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RECENT DELAWARE COURT RULINGS HIGHLIGHT NEED FOR REVIEW OF DIRECTOR INDEMNIFICATION ARRANGEMENTS

Two recent Delaware Chancery Court decisions stress the need for private equity funds to consider implementing and/or expanding indemnification arrangements for portfolio company directors.

***SCHOON V. TROY CORPORATION*: COURT ALLOWS RETROACTIVE REPEAL OF DIRECTOR ADVANCEMENT RIGHTS**

In *Schoon v. Troy Corporation*, the Delaware Court of Chancery held that the rights of former directors to advancement of legal fees can be eliminated by the corporation, even *after* the occurrence of the events or actions giving rise to the claim. In *Schoon*, during the director's (Bohnen's) tenure on the company's (Troy's) board, the company's bylaws permitted advancement of legal expenses to current *and* former directors. After Bohnen resigned, Troy amended its bylaws to eliminate this benefit for former directors. Subsequent to Bohnen's resignation, Troy filed an action against Bohnen alleging various breaches of fiduciary duty. When the company refused to advance legal fees to Bohnen based on the recent amendment to its bylaws, Bohnen brought an action to compel advancement of expenses.

The *Schoon* court held that Bohnen was not entitled to fee advancement because his rights did not vest until the time at which a claim was actually made against him, even if the actions (or omissions) giving rise to the claim occurred prior to the bylaw amendment, when his right to advancement still existed. Thus, under *Schoon*, until such time as formal litigation is brought against a director, the director has no vested legal right to advancement, and such rights can be lawfully terminated at any point prior to the commencement of a proceeding against the director.

***LEVY V. HLI OPERATING COMPANY, INC.*: DIRECTORS ARE NOT ENTITLED TO PAYMENT OF EXPENSES FOR UNSUCCESSFUL INDEMNIFICATION CLAIM; PRIVATE EQUITY FUND CAN WIND UP AS PRIMARY INDEMNITOR WITH LIMITED RECOVERY RIGHT**

The Delaware Court of Chancery held in *Levy v. HLI Operating Company, Inc.* that, as a matter of Delaware law, a director is not entitled to payment of his or her fees and expenses (so-called "fees on fees") incurred while pursuing an indemnification claim against the corporation if the outcome of the suit is unsuccessful, even if the corporation had provided such benefit to the directors in their indemnification agreement. Further, once a director has been indemnified by a third party, such as a private equity fund, the director cannot seek indemnification from the company on behalf of such third party seeking reimbursement; rather, the third party may pursue a contribution claim against the company.

In *Levy*, the directors had entered into indemnification agreements with the company (HLI), which provided that HLI would advance expenses in connection with any suit that the directors brought to enforce their rights to indemnification, regardless of whether the directors prevailed in such litigation. In addition, some of the directors on the HLI board were serving as representatives of the private equity fund that had invested in HLI, and thus had separate indemnification agreements with the fund as well. In connection with various securities fraud claims brought against the directors, certain of the directors settled for $4.8 million, which amount was paid by the fund. The directors then sought indemnification from HLI, and when the company refused, the directors sued HLI. Initially, the company advanced expenses to the directors in connection with their indemnification claim against HLI, but upon learning that the fund had paid the settlement amount on behalf of the directors, HLI ceased advancing fees and demanded reimbursement for expenses already advanced.

The *Levy* court held that the directors were not entitled to indemnification for monies paid on their behalf by the private equity fund. As their obligations were paid in full by the fund, they did not suffer an out-of-pocket loss, and thus they had no right to bring an indemnification action against the corporation. Further, notwithstanding language in each director's indemnification agreement to the contrary, under Delaware law, a company is not permitted to bear the expenses of a director's unsuccessful claim for indemnification, and as a result, the directors were required to reimburse HLI for the expenses already advanced. Finally, the court determined that the directors could not bring an indemnification action against the company in order to reimburse the fund; rather, the court held that the fund could bring an equitable contribution cause of action against the company, which would result in the fund being reimbursed only for HLI's equitable share of the $4.8 million payment—a far cry from being made whole.

LESSONS LEARNED

These two cases raise a host of issues for PE funds. Some PE funds have not entered into indemnification agreements with portfolio company directors. Perhaps they should. Other PE funds have included indemnification obligations in the management agreements entered into between the PE fund and the portfolio company, but these provisions may not cover outside directors. The *Schoon* holding should serve as a wake-up call to any director who does not have a contractual indemnification right. However, for those PE funds that have made use of director indemnification agreements, the *Levy* decision cautions private equity funds to think twice before actually making indemnification payments on behalf of their principals who sit on portfolio company boards.

In order to avoid the outcome in *Levy*, we suggest that PE funds review the governing documents of their portfolio companies and any indemnification arrangements previously implemented and consider adding language providing that:

- The company is the primary indemnitor, and any indemnification or advancement obligation of the fund is secondary;
- The company is responsible for any and all losses, expenses, fees, penalties, fines, judgments, etc., in connection with an indemnifiable claim, irrespective of any rights that the director may have against the fund; and
- The company waives, and releases the fund from, any claims for contribution, subrogation, or any other recovery of any kind.

Further, the indemnification arrangements should provide that any payments that are made by a fund do not affect any of the foregoing provisions, and in such event, the fund has a right of contribution and/or subrogation against the company to the extent of any such payment.

Finally, upon an exit from a portfolio company, PE funds should include a covenant in the sale agreement prohibiting the amendment of the indemnity provisions included in the governing documents of the portfolio company. In addition, while a buyer is almost certain to require the management agreement to be terminated as a condition to the sale, the indemnification obligations can survive such a termination.

LAWYER CONTACTS

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