IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

PETER TAFEEN,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Civil Action No. 023-N
	)	
HOMESTORE, INC., a Delaware corporation,	)	
	)	
	)	
Defendant.	)	

MEMORANDUM OPINION

Date Submitted: February 6, 2004
Date Decided: March 16, 2004
Date Revised: March 22, 2004

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CHANDLER, Chancellor

This is yet another case seeking advancement or indemnification of legal expenses, in this instance brought by a former officer of a Delaware company who is a defendant in multiple legal proceedings. What is unusual about this advancement case is the company's novel defense: it contends (among many other things) that the former officer is not entitled to advancement because he has offered a hollow, worthless promise to repay if he is ultimately found not to be entitled to indemnification. The defense is novel because it reminds one of a sinner who suddenly finds religion—the conversion is breathtaking. Content to adopt advancement and indemnification bylaws drafted with holes large enough to drive a truck through,[1] the defendant company (like so many others in this Court of late) suddenly "finds religion"—insisting on a rigorous interpretation of its loosely written bylaws. Despite the irony in this conversion, there are sufficient factual disputes surrounding the company's unclean hands defense in this case to warrant development of a more complete record. Accordingly, this case should proceed to trial as soon as possible in order to resolve disputed facts regarding the former officer's ability to repay advanced expenses.

[1] I recognize the incentives that would cause directors and senior officers to favor indemnification bylaws that are capacious in their scope of coverage. Care must be taken, however, that those incentives do not interfere with the obligation to ensure that advancement and indemnification bylaws are written in a manner that is fundamentally fair to the company and its stockholders.

I. INTRODUCTION

Plaintiff Peter Tafeen is a former officer of defendant Homestore, Inc. He seeks advancement of expenses in connection with various civil litigations in which he has been named as a defendant, including an ongoing investigation by the United States Securities and Exchange Commission and an ongoing investigation by the United States Department of Justice (collectively, the "Proceedings"). Tafeen relies upon 8 *Del. C.* § 145[2] and §§ 6.1 (the "Indemnification Bylaw") and 6.2 (the "Advancement Bylaw") of Homestore's bylaws. Homestore raised a number of defenses in its answer and seeks summary judgment in its favor based on the first nine of these defenses. Tafeen seeks partial summary judgment on liability. This Opinion concludes that outstanding questions of fact regarding Homestore's unclean hands defense prevent the grant of summary judgment at this time.

II. FACTUAL AND PROCEDURAL BACKGROUND

A. Company Background and its Bylaws

Homestore is a Delaware corporation engaged in providing online media and technology to the real estate industry. Tafeen was employed by Homestore from September 22, 1997 through November 30, 2001, first as

[2] Section 145(k) of the DGCL grants this Court "exclusive jurisdiction to hear and determine all actions for advancement of expenses . . . brought under this section or under any bylaw." This Court is further authorized to make determinations regarding advancement in a summary fashion. *Id.*

Vice President of Business Development and later as Executive Vice President of Business Development, Ads and Sales.

Pursuant to § 145 of the DGCL,[3] Homestore's bylaws, at the time that Tafeen's employment with Homestore ended, contained the following indemnification and advancement provisions:

> Section 6.1: Indemnification of Officers and Directors. Each person who was or is made a party to, or is threatened to be made a party to, or is involved in any action, suit, or proceeding, whether civil, criminal, administrative or investigative (the "Proceeding"), by reason of the fact that such person . . . is or was a director or officer of the Corporation . . . shall be indemnified and held harmless by the Corporation to the fullest extent permitted by the Delaware General Corporation Law, against all expenses, liability and loss . . . reasonably incurred or suffered by such person in connection therewith, provided such person acted in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the Corporation, and, with respect to any criminal action or Proceeding, had no reasonable cause to believe the person's conduct was unlawful. Such indemnification shall continue as to a person who has ceased to be a director or officer. . . .
>
> Section 6.2: Advance of Expenses. The Corporation shall pay all expenses (including attorneys' fees) incurred by such a director or officer in defending any such Proceeding as they are incurred in advance of its final disposition; provided, however, that if the Delaware General Corporation Law then so requires, the payment of such expenses incurred by such a director or officer in advance of the final disposition of such Proceeding shall be made only upon delivery to the Corporation of an undertaking, by or on behalf of such director or officer, to repay all amounts so advanced if it should be determined ultimately that such director or officer is not entitled

[3] Section 145, like most of the DGCL an enabling law, authorizes corporations to provide indemnification for and advancement of expenses arising from certain legal proceedings. *See* 8 *Del. C.* § 145(a-b), (e).

> to be indemnified under this Article VI or otherwise; and provided, further, that the Corporation shall not be required to advance any expense to a person against whom the Corporation directly brings a claim, in a Proceeding, alleging that such person has breached such person's duty of loyalty to the Corporation, committed an act or omission not in good faith or that involves intentional misconduct or a knowing violation of law, or derived an improper personal benefit from a transaction.

B. The Proceedings

On December 21, 2001, Homestore announced that its audit committee was conducting an inquiry into potential improprieties in its accounting practices and financial statements. That investigation revealed that Homestore had overstated its revenues by $41.4 million for the 2000 fiscal year,[4] and by $119 million for the first three quarters of the 2001 fiscal year.[5]

While the audit committee was conducting its investigation, the United States Securities and Exchange Commission and the United States Department of Justice both announced that they had commenced investigations into Homestore's prior accounting practices and financial reporting. Specifically, the Department of Justice is investigating Tafeen to determine whether he engaged in any criminal conduct as an officer of Homestore. Tafeen is seeking advancement for expenses in connection with

[4] Aff. of Michael R. Douglas (Dec. 8, 2003) ("Douglas Aff."), Ex. A (presenting a Newswire report on Homestore's restatement of earnings).
[5] Douglas Aff. Ex. B (same).

both of these investigations. He also seeks advancement for expenses in connection with 10 civil actions.

All 10 civil actions name Tafeen as defendant. Of the 10 civil actions, 6 are brought by insurers seeking rescission of director and officer liability insurance policies based on alleged misrepresentations in the applications for insurance and in warranty letters.[6] Of the remaining 4 civil actions, one is a class action suit alleging violations of federal securities laws;[7] one is a suit filed by an individual investor not in the class of persons engaged in the class action suit alleging violations of federal securities laws, intentional and negligent misrepresentation, and other state law violations;[8] one is a suit arising from the acquisition of another company by Homestore, in which part of the consideration given by Homestore was Homestore stock, alleging securities fraud, common law fraud, negligent misrepresentation, breach of

[6] *Royal Indem. Co. v. Homestore, Inc.* (C.D. Cal. filed Nov. 15, 2002); *Clarendon Nat'l Ins. Co. v. Homestore, Inc.*, No. 02-08521 (C.D. Cal. filed Nov. 6, 2002); *Genesis Ins. Co. v. Homestore, Inc.*, No. 02-7738 ER (VBK) (C.D. Cal. filed Oct. 3, 2002); *Fed. Ins. Co. v. Homestore, Inc.*, No. 02-7304 (C.D. Cal. filed Sept. 18, 2002); *TIG Ins. Co. of Mich. v. Homestore, Inc.*, No. BC290823 (Cal. Super. Ct. filed Feb. 21, 2003); *Lubermens Mut. Cas. Co. v. Homestore, Inc.*, No. LC062502 (Cal. Super. Ct. filed Oct. 8, 2002).

[7] *In re Homestore.com, Inc. Sec. Litig.*, No. 01-CV-11115 MJP (C.D. Cal. filed Nov. 15, 2002).

[8] *Pyfrom v. Homestore.com, Inc.*, No. 03-0042-FMC (C.D. Cal. filed Sept. 11, 2003).

contract and unjust enrichment;[9] and one is a derivative action alleging violations of fiduciary duty as well as other California state law claims.[10]

C. The Parties' Actions Regarding Advancement

In early 2002, Tafeen requested advancement of legal fees and costs incurred in defending the then-in-progress proceedings. At that time, Homestore notified Tafeen that it would reimburse him only for expenses accrued through February 2002 related to the audit committee's investigation. Homestore proceeded to reimburse Tafeen for those limited expenses.

On April 30, 2002, Homestore sent a letter (the "April 30 Letter") to Tafeen advising him that it would advance expenses in connection with the SEC investigation and then-pending civil litigation in which Tafeen had been named as a defendant.[11] According to the letter, however, Homestore's advancing of the expenses was conditioned upon Tafeen's delivery of "'an undertaking . . . to repay all amounts so advanced if it should be determined that [Tafeen is] not entitled to be indemnified under' Article VI of the Bylaws."[12] A form of undertaking was enclosed with the letter.

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[9] *Siegel v. Homestore, Inc.*, No. 02-8275 (E.D.P.A. filed Nov. 1, 2002).
[10] *In re Homestore.com, Inc. Derivative Litig.*, No. BC265709 (Cal. Super. Ct. filed Nov. 15, 2002).
[11] Douglas Aff. Ex. E.
[12] *Id.*

At issue is whether a memorandum, dated April 30, 2002 (the "April 30 Memo"), was sent with the April 30 Letter.[13] The memorandum contains a bullet point list of restrictions and requirements connected with advancement.[14] The requirements and restrictions in the April 30 Memo include, among other things, that Tafeen must execute an undertaking pursuant to Homestore's bylaws; that Tafeen's counsel must provide Homestore with the names and rates of all attorneys and paralegals to whom advancement would be paid, and receive Homestore's consent to those individuals and their rates; that Tafeen's counsel could not undertake any major research projects without prior consent by Homestore; that Homestore would not pay in excess of $1,000 per month for online research; and that only one attorney could attend any meeting, witness interview, deposition or other proceeding unless agreed to in advance by Homestore.[15]

Tafeen did not tender the requested undertaking and Homestore did not advance any expenses to Tafeen. In July 2003, Tafeen's counsel again requested advancement in connection with the Proceedings (now including the Department of Justice investigation). In a July 11, 2003 letter, Tafeen's

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[13] *Compare* Pl.'s Opening Br. in Supp. of his Mot. for Summ. J. ("Pl.'s Op. Br."), at 5 n.1 ("In that letter and an attached memorandum. . . ."), *with* Def.'s Combined Answering Br. and Opening Br. ("Def.'s Answering Br."), at 20 n.7 ("The only enclosure to the April 30, 2002 letter . . . was the form of undertaking offered to Tafeen.")

[14] Aff. of Charles D. Reed (Dec. 29, 2003) ("Reed Aff.") Ex. B.

[15] *Id.*

counsel wrote to Homestore's counsel demanding advancement yet again. Enclosed with this letter was a signed undertaking.[16]

D. Judicial Proceedings

Having not received funds from Homestore, Tafeen filed a complaint in this Court on October 28, 2003 containing two counts: one for advancement and one for fees-on-fees. Homestore's answer, including eleven defenses, was filed on November 18, 2003. Both parties have moved for summary judgment on the issue of liability for advancement. This opinion addresses those motions.

III. STANDARD OF REVIEW

Pursuant to Court of Chancery Rule 56, a motion for summary judgment shall be granted if "there is no genuine issue as to any material fact and . . . the moving party is entitled to a judgment as a matter of law."[17] The moving party has the burden of establishing that no genuine issue of material fact exists.[18] Any doubt as to the existence of such an issue will be resolved against the movant.[19] Importantly, at this stage in litigation, the only role for

[16] The undertaking stated, "I, Peter Tafeen, hereby agree to repay to Homestore any amounts advanced to me by Homestore for which it should be determined ultimately that I am not entitled to be indemnified under Article VI of Homestore's Bylaws or otherwise." Douglas Aff. Ex. F.
[17] Ct. Ch. R. 56(c); *Scureman v. Judge*, Del. Ch., 626 A.2d 5, 10 (1992), *aff'd sub nom., Wilmington Trust Co. v. Judge*, Del. Supr., 628 A.2d 85 (1993) (mem.).
[18] *Nash v. Connell*, Del. Ch., 99 A.2d 242, 243 (1953).
[19] *Id.*

the Court is to determine whether a genuine issue of material fact exists; the Court cannot try the issue.[20]

Tafeen has moved for summary judgment as to entitlement to advancement only and Homestore's cross-motion is based on its defenses related to liability.[21] Since the Court does not determine Tafeen's entitlement to bring an advancement claim at this time, it does not address how expenses should be advanced.

IV. DISCUSSION

Homestore's briefs raise several defenses to advancement, and its motion seeks summary judgment as to the first nine of these defenses. These defenses are considered in three categories—those involving Tafeen's conduct in the Proceedings, those involving Tafeen's conduct in seeking advancement, and those not involving Tafeen's conduct at all.

A. Defenses Involving Tafeen's Conduct in the Proceedings

The following defenses all seek court review of Tafeen's conduct in the Proceedings—that is, they seek court analysis of Tafeen's conduct *in the underlying actions*. Delaware courts have consistently declined to undertake

[20] *Banks v. Cristina Copper Mines, Inc.*, Del. Ch., 99 A.2d 504, 506 (1953).

[21] This is consistent with Court of Chancery Rule 56: "A summary judgment, interlocutory in character, may be rendered on the issues of liability alone although there is a genuine issue as to the amount of damages, or some other matter." Ct. Ch. R. 56 (c).

such an analysis and no defense proffered by Homestore moves this Court to do otherwise.

1. "By Reason of the Fact"

Homestore alleges that Tafeen is not entitled to advancement because he is not a party to any of the Proceedings "by reason of the fact" that he was an officer of Homestore. Tafeen suggests that this is not a requirement of Homestore's Advancement Bylaw, and that in any event, he is a party to the Proceedings by reason of the fact that he was an officer of Homestore.

Even assuming, as Homestore's brief argues, that the Advancement Bylaw only requires advancement if the person seeking advancement was made party to a proceeding "by reason of the fact" that she was a director or officer of Homestore, an allegation (such as Homestore's) that the person who is seeking advancement is a party to the underlying proceeding because of her own personal greed is not a defense to an advancement provision containing such a requirement.[22] To hold otherwise, as this Court has previously noted, would serve to "vitiate the protections afforded by § 145 and contractual advancement rights."[23] In *Perconti v. Thornton Oil Corp.*, this Court provided the test for whether one is party to a proceeding "by

[22] *Reddy v. Elec. Data Sys. Corp.*, Del. Ch., C.A. No. 19467, Strine, V.C., 2002 Del. Ch. LEXIS 69, at *14-*21 (June 18, 2002), *aff'd*, Del. Supr., 820 A.2d 371 (2003) (mem.); *Perconti v. Thornton Oil Corp.*, Del. Ch., C.A. No. 18630, Noble, V.C., 2002 Del. Ch. LEXIS 51, at *12-*21 (May 3, 2002).

[23] *Reddy*, 2002 Del. Ch. LEXIS 69, at *16.

reason of the fact" of her corporate position. In order for one to be deemed a party to a proceeding by reason of the fact of her corporate position, there must be a "causal connection or nexus between" the underlying proceeding and the "corporate function or 'official [corporate] capacity.'"[24] Motivation of the party is not a factor in this test.

This is entirely consistent throughout our caselaw. In *Reddy v. Electronic Data Systems Corp.*, for example, criminal proceedings were brought against a former employee of the defendant. The allegation against the former employee was that he purposely manipulated the financial records of the defendant in order to increase funds he would receive under incentive provisions in his compensation agreement. The former employee then sought advancement of his expenses in a § 145 proceeding under the company's bylaws (which covered former employees). In *Reddy*, similar to this case, the defendant argued that the former employee was not entitled to advancement because he was not a party to the underlying criminal action "by reason of the fact" that he was an "employee" of the defendant.[25] The defendant ground his allegation in the idea that the former employee's motivation for his actions in the underlying proceeding was personal greed. This Court rejected that argument, stating:

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[24] *Perconti*, 2002 Del. Ch. LEXIS 51, at *13 (citations omitted).

[25] In *Reddy*, the company's bylaws did not explicitly contain a "by reason of the fact" provision, but incorporated such a requirement by reference to § 145. *See* 8 *Del. C.* § 145 (a), (b).

> The problem with EDS's argument is that it has no logical stopping point. It is not uncommon for corporate directors, officers, and employees to be sued for breach of the fiduciary duty of loyalty, and to have to defend claims that they took official action for the primary purpose of diverting corporate resources to their own pocketbooks. . . . Therefore, it is highly problematic to make the advancement right of such officials dependent on the motivation ascribed to their conduct by the suing parties.[26]

This echoes the same policy noted in *Perconti*. And it is true here as well. To entertain Homestore's argument would be to transform advancement provisions into invitations to a trial on the merits of the underlying litigation.

Here, Tafeen is a party to the Proceedings because of his alleged role in a scheme to inflate Homestore's financial results while serving as an officer of Homestore. Because all the Proceedings are connected with Tafeen's role in this scheme in his capacity as a Homestore officer, they are within the scope of coverage of the Advancement Bylaw and Homestore's motion for summary judgment as to this defense is denied as a matter of law.

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[26] *Reddy*, 2002 Del. Ch. LEXIS 69, at *15-*16. This is not to say that the "by reason of the fact" requirement is illusory. As the Court noted in *Weaver v. ZeniMax Media, Inc.*, Del. Ch., C.A. No. 20439, Noble, V.C., 2004 Del. Ch. LEXIS 10, at *10-*11 (Jan. 30, 2004) (quoting Cochran v. Stifel Fin. Corp., Del. Ch., C.A. No. 17350, Strine, V.C., 2000 Del. Ch. LEXIS 179, at *19-*20 (Dec. 13, 2000), *aff'd in part, rev'd in part, remanded in part,* Del. Supr., 809 A.2d 555 (2002)), "claims brought by a corporation against an officer for excessive compensation paid or breaches of a non-competition agreement are 'quintessential examples of a dispute between an employer . . . and an employee' and are not brought 'by reason of the fact' of the director's position with the corporation."

2. The Contract Argument

Homestore next states that Tafeen's "underlying misconduct effectively served to fraudulently induce the corporation to enter into the officer employment relationship and, in that context, to extend contractual advancement rights to the officer employee."[27] Because Tafeen fraudulently induced Homestore to enter into an employment contract with him, the argument goes, the entitlements provided by the Advancement Bylaw, which are only extended to Tafeen because of his position as an executive officer, should not be provided to him.

While this may be a proper basis for a fraud-in-the-inducement action against Tafeen, the argument does not serve as a defense here. The Advancement Bylaw is not dependent upon Tafeen's employment contract. This action is to determine Tafeen's entitlement to advancement under Homestore's *governing* rules. Whether or not Homestore was fraudulently induced to enter into the *employment contract* with Tafeen is a peripheral issue. For the same policy reasons discussed in *Reddy*, the Court's analysis in a § 145(k) action extends only to entitlement according to advancement provisions; it does not extend to peripheral issues regarding the moving party's alleged conduct in the underlying action, even if ultimate entitlement

[27]Reply Br. of Def. Homestore, Inc. in Supp. of its Mot. for Summ. J. ("Def.'s Reply Br."), at 14.

to advanced fees may in some fashion be connected with those issues. Homestore's motion for summary judgment as to this defense is denied as a matter of law.

3. The Estoppel Argument

While still discussing Tafeen's fraudulent conduct, Homestore writes, "Tafeen thus already has profited, substantially, from his own wrongdoing. It cannot be appropriate to afford Tafeen advancement protection otherwise potentially available under Homestore's Bylaws when he never intended to act properly as a corporate officer in the first place."[28] This form of estoppel argument is essentially the same as Homestore's official capacity argument. Homestore simply substitutes "acted in a fraudulent manner" for "not party to the Proceeding by reason of the fact that." Both arguments are premised on the notion that Tafeen was motivated by personal greed. And, as discussed, this form of defense against advancement was considered and rejected in both *Reddy* and *Perconti*. Homestore's motion for summary judgment as to this defense is denied as a matter of law.

4. Indemnification Standard and its Relation to Advancement Claims

Contrary to long-established Delaware law, Homestore argues that Tafeen should not receive advancement because, due to his alleged actions

[28] Def.'s Answering Br. at 21.

in the Proceedings, he ultimately will not be entitled to indemnification. "The rights to indemnification and advancement are . . . . correlative but nonetheless independent and discrete entitlements."[29] Delaware courts historically have held that a right to advancement is independent from an ultimate right to indemnification, even if repayment of advanced expenses may ultimately turn on a right to indemnification.[30] This reflects the salutary purpose of section 145(e) of the DGCL—to allow corporations to pay interim costs in litigation subject to a final disposition as to whether indemnification is justified. I see no reason to, and Homestore has provided no argument why, this longstanding principle should be revisited.[31] Summary judgment as to this defense is denied as a matter of law.

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[29] Donald J. Wolfe, Jr. & Michael A. Pittenger, Corporate and Commercial Practice in the Delaware Court of Chancery § 8-2.

[30] *See Citadel Holding Corp. v. Roven*, Del. Supr., 603 A.2d 818, 822 (1992) (holding an advancement right not dependent on a right to indemnity); *Bergonzi v. Rite Aid Corp.*, Del. Ch., C.A. No. 20453, Chandler, C., 2003 Del. Ch. LEXIS 117, at *7 (Oct. 20, 2003) ("Advancement is a right that the Supreme Court has recognized as distinct from the right to indemnification."); *Lipson v. Supercuts, Inc.*, Del. Ch., C.A. No. 15074, Jacobs, V.C., 1996 Del. Ch. LEXIS 108, at *5 (Sept. 10, 1996) (noting that entitlement to indemnification is not relevant to an advancement action).

[31] Homestore attempts to distinguish cases cited by Tafeen by noting that those cases, including *Bergonzi*, 2003 Del. Ch. LEXIS 117, and *Lipson*, 1996 Del. Ch. LEXIS 108, dealt with documents explicitly stating that the person seeking advancement need not satisfy the "good faith" standard in order to make an advancement claim. Although the companies in each of these cases do not have the same bylaws, the principle behind the authorization of these bylaws—to allow corporations to pay interim costs in litigation subject to a final disposition of indemnification—is what drives the independence of the advancement and indemnification inquiries.

B. Defenses Involving Tafeen's Conduct in Seeking Advancement

Although the previous defenses considered would have required an analysis of Tafeen's conduct in the *Proceedings*, the following defenses require an examination into Tafeen's conduct in *making his advancement request*. That is, the following defenses, as opposed to the earlier ones, *assume Tafeen's contractual entitlement to advancement*. They do not require the Court to look at the nature of the pleading in the Proceedings. Rather, these defenses allege that due to Tafeen's conduct in seeking funds, he should not be permitted to *claim his entitlement* in a court of equity.[32] Specifically, the following defenses are based on the allegation that "Tafeen purchased an expensive home in Florida, a state that has extremely protective 'homestead' provisions against creditor claims," in order to shelter assets, thus avoiding repayment should Tafeen's claims ultimately be found to be nonindemnifiable.[33]

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[32] Although Homestore's defenses are couched in terms of equity, and will be addressed as such here, they may quite readily be conceptualized as contractual defenses. That is, assuming Tafeen is contractually entitled to advancement, Tafeen nonetheless breached the implied covenant of good faith and fair dealing, *see Burton v. PFPC Worldwide, Inc.,* Del. Ch., C.A. No. 20380, Chandler, C., 2003 Del. Ch. LEXIS 110, at *18-*20 (Oct. 20, 2003) (discussing this implied covenant), by engaging in a bad faith sheltering of assets.

[33] Tafeen has raised questions as to whether Homestore's bylaws require an undertaking to repay. *See Senior Tour Players 207 Mgmt. Co. LLC v. Golftown 207 Holding Co. LLC*, C.A. No. 20116, Lamb, V.C. (Mem. Op. Mar. 10, 2004) (refusing to imply an undertaking requirement in the Limited Liability Company Act, 6 *Del. C.* § 18-108, or in

1. Unclean Hands

Homestore argues that because Tafeen sheltered assets before seeking advancement, he has acted in bad faith. He thus, according to Homestore, comes to this Court with unclean hands and should be prohibited from receiving advancement.

The equitable doctrine of unclean hands bars litigants who have acted inequitably from seeking what might otherwise be available relief. This Court uses the doctrine to protect the integrity of itself and those who come before it.[34] Homestore's unclean hands argument is unique in that it is based not in Tafeen's conduct related to the underlying claims, as previous unclean hands arguments have been based, but in his conduct in making the advancement claim itself.[35]

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an LLC's operating agreement). Regardless of such an undertaking requirement, both sides agree that under § 145(e), there is a general obligation to repay should Tafeen's claims ultimately be found to be nonindemnifiable. *See*, *e.g., Reddy*, 2002 Del. Ch. LEXIS 69, at *14 ("[B]y accepting payments expressly termed an 'advancement,' Reddy necessarily acknowledges that his ultimate right to keep those payments depends on whether his underlying conduct is indemnifiable.")

[34] *See generally Nakahara v. NS 1991 Am. Trust*, Del. Ch., 718 A.2d 518, 522-24 (1998) (tracing the history of the doctrine of unclean hands).

[35] Homestore's argument is thus distinct from the argument considered and rejected in *Reddy* 2002 Del. Ch. LEXIS 69, at *14-*21. In that case, the unclean hands argument was based on the plaintiff's actions that formed the basis of the underlying proceeding. *Id.* at *28-*29.

Further, in a February 10, 2004 letter to the Court, counsel to Tafeen argued that an unclean hands defense, similar to the one made by Homestore, was made by the defense in *Bergonzi*. In their answer to the complaint, the defense in *Bergonzi* stated "Bergonzi's claims are barred by the doctrines of laches and unclean hands." Answer to Compl. and Countercl. at ¶ 40, *Bergonzi*, 2003 Del. Ch. LEXIS 117. Further, counsel in *Bergonzi* raised as a defense that "[t]he payment of the expenses for which Bergonzi seeks advancement in these proceedings would not comport with equity *because*

Whether Tafeen did indeed intentionally engage in a sheltering of assets, which would increase the difficulty of reimbursement should his advancement claims be found nonindemnifiable, is a question of fact to be determined at trial.[36] What is for the Court to determine at this stage is whether, should such facts be true, those facts would be sufficient to invoke the doctrine of unclean hands. The Court concludes they would.

In *Nakahara v. NS 1991 American Trust*, plaintiffs in an advancement action were entitled to advancement under the terms of a declaration of trust.[37] Because the plaintiffs violated a standstill agreement and an Isle of Man Court's instructions, the Court denied the plaintiff's request for advancement.[38] The Court stated "[a] court of equity will not use its equitable powers to condone such activity."[39] Similarly here, the Court will

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Bergonzi is financially unable to meet his obligation to repay any sums so advanced upon the determination that he is not entitled to indemnification." *Id.* at ¶ 38 (emphasis added). These arguments were two separate defenses. It is unclear upon what basis the nonspecific unclean hands defense was made. The separate financial inability to repay defense is *not* the same as the unclean hands defense made here and, in any event, was not considered in the Court's opinion. Mere speculation as to an inability to repay is not the basis for the defense proffered by Homestore. Rather, it is the *taking of an action* that would insulate Tafeen from an obligation to repay that forms the basis of Homestore's unclean hands defense.

[36] Tafeen's counsel argues that Tafeen purchased his home in June 2001, almost a year before Homestore requested an undertaking. *See* Pl.'s Combined Reply Br. in Supp. of his Mot. for Partial Summ. J. and Answering Br. in Opp'n to Def.'s Mot. for Summ. J. ("Pl.'s Reply Br."), at 21. At oral argument, however, questions arose as to whether Tafeen purchased this home with the specter of the upcoming Homestore investigation in mind. Thus, there remains a question of fact as to whether this home purchase was made with sheltering of assets and protection from creditors in mind.

[37] *Nakahara v. NS 1991 Am. Trust*, Del. Ch., 739 A.2d 770, 794 (1998).

[38] *Id.*

[39] *Id.*

not use its equitable powers to grant advancement to Tafeen if it is shown that Tafeen did indeed engage in a sheltering of assets with the intent to increase the difficulty of a potential reimbursement.

The Court acknowledges the strong Delaware policy of encouraging able persons to become directors and officers that is embodied in section 145(e).[40] Since section 145(e) represents this strong public policy, the policy underlying the doctrine of unclean hands must be balanced against the statute.[41] Where, as here, the allegations underlying the unclean hands defense involve conduct that, if true, would undermine the spirit of the statute, the balance is clearly in favor of not rewarding the alleged inequitable conduct.

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[40] *See VonFeldt v. Stifel Fin. Corp*., Del. Supr., 714 A.2d 79, 84 (1998) ("We have long recognized that Section 145 serves the dual policies of: (a) allowing corporate officials to resist unjustified lawsuits. . . ; and (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity."); *Fasciana v. Elec. Data Sys. Corp.*, Del. Ch., 829 A.2d 178, 186 (2003) ("By enacting § 145, our General Assembly helped ensure that capable persons would be willing to serve as directors, officers, employees, and agents of Delaware corporations."); *see also In re Cent. Banking Sys., Inc.*, Del. Ch., C.A. No. 12497, Jacobs, V.C., 1993 WL 183692, at *3 (May 11, 1993) ("Mandatory advances, like indemnification, serve the salutary purpose of encouraging qualified persons to become or remain as directors of Delaware corporations, by assuring them, *ex ante*, that they may resist lawsuits that they consider meritless, free of the burden of financing (at least initially) their own legal defense.")

[41] *Nakahara*, 718 A.2d at 523 (noting that "[t]he greatest limitation on the doctrine is the widely accepted exception that since it is ultimately based on public policy, countervailing public policy which points in the direction of reaching the case on the merits can preclude its operation," but finding that the self-help plaintiffs took prior to a judicial advancement proceeding justified the use of the unclean hands doctrine).

The Delaware Supreme Court has characterized Section 145 as follows:

> The invariant policy of Delaware legislation on indemnification is to "promote the desirable end that corporate officials will resist what they consider unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation they have served if they are vindicated." Beyond that, its larger purpose is "to encourage capable men to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve."[42]

Allowing an unclean hands defense based on alleged affirmative actions taken to shelter assets does not undermine this public policy. Corporate officials ought to continue to be "secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve."[43] They are simply now on notice that they will not be permitted to use *the statute itself* after taking improper actions at the expense of the corporation's stockholders.

Further, contrary to suggestions by counsel to Tafeen, the recognition of such a defense will not serve to undermine the summary nature of advancement claims. This case presents questions of fact as to whether Tafeen has acted in a way to avoid a potential obligation to repay advanced

[42] *Stifel Fin. Corp. v. Cochran*, Del. Supr., 809 A.2d 555, 561 (2002) (quoting Rodman Ward, Jr. et al., Folk on the Delaware General Corporation Law § 145 (2001)).
[43] *Stifel Fin. Corp*, 809 A.2d at 561.

funds. This Court has the ability to expedite cases and will do so in order to balance the salutary policy underlying section 145(e) against the need to protect corporations and their stockholders from the type of conduct alleged here.

2. Laches

Homestore argues that because Tafeen knew he had a potential advancement claim in early 2002 and waited until October 2003 to bring suit in this Court, the doctrine of laches bars Tafeen's claim. Laches, an equitable doctrine, bars a plaintiff from delaying unreasonably in bringing a claim to the detriment of the defendant.[44] Although there is no bright-line rule as to what constitutes laches, there are three generally accepted elements to this equitable defense: (1) plaintiff's knowledge that she has a basis for legal action; (2) plaintiff's unreasonable delay in bringing a

[44] *See Porach v. City of Newark*, Del. Ch., C.A. No. 16578, Lamb, V.C., 1999 Del. Ch. LEXIS 143, at *9-*10 (June 25, 1999) ("'Laches is an equitable principle that operates to prevent the enforcement of a claim in equity where a plaintiff has delayed unreasonably in bringing suit to the detriment of the defendant or third parties.'") (quoting Donald J. Wolfe, Jr. & Michael A. Pittenger, Corporate and Commercial Practice in the Delaware Court of Chancery § 11-5); *Kirby v. Kirby*, Del. Ch., C.A. No. 8604, Chandler, V.C., 1989 Del. Ch. LEXIS 133, at *12 (Sept. 26, 1989) ("The doctrine of laches bars suit where the plaintiff has unreasonably delayed in bringing his cause of action, and that delay has disadvantaged the defendant to the extent that it would be inequitable to allow suit to go forward.")

lawsuit; and (3) identifiable prejudice suffered by the defendant as a result of the plaintiff's unreasonable delay.[45]

Whether or not these three elements exist is generally determined by a fact-based inquiry, and therefore summary judgment is rarely granted on a laches defense.[46] Where, however, there is a "clear showing of the absence of a genuine issue of material fact upon the issue of laches," summary judgment will be granted by the Court.[47]

In this case, it is undisputed that Tafeen knew of a potential advancement claim by early 2002.[48] Thus the first element of laches is satisfied. Tafeen did not file a complaint in this Court until October of 2003. The briefings have raised sufficient questions as to the second element, whether this delay was unreasonable, to prevent the Court from determining whether that element of laches is satisfied. Homestore has not, however,

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[45] *See Porach*, 1999 Del Ch. LEXIS 143, at *10.

[46] *See Clark v. Packem Assoc.*, Del. Ch., C.A. No. 1326, Chandler, V.C., 1991 Del. Ch. LEXIS 34, at *20 (Mar. 6, 1991) ("The determination of the validity of the laches defense is one of fact, and is rarely granted on summary judgment.")

[47] *Church of Religious Sci. v. Fox*, Del. Supr., 266 A.2d 881, 884 (1970). Other cases where summary judgment has been granted on a laches defense include *Porach*, 1999 Del. Ch. LEXIS 143, and *Weller v. Am. Tel. & Tel. Co.*, Del. Ch., 290 A.2d 842 (1972). *See also Fasciana*, 829 A.2d at 163 n.2 (rejecting a laches defense in an advancement case at the summary judgment phase).

[48] Compl. ¶ 14 ("In early 2002, Mr. Tafeen, through his counsel, requested advancement of his legal fees and costs and indemnification for the Proceedings from the Company . . . .")

presented any evidence as to the third element of laches: causation of prejudice.

Here, as in the unclean hands defense, the prejudice is rooted in alleged sheltering of assets by Tafeen. Specifically, Homestore argues prejudice is caused by a potential increase in the difficulty in obtaining repayment should Tafeen's claims ultimately be found to be nonindemnifiable.[49] The delay in filing suit, however, is not the *cause* of this prejudice; rather the cause of the prejudice is the sheltering of assets. It is entirely conceivable that Tafeen would have submitted either an undertaking and advancement request to Homestore, or come to this Court with a complaint for advancement, and then later engaged in the alleged sheltering of assets. Because the delay in filing the complaint is not the cause of the alleged prejudice, Homestore's motion for summary judgment as to the laches defense is denied as a matter of law.

C. Defenses Not Related to Tafeen's Conduct

1. The Direct Claim Carve Out

The Advancement Bylaw states that Homestore is not required to provide advancement to a person if Homestore directly brought a claim against that person alleging she breached her duty of loyalty, derived an

[49] Homestore states, "Homestore believes that, if it is required to advance Tafeen's legal fees and expenses . . . and it later is determined that Tafeen was not entitled to indemnification, Homestore will have little recourse against Tafeen if he refuses to repay the advanced funds." *Id.* at 13.

improper benefit from a transaction, committed an act or omission not in good faith, or engaged in an act involving intentional misconduct or a knowing violation of law. Homestore suggests that the stockholder's derivative action included among the Proceedings, *In re Homestore.com, Inc. Derivative Litigation*,[50] should be treated as an action brought directly by the company, and thus within the carve out provision of the advancement bylaw.[51]

Homestore essentially asks this Court to apply "logic, fairness, and public policy" to rewrite its bylaw carve out to apply to any derivative action which, if brought directly by the company, would turn on the same facts that underlie the derivative case. This bylaw, however, is unambiguous and the Court will not "interpret it or search for the parties' intent behind [it]."[52] Unambiguous bylaws are construed as they are written, and this Court gives "language which is clear, simple, and unambiguous the force and effect required."[53]

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[50] No. BC265709 (Cal. Super. Ct. filed Nov. 15, 2002).

[51] It is unclear whether Homestore is arguing that a direct action brought by it would provide a defense to all advancement claims or only those made in connection with the direct action itself. Since I do not find *In re Homestore.com, Inc. Derivative Litigation* to be a direct action within the meaning of Homestore's bylaws, I do not reach this issue, although I find it highly unlikely that the broader interpretation of § 6.2 would be the more reasonable one were I to reach it.

[52] *Hibbert v. Hollywood Park, Inc.*, Del. Supr., 457 A.2d 339, 343 (1983).

[53] *Id.*

Homestore's advancement carve out applies only to actions brought directly, not derivatively. *In re Homestore.com, Inc. Derivative Litigation* is a case brought derivatively.[54] Defendant's motion for summary judgment as to the import of the carve out language is denied as a matter of law.

2. The Sarbanes-Oxley Act and its Relation to DGCL § 145(e)

The Sarbanes-Oxley Act of 2002 ("Sarbox"),[55] Congress's response to the turn-of-the-century corporate scandals, amends the Securities and Exchange Act of 1934 (the "'34 Act")[56] so as to prohibit personal loans to directors or executive officers. Specifically, Sarbox states:

> It shall be unlawful for any issuer . . . directly or indirectly, . . . to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.[57]

There has been much discussion as to what effect, if any, this provision of Sarbox ("Section 402") has on advancement to *current* directors

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[54] *See* First Amended Consolidated Shareholder Derivative Complaint at ¶ 1, *In re Homestore.com, Inc. Derivative Litig.*, No. BC265709 (Cal. Super. Ct. filed Nov. 15, 2002), *in* Aff. of Marc A. Fenster (Nov. 18, 2003) ("Fenster Aff."), Ex. E ("This is a shareholder's derivative action brought for the benefit of nominal defendant Homestore.com, Inc. . . .")

[55] Pub. L. No. 107-204, 116 Stat. 745.

[56] 15 U.S.C. § 78m (2004).

[57] Pub. L. No. 107-204, § 402, 116 Stat. 787 (2002) (codified at 15 U.S.C. § 78m(k)(1) (2004)).

and officers under section 145(e) of the DGCL.[58] This issue, however, is not ripe for discussion here.

Section 402 applies to directors, executive officers, or equivalents thereof. Homestore contends that because Section 402 does not limit its application to *current* directors and officers, it necessarily applies to *former* directors and officers. I disagree.

First, as a matter of statutory interpretation, Section 402 is clear and unambiguous. Under the "plain meaning rule," so long as the language of a statute is clear and unambiguous, there is "no need to 'interpret' the language."[59] And, as the United States Supreme Court has stated, "where the language of an enactment is clear and construction according to its terms does not lead to absurd or impracticable consequences, the words employed are to be taken as the final expression of the meaning intended."[60] The words of the statute, moreover, are given their common meaning.[61] Here, the statute clearly states "director or executive officer," *not* "current or

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[58] *See, e.g.,* Sarbanes-Oxley Act Interpretive Issues under § 402—Prohibition of Insider Loans (reporting a discussion, among 25 law firms, as to whether section 402 of Sarbox prohibits advancement to directors or officers).

[59] *Church of Scientology v. United States Dep't of Justice*, 612 F.2d 417, 421 (9th Cir. 1979) (citing *Packard Motor Car Co. v. NLRB*, 330 U.S. 485, 492 (1947), and *Caminetti v. United States*, 242 U.S. 470, 490 (1917)).

[60] *United States v. Mo. Pac. R.R. Co.*, 278 U.S. 269, 277 (1929), *quoted in Church of Scientology*, 612 F.2d at 421.

[61] *Perconti*, 2002 Del. Ch. LEXIS 51, at *13.

former director or officer." Not only is this clear and unambiguous, it leads to a perfectly logical conclusion.

Second, even if one were to interpret the language of Section 402, the legislative history indicates that the purpose of Section 402 is to prohibit loans to those in control of corporate decision making.[62] Once a director or officer steps down from her position, becoming a former director or officer, the ability to control corporate decision making is diminished considerably. Though not completely eliminated, Congress did not see former officers and directors as sufficient threats to specifically address in Sarbox. As Congress was presumably aware, any undue influence brought by former officers or directors on those currently holding a corporation's decision-making powers can be remedied by a breach of loyalty suit brought by aggrieved stockholders.

Further instructive is Section 402 and its interaction with the '34 Act. Although Sarbox does not define director or executive officer, the interpretive rules of the '34 Act, which Section 402 amends, do define

[62] *See, e.g.*, Staff of Senate Governmental Affairs Comm., 107th Cong., The Role of the Board of Directors in Enron's Collapse (Comm. Print 2002) (concluding that Enron's collapse was related to, among other things, fiduciary failure of Enron's board, inappropriate conflicts of interest, and excessive compensation, and recommending in response a prohibition on company-financed loans to directors and senior officers of the company); *House Fin. Servs. Comm. Hearing on Worldcom Accounting Errors (Panel I)*, 107th Cong. (2002) (statement of Jim Leach, U.S. Representative) ("[W]ith corporate governance, moral clarity requires that CEOs of public corporations not put personal interests above shareholder values. To put it plainly, it is self-dealing for a corporate head to give himself a multi hundred million-dollar loan, and it is a dereliction of duty for a board to go along.")

executive officer. Rule 3b-7 of the General Rules and Regulations promulgated under the '34 Act defines executive officer,[63] when used with reference to a registrant (which Homestore undoubtedly is under the '34 Act), as the registrant's "president, any vice president of the registrant in charge of a principal business unit, division, or function (such as sales, administration or finance), any other officer who *performs* a policy making function or any other person who *performs* similar policy making functions for the registrant."[64] Given the use of the present tense in this definition of executive officer, it is apparent that the term "executive officer," as employed in Section 402, does not include former executive officers.

Since Section 402 applies only to current directors and executive officers, and Tafeen is a *former* executive officer, Section 402 has no application here. Homestore's motion for summary judgment as to this issue is denied as a matter of law.[65]

3. Undue Financial Hardship

Homestore argues that by having to advance expenses to Tafeen, it would be placed "in a position of severe financial hardship."[66] The Court

[63] Tafeen is a former executive officer; he was never a director of Homestore.
[64] 17 CFR 240.3b-7 (2004) (emphasis added).
[65] The Court does not reach the issue of Sarbox's impact on section 145 of the DGCL as it pertains to *current* officers and directors.
[66] Def.'s Answering Br. at 34.

need not reach the factual questions presented by Homestore because this argument, without more, is not a legally cognizable defense to advancement.

Homestore argues that it did not bargain for the credit risk posed in advancement. As discussed above, this is simply false. DGCL § 145(e) allowed for Homestore to lessen its credit risk simply by drafting its bylaws differently. By drafting its bylaws as it did, Homestore opened itself up to a large credit risk.

This Court has historically given great deference to informed decisions of a board of directors. Whether ultimately proven to be a fiscally advantageous or disadvantageous decision, this Court will not interfere with informed and loyal decisions of an independent board.[67] The same is to be said of the drafters of a company's bylaws. Homestore's bylaws may ultimately prove to be disadvantageous; indeed here they may "'significantly lower Homestore's chances for future operations and related recovery.'"[68] But there is no case precedent, nor good reason, to interfere with the decision of the bylaw drafters simply because the bylaws might cause the company financial hardship. Indeed, to allow a financial hardship

[67] Delaware courts presume that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, Del. Supr., 473 A.2d 805, 812 (1984). Absent abuse of discretion, a board's judgment is respected by Delaware courts. *Id.*

[68] Douglas Aff. ¶ 18 (quoting Letter from Michael J. Eggers to Hon. Dan Weinstein 2 (July 16, 2003), *at* Douglas Aff. Ex. G).

exemption, without more, would be to undermine the salutary purpose of allowing advancement. Advancement would be less of an inducement to becoming a director or officer of a company if the company could simply avoid its advancement obligation when times are difficult.

Homestore acknowledges this, conceding that "'financial hardship' typically has not been a defense to advancement," but argues that "this is anything but the 'typical case,' and this court of equity has broad latitude in granting or denying relief."[69] While this Court is a court of equity, and is certainly sympathetic to facts that, if true, indicate Tafeen has engaged in serious misconduct, one of the fundamental maxims of equity is that equity aids the vigilant, not those who slumber on their rights.[70] I do not deviate from this maxim. Homestore had the right to lessen the credit risk posed by its advancement bylaw. It did not do so.[71]

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[69] Def.'s Reply Br. at 10-11.

[70] *Grand Lodge of De., I.O.O.F. v. Odd Fellows Cemetery of Milford, Inc.*, Del. Ch., C.A. No. 1461-K, Noble, V.C., 2002 Del. Ch. LEXIS 136, at *25 n.29 (Nov. 18, 2002), *aff'd*, Del. Supr., 2003 Del. LEXIS 540 (Oct. 28, 2003) (mem.); *Fike*, 754 A.2d at 262 (quoting *Adams v. Jankouskas*, Del. Supr., 452 A.2d 148, 157 (1982)); *Fontana v. Julian*, Del. Ch., C.A. No. 5056 (1976), Hartnett, V.C., 1980 Del. Ch. LEXIS 500, at *4 (Jan. 2, 1980).

[71] Section 145(e) sets forth the bare minimum requirements should a corporation elect to have an advancement provision. These minimum requirements are strikingly lax. As discussed, this reflects the General Assembly's embodiment of the strong policy of encouraging able persons to serve as directors.

The General Assembly, however, left to corporations themselves to determine the *proper balance* between seeking able persons to serve as directors and officers and safeguarding the expenses advanced by the company, and thus the corporation's stockholders. At one end, companies may choose to adopt no advancement provision, thus rejecting this policy embodiment altogether. At the other end, companies may, as

Further, Homestore's reliance on *Dunlap v. Sunbeam Corp.*[72] is misplaced. While declining to state that hardship would never be a factor in determining whether advancement should be denied, the Court declined in that case to consider hardship as a factor. Similarly, this opinion does not foreclose the future possibility of financial hardship as a defense. It simply holds that the existence of financial hardship due to an extremely lax advancement bylaw, without more, is not a defense, especially when the corporation was free to adopt a more stringent bylaw.

Homestore did here, adopt the extremely lax safeguard of requiring only an unsecured undertaking, and possibly only requiring that undertaking from current officers and directors. *See In re Cent. Banking Systems*, *Inc.* 1993 WL 183692, at *3 (noting that no "provision of Delaware law requires that the undertaking be secured or be accomplished by a showing of the indemnitee's financial responsibility").

There is a considerable middle ground between these two extremes. Corporations may require secured undertakings, permissive advancement, board oversight of the litigation process, etc. Homestore's April 30 Memo itself illustrates a number of restrictions corporations may put in their advancement provision. By taking advantage of this ability, issues raised in cases such as this one, *Reddy*, *Bergonzi*, and *In re Central Banking Systems*, would likely not be litigated, saving corporations perhaps as much money as they expend litigating advancement cases. In the absence of taking advantage of this ability, however, this Court will not permit corporations "to do retrospectively what [they could have] precluded [themselves] from doing *ex ante*." *Id.* at *4.

It is unfortunate when a corporation's advancement provision exposes the corporation, and ultimately the stockholders, to the form of credit risk that Homestore's does. Simply by requiring a secured undertaking, for example, Homestore could presumably, given its confidence that Tafeen's conduct in the Proceedings will ultimately render his claims nonindemnifiable, have used the secured note as collateral on a loan to the company, pending the outcome of the Proceedings. Given the high incidence of advancement proceedings, directors should be mindful of their fiduciary duties to stockholders, and the possibility of stockholder action, when reviewing and adopting advancement and indemnification bylaws. In my view, the fact that § 145 is a broad, enabling statute does not confer license to adopt loosely written bylaws that impose excessive credit risks on a company and its stockholders.

[72] Del. Ch., C.A. No. 17048, Chandler, C., 1999 Del. Ch. LEXIS 126 (June 23, 1999).

Homestore's motion for summary judgment as to this defense is denied as a matter of law.

V. CONCLUSION

For the foregoing reasons, Homestore's motion for summary judgment, with respect to all but the unclean hands defense, is denied as a matter of law. Because trial is necessary on the merits of this defense, Tafeen's motion for summary judgment is denied.

IT IS SO ORDERED.