

**COURT OF CHANCERY
OF THE
STATE OF DELAWARE**

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Re: *Xu Hong Bin v. Heckmann Corporation*
Civil Action No. 4802-CC

Dear Counsel:

I have carefully reviewed the briefs supporting and opposing Plaintiff Xu's motion for summary judgment seeking advancement and partial indemnification of his legal fees and expenses. I have also weighed the contentions made by counsel at oral argument on the matter. I hold that Defendant Heckmann Corporation may place reasonable terms and conditions on Xu's right to advancement. In so holding I draw no conclusions as to the reasonableness of the terms and conditions that have already been demanded by Heckmann. I further hold that Xu is entitled to indemnification for reasonable expenses incurred defending Count III of Heckmann's Counterclaim because he has prevailed on the merits as to that count. Finally, I hold that Xu is not entitled to prejudgment interest or to "fees-on-fees" for bringing this action. The analysis underlying my holding follows.

I. FACTUAL BACKGROUND AND PROCEDURAL HISTORY

The facts underlying this dispute are discussed at length in my October 26, 2009 memorandum opinion in this matter.¹ Formal terms used in this letter opinion are the same as those used in my earlier memorandum opinion.

Xu filed his initial suit against Heckmann on June 1, 2009.² Heckmann filed an Answer and Counterclaim on June 22, 2009 lodging three counts against Xu. Xu seeks advancement of the expenses he has incurred or will incur in defending himself against Count I of Heckmann's Counterclaim, which alleges claims for breach of fiduciary duty. Xu seeks indemnification for the expenses he incurred defending himself against Count III, which alleges a claim for conversion. In my earlier memorandum opinion I dismissed Count III for failure to state a claim.³

II. ANALYSIS

A. Summary judgment standard

Summary judgment is appropriate where the moving party demonstrates that there are no genuine issues of material fact and that the moving party is entitled to judgment as a matter of law.⁴ Fee advancement actions are particularly appropriate for summary judgment because a party's entitlement to advancement can be determined by applying the allegations contained in the pleadings to the relevant corporate documents.⁵ Thus, as a threshold matter I must determine which documents are relevant to Xu's purported right of advancement. A ruling on indemnification is also appropriate at the summary judgment stage where there are no material factual disputes germane to indemnification and the moving party is entitled to judgment as a matter of law.

¹ *Xu Hong Bin v. Heckmann Corp.*, 2009 WL 3440004 (Del. Ch. Oct. 26, 2009). My memorandum opinion technically relates to a different civil action (4637-CC) than the one involved here. But this is only because Xu filed a separate suit seeking advancement of his legal expenses, as is common. The underlying facts in both cases are identical, as are the parties.

² The claims Xu asserts against Heckmann in his initial suit are not directly relevant to Xu's claims for advancement in this suit and, accordingly, are not discussed.

³ *Xu Hong Bin*, 2009 WL 3440004, at *13.

⁴ CT. CH. R. 56(c).

⁵ *Weaver v. Zenimax Media, Inc.*, 2004 WL 243163, at *2 (Del. Ch. Jan. 30, 2004).

B. What documents are relevant to Xu's requests for advancement and indemnification?

Xu asserts that three documents entitle him to mandatory advancement and indemnification: (1) China Water's original articles of incorporation, (2) the Merger Agreement⁶, and (3) Heckmann's articles of incorporation. Xu contends that he is entitled to advancement and indemnification under all three documents because Counts I and III relate to conduct that he allegedly engaged in before and after the Merger in his capacities as both a China Water director and a Heckmann director. Heckmann counters that Xu is not entitled to mandatory advancement or indemnification under the China Water articles or the Merger Agreement because Counts I and III are lodged against Xu solely in his capacity as a Heckmann director and solely for conduct committed post-Merger.

There is no dispute that China Water's articles provide mandatory advancement rights when they apply to a given suit or proceeding. The relevant language in China Water's articles clearly requires advancement; conditioned only on the execution of an undertaking by the recipient that the funds will be repaid if it is ultimately determined that person has no right to indemnification.⁷ The important question today is whether the China Water articles apply to Xu's claims for advancement. This question can be answered by reading the China Water articles and considering the scope of Heckmann's claims in Counts I and III. Paragraph 7 of the China Water articles specifies when advancement and indemnification rights arise:

⁶ Of course, China Water has ceased to exist as a legal entity. Its indemnification obligations, however, have been preserved by the Merger Agreement. Section 5.11(a) of the Merger Agreement contains a provision that requires Heckmann's wholly owned subsidiary "Newco"—used to acquire China Water—to honor China Water's advancement and indemnification obligations for a period of six years after the Merger. In Section 5.11(c) Heckmann guarantees Newco's performance of Section 5.11(a). To the extent Xu is entitled to advancement or indemnification under the China Water articles the Merger Agreement ensures that those obligations will be met for a period of six years by either Newco or Heckmann.

⁷ Paragraph 7 of the China Water articles reads, in relevant part, as follows:

The expenses of officers and directors incurred in defending the civil suit or proceeding *must be paid by the corporation as incurred and in advance of the final disposition of the actions, suit or proceeding*, under receipt of an undertaking by or on behalf of the director or officer to pay the amount if it is ultimately determined by a court of competent jurisdiction that he or she is not entitled to be indemnified by the corporation. (emphasis added).

Every person who was or is a party to, or is threatened to be made a party to, or is involved in any such action, suit or proceeding, whether civil, criminal, administrative or investigative, *by reason of* the fact that he or she . . . is or was a director of the corporation . . . shall be indemnified and held harmless to the fullest extent legally permissible⁸

Thus, advancement and indemnification rights are available to Xu under the China Water articles only if the claims in Counts I and III arise “by reason of” the fact that he was a director of China Water. Under Delaware law, a claim is deemed to have been brought “by reason of” an individual’s status as an officer or director of a company if a “causal connection or nexus” exists between the underlying claims and the individual’s official capacity.⁹ In this case, then, Xu has advancement and indemnification rights under the China Water articles only if there is a nexus between the claims in Counts I and III and Xu’s conduct in his official capacity as a China Water director.

Count I alleges that Xu “repeatedly” breached his fiduciary duties “through the embezzlement of millions of dollars from Heckmann, forgery, deceit, fraud, and other conduct that was disloyal and in bad faith.”¹⁰ Count I also alleges that Xu breached his fiduciary duties by “affirmatively conceal[ing] his knowledge of his own misconduct.”¹¹ Count III asserts that Xu is liable for the conversion of \$6 million he accepted as reimbursement for equipment purchases he never actually made.

Prior to oral argument on this motion there was some confusion regarding the scope of Counts I and III. Xu understood Counts I and III as asserting fiduciary duty and conversion claims against him not only in his capacity as a Heckmann director, but also in his capacity as a China Water officer and director. Xu understood Counts I and III to be based on all of the fraudulent conduct he is alleged to have committed, both before and after the Merger.

Contrary to Xu’s understanding, Heckmann took the position in its answering brief and during oral argument that Counts I and III only assert claims

⁸ Nachbar Aff. Ex. F ¶ 7 (emphasis added).

⁹ *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 213 (Del. 2005).

¹⁰ Def.’s Answer ¶ 52.

¹¹ *Id.* at ¶ 53.

against Xu for his post-Merger conduct as a Heckmann director. Heckmann has represented that it is not pursuing claims against Xu for actions he took as a China Water officer or director before the Merger because it does not believe that it has standing to do so.¹² Because Heckmann’s representations to the Court are binding I accept them. Thus, we proceed on the understanding that Heckmann is not pursuing, and will not pursue, claims against Xu for conduct he engaged in as a China Water; officer or director before the Merger. Accordingly, there is no nexus or causal connection between the claims in Counts I and III and Xu’s directorship at China Water, nor do Counts I and III arise “by reason of” Xu’s directorship at China Water. The China Water articles (and the Merger Agreement) are, therefore, inapplicable to Xu’s advancement and indemnification claims for Counts I and III.

C. Is Xu entitled to advancement under the Heckman articles for the expenses he has incurred, or will incur, in defending himself against Count I?

Article Ninth of the Heckmann articles contains an indemnification and advancement provision which reads as follows:

The Corporation shall indemnify its directors and officers to the fullest extent authorized or permitted by law, as now or hereafter in effect, and such right to indemnification shall continue as to a person who has ceased to be a director or officer of the Corporation and shall inure to the benefit of his or her heirs, executors and personal and legal representatives; provided, however, that except for proceedings to enforce rights to indemnification, the Corporation shall not be obligated to indemnify any director or officer (or his or her heirs, executors or personal or legal representatives) in connection with a proceeding (or part thereof) initiated by such person unless such proceeding (or part thereof) was authorized or consented to by the Board of Directors. The right to indemnification conferred by this

¹² See e.g., Def.’s Answering Br. 12 (“Mr. Xu’s claim to advancement under China Water’s charter and the Merger Agreement is based on underlying claims that Heckmann never brought and could not have brought. Heckmann is not suing Mr. Xu for breaches of duty to China Water arising from pre-Merger conduct. Before the Merger, Heckmann was not a shareholder of China Water to whom Mr. Xu owed fiduciary duties.”); Transcript of Oral Argument at 30 (“[W[e] have expressly disavowed any fiduciary duty claim against Mr. Xu for actions taken prior to the merger, including as a China Water director or officer.”).

*Article NINTH shall include the right to be paid by the Corporation the expenses incurred in defending or otherwise participating in any proceeding in advance of its final disposition.*¹³

Xu contends that the advancement provision in this article is mandatory. Heckmann contends that it merely gives Xu a right to advancement that may be subject to reasonable conditions imposed by the board, which preserved the right in the Heckmann bylaws to impose conditions on advancement. Section 6 of the Heckmann bylaws state:

*Expenses (including attorneys' fees) incurred by a director or officer in defending any civil, criminal, administrative or investigative action, suit or proceeding shall be paid by the Corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the Corporation Such expenses (including attorneys' fees) incurred by former directors and officers or other employees and agents may be so paid upon such terms and conditions, if any, as the Corporation deems appropriate.*¹⁴

Xu responds that this bylaw provision is in direct conflict with the articles and is therefore invalid under 8 *Del. C.* § 109(b).¹⁵ In addition, while Xu concedes that corporations may, in some circumstances, place reasonable conditions on advancement rights, he contends that Delaware law requires that the preservation of a right to place conditions on advancement must be made in the same instrument that creates the advancement right. According to Xu, because Heckmann gave him advancement rights in the articles, if it wished to preserve its ability to place conditions on those rights it was required to do so in the articles, not the bylaws. Xu cites *Tafeen v. Homestore, Inc.*,¹⁶ *Reddy v. Elec. Data Sys. Corporation*,¹⁷ and

¹³ Nachbar Aff. Ex. G, Article Ninth (emphasis added).

¹⁴ Larkin Aff. Ex. B, § 6 (emphasis added).

¹⁵ 8 *Del. C.* § 109(b) reads: "The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees."

¹⁶ 2004 WL 556733, at *10 (Del. Ch. Mar. 22, 2004).

¹⁷ 2002 WL 1358761, at *4 (Del. Ch. June 18, 2002).

*In re Central Banking Systems, Inc.*¹⁸ in support of this proposition. I do not read these cases to stand for the proposition Xu puts forward. The facts of all three cases are distinguishable.¹⁹

I hold that Heckmann is entitled to place reasonable conditions on Xu's right to advancement. Two important, undisputed facts lead me to this conclusion.

First, the Heckmann articles and bylaws were executed at the same time. Under Delaware law, every effort should be made to reconcile the provisions of simultaneously enacted founding documents.²⁰ I proceed on the assumption that the drafters of the Heckmann articles and bylaws did not intend for these two documents to conflict. It is not extremely difficult to reconcile these two documents because there is nothing inherently contradictory in recognizing that directors have advancement rights while at the same time recognizing the corporation's ability to set reasonable terms and conditions for the payment of

¹⁸ 1993 WL 183692, at *3 (Del. Ch. May 11, 1993).

¹⁹ In *Tafeen*, the advancement rights of a former officer were fully delineated in the corporation's bylaws. The only condition the bylaws placed on advancement required the officer to deliver an unsecured undertaking promising to repay the corporation if he was ultimately not entitled to indemnification. The corporation argued that it should not be required to advance unsecured funds to the officer because it was likely to suffer financial hardship in the event he could not repay those funds. The court required the corporation to honor its obligations because the corporation had failed, in the first instance, to preserve its right to place conditions on advancement. The case does not state or otherwise imply that the corporation would have had to preserve its right to place conditions on advancement in the bylaws because that is the document granting the officer advancement rights. In *Central Banking*, the corporation granted mandatory advancement rights to a director in its bylaws and a separate indemnification agreement. Some time after advancing funds to the director the corporation attempted to protect itself by requiring that some of the director's assets be placed in an escrow account, which would be used to repay the corporation should the director ultimately not be entitled to indemnification. The court did not permit the escrow arrangement because it was an *ex post* attempt by the corporation to do something it had precluded itself from doing *ex ante* by giving mandatory advancement rights to the director. Again, the case makes no mention of a rule requiring conditions on advancement rights to be placed in the document creating advancement rights. Finally, in *Reddy*, the corporation delineated all advancement rights for a former employee in its bylaws but failed to preserve its right to place conditions on those rights in the bylaws or any other document. The court held that the corporation did not have to provide mandatory advancement rights in the first place but was bound to honor those rights after providing them. Nowhere in the opinion does the court state that conditions on advancement have to be included in the same document that creates the advancement rights.

²⁰ *Essential Enters. Corp. v. Automatic Steel Prods., Inc.*, 159 A.2d 288, 289 (Del. Ch. 1960).

expenses pursuant to those rights.²¹ Admittedly, the articles would have been better drafted if they included some language in Article Ninth that pointed the reader to the bylaws for further information about advancement and indemnification rights. But I decline to adopt a rule that requires a corporation, when simultaneously executing its articles and bylaws, to cross-reference every provision in the articles that may be further explained or qualified in the bylaws or risk a holding that the articles and bylaws conflict at the outset. Where related provisions in simultaneously enacted articles and bylaws can be reconciled there is no need to adopt a stringent rule that renders bylaw provisions void because they qualify the basic rights provided in the articles.

Second, both the articles and the bylaws were in effect when Xu began his directorship. Thus, Xu had every opportunity to read the articles and bylaws and become fully informed regarding the scope of his indemnification and advancement rights before agreeing to serve as a director. I must proceed on the assumption that directors of Delaware corporations read the articles and bylaws before joining the board, particularly those provisions that relate to indemnification and advancement rights.²²

D. Is Xu entitled to indemnification under the Heckmann articles for the expenses he incurred in defending himself against Count III?

In my October 26 decision I dismissed Count III against Xu for failure to state a claim.²³ 8 *Del. C.* § 145(c) provides that a director who has obtained indemnification rights from his corporation shall in fact be indemnified against expenses (including attorney’s fees) when he is successful on the merits of a claim asserted against him. When Xu became a Heckmann director he obtained indemnification rights under Article Ninth of the Heckmann articles. Xu prevailed on the merits of Count III when I dismissed it for failure to state a claim. Thus, Xu

²¹ Had Section 6 of the bylaws been enacted at some point subsequent to the execution of the articles my opinion on this matter might have been different. I decline a foray into that question today because it involves a different circumstance than the one at issue. Today I focus only on circumstances such as this where the articles and bylaws are enacted simultaneously.

²² If Xu had become a Heckmann director at a time when only Article Ninth of the articles was in effect, Heckmann would be precluded from subsequently enacting Section 6 of the bylaws without Xu’s knowledge or consent. *See Salaman v. Nat’l Media Corp.*, 1992 WL 808095, at *6 (Del. Super. Oct. 8, 1992) (holding that a corporation “may not . . . unilaterally rescind a vested contract right upon which [plaintiff] relied.”). But that did not occur.

²³ *Xu Hong Bin v. Heckmann Corp.*, 2009 WL 3440004, at *13 (Del. Ch. Oct. 26, 2009).

is now entitled to indemnification under the Heckmann articles for reasonable expenses incurred defending Count III. For its part, Heckmann does not dispute Xu's right to indemnification for reasonable expenses incurred in defending against Count III.²⁴

E. Prejudgment interest and "fees-on-fees"

Xu is not entitled to prejudgment interest on any amounts which may ultimately be advanced to him because he must first comply with any reasonable conditions that Heckmann places on his advancement rights. In addition, Xu is not entitled to be reimbursed for his fees in bringing this action because he has not been successful on the merits with regards to his advancement claims. The core of this dispute was over Heckmann's right to place reasonable conditions on Xu's advancement rights. Heckmann has prevailed on this argument and Xu, therefore, is not entitled to fees.

Xu is not entitled to be reimbursed for any fees incurred seeking indemnification rights for Count III expenses because Heckmann has not disputed Xu's right to indemnification or refused to pay reasonable expenses.²⁵

III. CONCLUSION

For all of the foregoing reasons, Xu's motion for summary judgment seeking mandatory advancement of his expenses under Count I is denied. Heckmann's board may place reasonable conditions on Xu's advancement rights. Xu's motion

²⁴ See T. J. Allingham letter to Court of Chancery dated Jan. 8, 2010 at 1. Heckmann makes clear that Count I still lays claim, on fiduciary duty grounds, to the \$6 million reimbursement that Xu obtained by purportedly fraudulent means.

²⁵ See *Steel Fin. Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002) (holding that fees for bringing a successful action to enforce indemnification rights are appropriate where the company has refused to honor its indemnification obligations because "the corporation itself is responsible for putting the director through the process of litigation."). In this case, Heckmann never declined to honor its indemnification obligations and, accordingly, is not responsible for any expenses Xu may have incurred arguing his indemnification rights on the present motion. At any rate, the expenses Xu incurred seeking to enforce his indemnification rights (as opposed to advancement rights) should be minimal. My ruling dismissing Count III came down after the parties had filed opening and answering briefs on this motion for summary judgment seeking advancement. In his reply brief, Xu briefly discussed (in one paragraph) his right to indemnification for Count III expenses in light of my dismissal of that count, which was an appropriate breadth of treatment given the simplicity of the legal analysis involved.

for summary judgment seeking indemnification for reasonable expenses incurred defending Count III is granted. Finally, Xu's motion for prejudgment interest and "fees-on-fees" is denied.

Very truly yours,

A handwritten signature in cursive script that reads "William B. Chandler III". The signature is written in black ink and includes a horizontal line under the "III" at the end.

William B. Chandler III

WBCIII:arh