 8803, 2016 WL 687629 (N.C. Super. Ct. Feb. 18, 2016).

11. C.A. No. 11746-CB, 2016 WL 3226933 (Del. Ch. June 3, 2016).

that the misappropriated information, which was alleged to have been taken in the underlying action, was accessible to all employees and, therefore, it was not necessary to establish that the corporate powers of an officer and director were used to misappropriate that information.

The applicable charter language that provided for advancement also made it easy to argue that it was not necessary that the former directors and employees be named parties in the underlying lawsuit, as the charter only required that they be “involved in” litigation, even if not named as a party. The court found that there was a sufficient basis to establish that the claimants were incurring expenses in connection with depositions and document production that satisfied this requirement even if they were not named parties.

The specific language of the corporate charter involved, as well as a separate LLC agreement providing relevant rights in light of claims related to that affiliated entity, were dispositive to the extent they provided for broader rights than typically allowed in most advancement disputes. These dispositive documents on which the rights were based allowed the court to distinguish several prior advancement decisions. For example, the court distinguished *Paolino v. Mace* because even though an employment agreement was involved in that decision, the causal-nexus test used to interpret the “by reason of the fact” requirement was still satisfied. The court reasoned that the requirement is satisfied where, as here: “a claim against a director or officer [or in the instant case, an employee], is for matters relating to the corporation...even if the individual is a party to an employment agreement.” This is meant to separate advancement claims from disputes only related to an employment agreement.

Also, because the plaintiffs were not parties to the litigation for which they sought advancement, they needed to allocate their expenses incurred as opposed to expenses for the entity that was sued, and for which advancement expenses were not allowed.

The court also made a distinction between the language in the charter of one of the entities involved, which only required that a person “be involved in” a proceeding, with a separate LLC agreement. That separate agreement was relevant because the plaintiffs were also claiming an entitlement to advancement under that LLC agreement, which had a requirement that the person claiming advancement be either “threatened to be made a party,” or merely be one who was “threatened” with a lawsuit. The court found a sufficient basis to conclude that those requirements were met. The court also awarded fees on fees, as is customary for those portions of the advancement claim that succeed.

§ 11.2.2.10 *Trascent Mgmt. Consulting, LLC v. Bouri*¹²

The Delaware Supreme Court explains in this short opinion the public policy supporting the expedited nature of advancement proceedings for officers and directors of corporations, and managers of LLCs. Although the principles

12. No. 126, 2016, 2016 WL 6947014 (Del. Nov. 28, 2016).

discussed in this opinion are not new, and the result of the case is a predictable rejection of a defense to advancement, we include this decision, as it is the most recent Supreme Court pronouncement on the topic. The most noteworthy aspect of this opinion is the court's explanation of the public policy reasons in support of advancement and the need for prompt resolution of such claims.

In this case, a former manager of an LLC sought advancement for fees incurred in connection with defending a claim by his former employer. His employment agreement and the LLC agreement both contained nearly identical language providing the right to advancement. The company attempted to defeat the advancement claim by alleging that the manager who was seeking advancement procured his position by fraud and that the agreements providing for advancement were based on fraudulent inducement.

The court found that these were plenary claims. However, they would not be considered to impede the advancement claim for several reasons. First, whether the allegations of fraud were ultimately successful was an issue to address in connection with indemnification. Whether indemnification was appropriate was not a defense to advancement in the interim. Second, the court explained that a party cannot escape an otherwise valid contractual provision by arguing that the underlying contract was fraudulently induced or invalid for some reason unrelated to that provision. In addition, the court emphasized that advancement proceedings are summary in nature, and Delaware courts do not countenance attempts to delay the proceedings by addressing plenary claims.

§ 11.2.2.11 *Wong v. USES Holding Corp.*¹³

Plaintiffs, who were former directors of Defendant USES Holding Corp. ("USES"), sought advancement for fees and expenses incurred in defending an action in New York that challenged their conduct in the sale of USES to its current owner. Specifically, Plaintiffs sought "fees on fees" and costs for the Special Master.

In USES' bylaws, it stated that if a director makes a demand for advancement, and that demand is not met within 60 days, that director may bring suit to recover the unpaid amount of the claim. If that suit is in whole or in part successful, USES will pay the fees incurred in prosecuting the case.

The court began by outlining the parties' agreement. A party who is entitled to advancement is also entitled to recover the fees expended in contesting a wrongful rejection of that advancement—colloquially known as fees on fees. According to the bylaws, USES was not obligated to advance litigation expenses until Plaintiffs demonstrated a right to that advancement. Plaintiffs did not make any such demand until November 2015. Therefore, any fees incurred prior to that demand were not USES's obligation.

Second, a Special Master was appointed to help resolve this case. Instead of waiting the full 60-day period to file an action—as was required by the bylaws—Plaintiffs filed their advancement action after only 35 days. The court

13. C.A. No. 11475-VCN, 2016 WL 769043 (Del. Ch. Feb. 26, 2016).

held that although Plaintiffs did not abide by the time period in the bylaws, Plaintiffs were not required to absorb all costs for the Special Master because the purpose of the time period was only to allow USES enough time to assess the advancement claim. Therefore, Plaintiffs were not precluded from shifting fees to USES for the Special Master.