DIRECTOR AND OFFICER LIABILITY

Delaware Reinforces the Limits on Indemnification Claims

In two recent decisions, the Delaware Chancery Court has challenged settled expectations around advancement and indemnification rights in the private equity deal context. The implications of the Chancery Court's decisions should be carefully considered by all private equity investors and those who advise them.

by Randall W. Bodner and Peter L. Welsh

With the rise of private equity deal making in recent years, litigation involving sponsor firms and their portfolio companies likewise has increased. And, as economic conditions worsen, the litigation risks facing private equity funds, their portfolio companies and private equity principals who serve as directors and officers of portfolio companies only will intensify. In this environment, a single judicial decision by the Delaware Chancery Court, in the 2007 case *Levy* v. *HLI Operating Company, Inc.*, has raised the financial stakes for sponsor firms and their principals in the event of litigation.[1] The Chancery Court recently reinforced its holding in *Levy* in *Schoon* v. *Troy Corporation*.[2]

Levy and *Schoon* each address the issue of who is responsible to provide advancement and indemnification to a director or officer, when both a corporation and a shareholder of the corporation contractually have agreed to provide indemnification and advancement of defense expense on behalf of the director or officer. This issue is of considerable importance to private equity and venture capital firms, as well as other institutional investment firms that regularly designate their principals to serve as directors or officers of the portfolio companies in which the firm has invested. Most private equity sponsors provide contractual advancement and indemnification rights to their principals for, among other things, claims made against the principals arising out of the principals' services as directors or officers of the portfolio companies. Most portfolio companies likewise provide contractual advancement and indemnification rights to their directors and officers, including the sponsor's principals serving as directors or officers of the portfolio company.

In these circumstances, the widespread expectation is that the portfolio company is primarily liable to the directors and officers, including the sponsors' director designees, for advancement and indemnification and that the sponsor is liable only secondarily in the event the portfolio company cannot fund its indemnification and advancement obligations, for example, in the event of a bankruptcy filing by the portfolio company. *Levy* is noteworthy because it disrupts this settled expectation.

Levy v. *HLI Operating Company, Inc.*

In *Levy*, a private equity sponsor designated four of its principals to serve on the board of directors of HLI Operating Company, Inc. (HLI), a public company of which the private equity sponsor was a shareholder. As directors of HLI, the principals enjoyed indemnification rights from HLI "to the fullest extent permitted by law" against "all [e]xpenses, judgments, fines, penalties and amounts paid in settlement" for any threatened, pending or completed action suit or proceeding "by reason of the fact that" such person served as a director or officer of HLI.[3] As principals of the private equity firm, the sponsor's designees also enjoyed indemnification rights from the private equity fund in their capacity as the sponsor's designees to serve on the HLI Board of Directors. Sorting out the "concomitant" contractual obligations, owed by the sponsor and

Randall Bodner is a partner, and Peter Welsh is an associate, at Ropes & Gray LLP in Boston, MA. The statements contained in this article do not necessarily represent the views of Ropes & Gray LLP or its clients and are not intended to constitute, and do not constitute, legal advice.

the portfolio company, to indemnify the sponsor's board designees was the challenge presented to, and decided by, the Chancery Court.[4]

In late 2001, HLI announced that its financial statements for the period 1999 to early 2001 were materially inaccurate and should not be relied on. Thereafter, HLI's shareholders and bondholders filed suit against HLI and certain officers and directors of HLI, including the private equity sponsor's board designees, alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Within weeks, the Company filed for protection under Chapter 11 of the US Bankruptcy Code. The SEC also commenced an investigation into HLI's financial reporting. On May 12, 2003, a plan of reorganization was approved pursuant to which HLI became an operating subsidiary of a newly-created entity, Hayes Lemmerz International, Inc. (Hayes Lemmerz). Both HLI and Hayes Lemmerz emerged from bankruptcy at that time.

On May 2, 2005, the parties to the shareholder and bondholder litigation reached a settlement of those actions. Pursuant to the terms of the settlement, HLI's D&O insurance carrier contributed $20.3 million to a settlement fund for the benefit of the HLI shareholders and bondholders. The sponsor's four director designees contributed $4.8 million toward the settlement. The director designees then sought indemnification from HLI for the $4.8 million paid toward the settlement of the shareholder and bondholder litigation. When HLI refused, the designees commenced suit against HLI to enforce their indemnification rights and to recover amounts paid to settle the shareholder and bondholder litigation.

In their original complaint, the director designees alleged that they personally had paid the $4.8 million toward the settlement. However, in the course of discovery in the case, it was revealed that they did not pay the $4.8 million personally; instead, the private equity sponsor that employed the director designees paid the $4.8 million on the designees' behalf pursuant to the sponsor's indemnification obligations to the director designees under the private equity fund's limited partnership agreement. After learning that the private equity fund had indemnified the director designees, HLI moved for summary judgment on the director designees' claim for indemnification for the $4.8 million paid toward the settlement of the shareholder and bondholder claims.

In its motion for summary judgment, HLI argued that the sponsor's representatives were only entitled to indemnification by HLI for "amounts paid in settlement" out of their own pockets. Because the private equity fund paid the amount of the settlement, not the director designees themselves, HLI contended, the director designees had no indemnifiable loss and, therefore, no contractual right to indemnification pursuant to their agreements with HLI.

Whether or not the private equity sponsor actually pays indemnification on behalf of its director designee might not affect the outcome.

The Chancery Court agreed with HLI and held that the sponsor's director designees did not have standing to pursue indemnification from HLI. HLI also contended that the private equity fund was not entitled to repayment from HLI of the $4.8 million it paid toward the settlement on behalf of its director designees. After surveying the common law of contribution, subrogation, and indemnification, the Chancery Court held that, because the private equity fund and HLI each owed "concomitant" indemnification obligations to the director designees, each was responsible for part of the loss paid in the settlement. Accordingly, the private equity fund was only entitled to recover a percentage of the $4.8 million it paid on behalf of the director designees through a claim for contribution.[5] As the court explained,

> when an indemnitor, pursuant to [Delaware General Corporation Laws] section 145, fully satisfies a joint indemnification obligation it shares with a co-indemnitor covering the same indemnitee and the same challenged activity, the indemnitor must sue the co-indemnitor on a theory of contribution. The facts presented here fit squarely within this framework, and proper resolution of this case, then, also rests on contribution.[6]

On this reasoning, whether or not the private equity sponsor actually pays indemnification on behalf of its director designee might not affect the outcome. Under *Levy*, the mere fact that the sponsor provides indemnification rights to the director designee arguably creates "co-indemnitor" obligations, limiting the portfolio company's obligation to, at most, a percentage of the total amount for which the designee is indemnified by both the portfolio company and the sponsor. In short, a sponsor potentially places itself into contribution land with respect to its Delaware portfolio companies the moment it contractually obligates itself to indemnify any of its principals serving as officers or directors of its portfolio companies.

Thus, even when a portfolio company wrongfully refuses to indemnify the director designee of a private equity sponsor, if the sponsor also indemnifies the designee, then the designee and the sponsor's recovery from the portfolio company very well might be capped at a significantly reduced percentage of the amount for which the portfolio company is otherwise obligated to indemnify its designee.[7]

Schoon v. *Troy Corporation*

The Chancery Court revisited its holding in *Levy* in a recent decision in *Schoon* v. *Troy Corporation.* In *Schoon* v. *Troy Corporation*, Steel Investment Company (Steel) owned some 35 percent of Troy Corporation's equity interests. Steel had previously appointed William J. Bohnen as its director designee to the board of directors of Troy. In 2005, Bohnen resigned and Troy appointed Richard W. Schoon to take Bohnen's place on the Troy board of directors. Schoon and Steel thereafter each brought a statutory books and records action against Troy pursuant to Section 220 of the Delaware General Corporation Laws. These actions were consolidated. In its answer and affirmative defenses to the books and records action, Troy alleged that Schoon had shared confidential Troy business records with Steel in breach of Schoon's fiduciary duties to Troy. Troy made no claims against Bohnen at this time. Troy then amended its bylaws to eliminate retroactively mandatory advancement rights for former directors of Troy. Before the amendment, former Troy directors, including Bohnen, had enjoyed broad mandatory advancement rights. The practical effect of the amendment of the Troy bylaws was to eliminate Bohnen's automatic right to advancement against the Company. Shortly after approving this amendment, Troy sued Bohnen, as well as Schoon, for breach of fiduciary duty.

A sponsor potentially places itself into contribution land with respect to its Delaware portfolio companies the moment it contractually obligates itself to indemnify any of its principals.

Following the filing of Troy's breach of fiduciary duty action against Schoon and Bohnen, Schoon and Bohnen sought advancement of their defense expenses from Troy. Troy ultimately refused to advance defense expenses for the benefit of Bohnen on the grounds that the Troy bylaws had been validly amended and that, as a consequence of that amendment, Bohnen was no longer entitled to mandatory advancement of defense expenses.

To the surprise of many practitioners, the Chancery Court agreed with Troy. In the core holding of *Schoon* v. *Troy*, the Chancery Court held that, unless and until an indemnifiable claim is made against a director, the director's right to advancement does not vest, and the director does not have standing to assert a claim for advancement or to bring suit to enforce the director's right to advancement, until an indemnifiable claim has arisen; in the meanwhile, the corporation is permitted to amend its bylaws to impair the directors' advancement rights. In effect, Troy validly eliminated Bohnen's rights to advancement because it amended its bylaws before an indemnifiable claim against Bohnen had ripened and Bohnen's right to advancement had thereby vested. Importantly, the core holding in *Schoon* is not, by its terms, limited to advancement and also could well apply to any claim for indemnification (except for a claim for mandatory statutory indemnification under Section 145(c) of the Delaware General Corporation Laws).[8]

In the course of litigating Schoon's claim for advancement, it was revealed that the shareholder Steel had voluntarily advanced defense expenses for the benefit of Schoon and Bohnen. Specifically, although Steel had no obligation to advance defense expenses, it did so, and Schoon and Bohnen each agreed to repay Steel any amounts advanced by Steel to the extent that Schoon or Bohnen received advancement or indemnification from Troy.[9] In view of this development, the Chancery Court requested that the parties submit supplemental briefing on the issue of whether *Levy* bars or limits advancement or indemnification for amounts paid by Steel for the benefit of Schoon and/or Bohnen.

In its decision, the Chancery Court held that the fact that Steel was advancing defense expenses for the benefit of Schoon did not preclude a claim by him for advancement or indemnification from Troy.[10] The court reasoned that because Steel had undertaken *voluntarily* to advance defense expenses and because Schoon was obligated to reimburse Steel for any amounts recovered from Troy, Schoon did not have an unqualified contractual right to advancement or indemnification from Steel. As a result, Schoon had suffered a sufficiently cognizable injury, as a result of Troy's refusal to advance defense expenses to him, to bring a claim for advancement against Troy. As the Chancery Court noted:

> Although this case appears strongly similar to *Levy* at first glance, it is distinguishable from *Levy* in one important way: as both parties conceded, unlike JLL Fund [in *Levy*], Steel is not obligated to advance Schoon his defense costs. Rather, Steel has provided what is essentially a gift, voluntarily undertaking to pay the fees and expenses of Schoon, without any obligation to continue doing so in the future. For two reasons, this singular fact establishes that Schoon has standing. First, . . . Schoon has no assurance that Steel will continue advancing his defense costs and is obliged to repay those amounts to the extent he recovers them from Troy . . . . Second, accepting Troy's arguments regarding standing would inequitably reward Troy.[11]

In short, *Schoon* declined to apply *Levy* to circumstances in which a shareholder voluntarily undertakes to advance defense expenses for the benefit of its board designee and where the designee is obligated to repay such amounts to the shareholder.

The Takeaway from *Levy* and *Schoon*

While not entirely clear from the Chancery Court's holdings in *Levy* and *Schoon*, collectively they suggest the following:

1. In any case in which a portfolio company declines to pay indemnification to a sponsor's designee, and when the sponsor is both obligated to pay and does actually pay indemnification on behalf of the designee, the designee loses standing (as a result of such payment) to pursue the portfolio company for indemnification;
2. In any case in which a sponsor is both obligated to pay and does actually pay indemnification for the benefit of its director designee, the sponsor may recover from the portfolio company a percentage of the amount paid as indemnification on behalf of its designee; and
3. In any case in which the sponsor is not obligated to advance defense expenses on behalf of the sponsor's director designee, but nonetheless voluntarily undertakes to pay advancement on behalf of the designee, the sponsor's director designee retains standing to pursue the portfolio company for indemnification.

In addition, based on the reasoning of *Levy* and *Schoon*, in any case when a sponsor provides a contractual right to indemnification for the benefit of any of its director designees (but does not pay such indemnification), and when one of the sponsor's portfolio companies pays indemnification it owes to the director designee, a court applying Delaware law might well hold that the portfolio company is entitled to assert a claim against the sponsor for contribution to recover a percentage of the amount paid by the portfolio company to or for the benefit of the director designee. By merely granting contractual indemnification rights to its director and officer designees, in other words, the sponsor is potentially exposed to a claim for contribution by each of its portfolio companies.

Potential Contractual Workarounds

A critical issue for private equity sponsors, and other institutional shareholders with board designation rights, is whether there is a potential contractual means of working around the *Levy* decision. The Chancery Court recognized one potential workaround in *Schoon*. Specifically, in *Schoon*, the Chancery Court held that a director designee of a sponsored portfolio company retained standing to pursue a claim for advancement and indemnification when the sponsor had merely *voluntarily* advanced defense expenses to the director designee. The obvious difficulty with this "solution" is that, in order to be effective under *Levy* and *Schoon*, it necessarily exposes the director designee to the risk of personal liability. Indeed, if advancement by the sponsor is not truly voluntary—and the director designee is not, therefore, exposed to a genuine risk of bearing personal responsibility, out of the director's own pocket, for the amounts advanced—then such advancement likely is not sufficient to fit within the exception to *Levy* recognized in the *Schoon* decision. Yet, an arrangement whereby the sponsor's director designee bears a meaningful risk of personal liability for amounts paid as advancement is hardly a satisfactory solution for a sponsor or its board designee.

So, are there potential contractual workarounds that do not expose the sponsor's director designees to the risk of personal liability? Certainly potential workarounds that do not involve a risk of personal liability for the sponsor's director designees can be conceived. The difficulty is that, without further guidance from the courts, it is unclear whether such workarounds would be enforceable under the common law or under the statutory corporate law of many jurisdictions. There are a few potential contractual workarounds to consider.

Backstop Indemnity from Portfolio Company to the Private Equity Sponsor

The preferred, most straightforward and potentially effective protection for a sponsor firm against the holding in *Levy* is to require each of the sponsor's portfolio companies to agree to indemnify the sponsor directly for any amounts that the sponsor pays as indemnification or advancement on behalf of its principals serving as directors or officers of the portfolio company. A contractual provision requiring each portfolio company to reimburse the sponsor should allow the sponsor to indemnify and advance funds on behalf of its portfolio company director designees while minimizing the risk that such payments would limit the ability of the sponsor to recoup those amounts from the portfolio company. Such an agreement should permit the sponsor to pursue claims against its portfolio company to recover amounts advanced, or paid as indemnification, on behalf of its director designees. The reason is the sponsor would, as a result of such an agreement, hold indemnification rights separate from those rights that the sponsor's designees hold as a result of their indemnification arrangements with the portfolio company.

An indemnity agreement between the private equity investor and its portfolio company could take different forms—an indemnification provision could be included in any management agreement that the sponsor may have with its portfolio company, or the sponsor, and its director designees, or could enter into separate indemnification agreements with the sponsor's portfolio companies. In substance, the portfolio company would agree to reimburse, indemnify and hold the private equity sponsor harmless for any amounts advanced, or paid as indemnification, on behalf of any of the sponsor's director-designees for actions involving the designees related to the portfolio company and occurring during the time any such designee served as a director or officer of the portfolio company at the request of the sponsor.

Ordinarily, indemnity provisions between third parties are enforceable.[12] Obviously, however, such an indemnity must be carefully drafted to accomplish its purpose and to comply with applicable legal and public policy limitations. In particular, such an indemnification agreement should specifically clarify that it is intended to indemnify and hold the sponsor harmless for amounts advanced, and paid as indemnification, on behalf of any of the sponsor's principals who is subject to any demand, claim, action, suit, or other proceeding to the full extent permitted by Delaware (or other applicable) law, including without limitation a claim, action, suit, or

other proceeding for breach of fiduciary duty, negligence, misrepresentation or other similar claims.

Other Contractual Protections at the Sponsor Level

In addition to a direct contractual indemnity between a private equity sponsor and its portfolio company, the sponsor could seek to further protect itself and its principals from the consequences of the decision in *Levy* by including certain terms in the sponsor's agreements to indemnify, and advance expenses to or for the benefit of, the sponsor's director designees. Whether such additional contractual terms are appropriate will depend significantly on the terms and conditions of the sponsor's pre-existing advancement and indemnification agreements with its principals and the sponsor's overall approach to indemnification of its principals.

Possible additional contractual terms that might achieve the sponsor's goals include the following:

1. To the extent the sponsor provides advancement or indemnification rights to its principals as a matter of contract, the sponsor should make clear that such advancement or indemnification rights are secondary to any valid and collectible advancement and indemnification available from the relevant portfolio company. In particular, any contractual advancement and indemnification by the sponsor should be expressly payable by the sponsor only if, and to the extent that, the portfolio company does not actually pay advancement or indemnification to the sponsor's principal. The sponsor should also require the director or officer to reimburse the sponsor for any amounts paid by the sponsor as advancement or indemnification to the extent that its designee receives payment of any advancement or indemnification from the portfolio company.[13]
2. As a condition of advancement, the sponsor could require its principals to assign all of their rights against the portfolio company to the sponsor. It is doubtful whether such an assignment would provide enforceable rights to the sponsor, however. In particular, the court in *Levy* held that because the directors in that case were fully indemnified by the private equity sponsor, they had suffered no indemnifiable loss and, consequently, had no standing to proceed against the portfolio company pursuant to their advancement and indemnification rights.[14] Because, according to *Levy*, such a director has no standing to pursue a claim in the director's own name, the director likely also has no enforceable right that it could assign to the private equity sponsor. It is not entirely clear, however, whether a court would decline to enforce such an assignment. Because there are no evident drawbacks to including such a provision as a potential safeguard, and because a court might enforce it, a sponsor may wish to consider including such an assignment term in the indemnification provisions of its limited partnership agreements.
3. The sponsor could include in any advancement or indemnification agreement it has with its principals a term providing that, as a result of any payment of advancement or indemnification by the sponsor, the sponsor is thereby subrogated to the principal's rights to pursue a claim for indemnification against the portfolio company. *Levy* casts some doubt on whether such a provision would be effective to permit the sponsor to pursue claims against the portfolio company. However, it is arguable that the sponsor would retain a claim for reimbursement against the portfolio company pursuant to such subrogation rights. Because such a subrogation provision may be effective, in whole or in part, and there is no evident reason not to include it in the sponsor's agreements with its principals, a sponsor may wish to consider adding contractual subrogation to the indemnification provisions of its limited partnership agreements as well.

Conclusion

Private equity sponsors, and other institutional investors that regularly designate their principals to serve as directors and/or officers of the investor's portfolio companies, have come to rely, in significant part, on contractual rights to advancement and indemnification from the portfolio companies at which their principals serve. Both *Levy* and *Schoon* disrupt settled expectations concerning the reliability of advancement and indemnification in certain significant respects. In the wake of these decisions,

it is important for institutional investors, and those who advise them, to take a fresh look at the contractual protections provided to their director and officer designees, and to the investors themselves. In this context, an ounce of prevention can be worth more than a pound of cure.

NOTES

1. *Levy* v. *HLI Operating Company, Inc.*, C.A. No. 1395-VCL, 2007 WL 1500032 (Del. Ch. May 16, 2007).

2. *Schoon* v. *Troy Corp.*, C.A. No. 2362-VCL, 2008 WL 821666 (Del. Ch. March 28, 2008).

3. *Levy*, 2007 WL 1500032 at *2; for the potential significance of "by reason of the fact" advancement and indemnification terms, *see, e.g., Citrin* v. *I'ntl Airport Centers, LLC* et. al, C.A. 2005-VCS (Del. Ch. Sept. 7, 2006); *Brown* v. *Liveops, Inc.*, C.A. 1991-VCN (Del. Ch. June 12, 2006) (holding that a suit against a former officer by his former employer accusing the officer of misappropriating confidential information and using the information to launch a competing business was a suit "by reason of the fact that" the former officer was a former officer and requiring the former employer to advance the former officer's costs of defending against the suit).

4. *Levy*, 2007 WL 1500032 at *1.

5. The Court of Chancery specifically noted that HLI also still retains all of its factual, and certain of its legal defenses in addition to its claim that it owes no more than its equitable proportion of the $4.8 million paid by the sponsor toward the settlement. Thus, it would seem that HLI is obligated to reimburse the sponsor for no more than 50 percent—and possibly less than 50 percent—of the $4.8 million. *Id.* at *9, n.47.

6. *Id.* at *8.

7. It should be noted that the Chancery Court does aver in its decision that "the Court of Chancery will freely saddle a co-indemnitor who 'unreasonabl[y] refus[es] to acknowledge its contractual obligation to [its indemnitee]' with the costs and fees associated with the enforcement suit." *Id.* at *9.

8. While not the focus of this article, in view of the Chancery Court's core holding in *Schoon*, directors and officers of public and private companies would do well to consult their respective company's charters and bylaws to confirm that those documents contain a robust savings provision clarifying that any amendment to the charter or bylaws will not apply to any acts or omissions that have occurred prior to such amendment. Because the issue has not been addressed post-*Schoon*, it is unclear whether such a savings provision will be effective to avoid the issue raised by the core holding of *Schoon*. A more reliable protection against the problem identified in *Schoon*, therefore, is a separate indemnification agreement that may not be amended except with the director's or officer's written consent.

9. *Schoon*, 2008 WL 821666 at *13.

10. Because, by this point in its decision, the Chancery Court had already determined that Bohnen, the former director indemnitee, was not entitled to advancement, Bohnen's claim for advancement was not subject to the court's analysis under *Levy*. *Id.* at *7.

11. *Id.* at *13.

12. *See, e.g., ABRY Partners LLC* v. *F&W Acquisition LLC.*, 891 A.2d 1032, 1055 (Del. Ch. 2006); *Marshall* v. *Maryland, D. & V. Ry. Co.*, 112 A. 526 (Del. Super. Ct. 1921).

13. *SeeSchoon*, 2008 WL 821666 at *13.

14. *Levy*; 2007 WL 1500032 at *8; *see also Schoon*, 2008 WL 821666, at *12–14.