INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

ASPEN PUBLISHERS

Volume 22 Number 9, September 2008

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ELIZABETH A. ISING and **CHARLES H. HAAKE** of Gibson, Dunn & Crutcher LLP examine recent attention to disclosure of climate change information in SEC filings, including a settlement with the New York Attorney General, pending legislative, regulatory, and litigation developments and calls by activists, and suggest that, as a result, public companies consider whether and to what extent they should include climate change disclosures in their SEC filings.

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J. TRAVIS LASTER of Abrams & Laster LLP and **STEVEN M. HAAS** of Hunton & Williams LLP explain why the decision by the Delaware Chancery Court in *Ryan v. Lyondell* does not merit any meaningful change in existing deal practice, counter to the attention it has generated.

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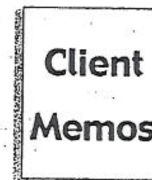

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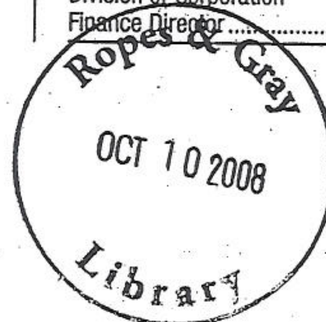

STATE CORNER

Advancement and Indemnification Update: *Sadona* v. *American Stock Exchange*

by Randall W. Bodner and Peter L. Welsh

In the August 2008 issue of *INSIGHTS*, we wrote about the Delaware Chancery Court's decision in *Levy* v. *HLI Operating Co., Inc.*, which addressed the issue of the relative obligations of a private equity fund and a portfolio company owned by the private equity fund to pay advancement and indemnification to, or on behalf of, a principal of the private equity fund serving as a director or officer of the portfolio company.[1] A decision issued on July 15, 2008, (after the August article went to press) by the Chancery Court in *Sadona* v. *American Stock Exchange*[2] addresses certain issues raised by the *Levy* v. *HLI* decision. It provides a partial roadmap on how a private equity fund may be able to contract around the issues raised by the *Levy* decision.

The *Levy* Decision

Levy v. *HLI* involved a claim for indemnification against a sponsored portfolio company. In *Levy*, the portfolio company refused to indemnify the sponsor's board designees. The sponsor fund indemnified its board designees instead pursuant to the fund's limited partnership agreement. The board designees and the sponsor then both sued the portfolio company in Delaware to recoup the amounts that the sponsor paid on behalf of its board designees. In *Levy*, Vice Chancellor Lamb held that, as a result of payments made by the sponsor to indemnify its board designees, the designees no longer had any financial loss and, therefore, lost standing to sue the portfolio company. Vice Chancellor Lamb also held that, while the sponsor could recover from the portfolio company, the sponsor could only bring a claim for contribution and the sponsor's recovery was consequently capped at the amount that it paid *in excess* of the amount it equitably owed to the board designees as a co-indemnitor with the portfolio company.

As discussed in our August article, one of the potential contractual workarounds to the *Levy* v. *HLI* decision entails including in the private equity fund's limited partnership agreements, a prioritization/set off provision that specifies that any obligation that the fund owes to indemnify its principals is secondary to any right to indemnification that the principal has against one of the fund's portfolio companies.

The *Sadona* Decision

In *Sadona*, the Chancery Court considered just such a prioritization/set off provision. *Sadona* involved an SEC investigation of Salvatore Sadona, the former CEO and Chairman of the American Stock Exchange (Amex), who was serving at the Amex at the request of his then-employer, the NASD, during a time when the NASD owned the Amex. The SEC's investigation concerned Sadona's activities at Amex. Both the NASD and the Amex had extended indemnification rights to Sadona. When the SEC investigation intensified, the Amex notified Sadona that it would no longer pay his legal expenses, because those expenses were, in the Amex's view, excessive. [3] Sadona than requested that the NASD advance his expenses. When the NASD refused, Sadona filed suit against the Amex and the NASD seeking an order requiring the Amex and the NASD to advance his unpaid legal expenses and any future expenses related to the SEC matter. The Amex, in turn, sought an order from the Chancery Court that, to the extent the court were to hold that the Amex is obligated to pay advancement or indemnification to Sadona, the Amex is, as a co-indemnitor with the NASD, only obligated to

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pay, at most, one half of the amounts incurred by Sadona in defense of the SEC investigation, with the NASD being obligated to pay the other half. [4]

Construing *Levy*, and *Chamison*[5] (an earlier decision, which played a significant part in Vice Chancellor Lamb's decision in *Levy*), Vice Chancellor Strine rejected the Amex's argument. In particular, the Vice Chancellor noted that the NASD's organizational documents included a prioritization/set-off provision, which stated in relevant part:

> The NASD's obligation, if any, to indemnify or advance expenses to any person who is or was serving at its request as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, enterprise, or non-profit entity shall be reduced by any amount such person may collect as indemnification or advancement from such other corporation, partnership, joint venture, trust, enterprise, or non-profit entity.[6]

Vice Chancellor Strine held that this provision showed a clear intent to render the NASD's obligation secondary to the indemnification obligation of any other corporation, including the Amex, at which an NASD director or officer was serving at the request of the NASD. As a result, Vice Chancellor Strine held the NASD and the Amex are not co-indemnitors with co-equal indemnification obligations to Sadona. Rather, the Amex is obligated to indemnify first and the NASD is obligated to indemnify second, and then only if the Amex were financially or legally unable to make such payment. [7]

In so holding, the Court noted that its decision comports with fundamental principals of corporate law and the importance of corporate forms:

> That the Amex is responsible for [Sadona's] legal expenses if it has the ability to fully meet them is rational and consistent with one of the primary purposes for forming subsidiary corporations – confining the costs and liabilities of a particular line of business. It is natural that an entity (such as the NASD) that made the business decision to operate a subsidiary as a separate entity (like the Amex) would want to retain the distinction between those entities and have the subsidiary entity be primarily liable for obligations resulting from actions taking place at the subsidiary level.[8]

Indeed, to decline to respect this corporate structure would run counter to well-settled tenets of Delaware corporate law.

Although *Sadona* does much to clarify the state of the law following *Levy*, an important issue was explicitly left unaddressed by the court. In footnote 77 of the decision, Vice Chancellor Strine raises the issue of the effect of a primary indemnitor's refusal to honor its indemnification obligations:

> One interesting question about the effect of a provision such as [the NASD prioritization/set off provision] in the context of an advancement dispute where the entity with primary liability refuses to honor its advancement obligation is whether the entity with secondary liability is required to begin advancing funds to the corporate official upon a demand and a demonstration of the primary obligor's refusal, and protect itself solely through subrogation to the rights and claims the corporate official has against the entity with primary liability. That issue is not in dispute in this action and prudence weighs against commenting on it without the aid of briefing.[9]

At the same time, however, the Vice Chancellor makes clear that, leaving aside whether the secondary indemnitor is obligated to indemnify in such circumstances, where it chooses to indemnify, it should be entitled to recover the full amount from the primary indemnitor: "If an entity like the Amex simply refused to honor its *clear* primary obligation to advance, a secondary obligor who honors its duties should have the right to recover fully against the primary obligor." [10]

A Contractual Workaround

Apart from the residual uncertainty created by footnote 77, the decision in *Sadona* suggests a potentially viable contractual workaround to *Levy*,

particularly if the decision is more widely followed in Delaware and other jurisdictions. In light of *Sadona*, private equity sponsors would do well to consider including within their limited partnership agreements—or in side agreements, supplementing their limited partnership agreements—a provision clarifying that the private equity fund's obligation to pay advancement and/or indemnification to, or on behalf of, its principals is secondary to the obligation of any of the fund's portfolio companies to indemnify the principal. [11] In addition to the prioritization/set off provision approved by *Sadona*, other potential contractual workarounds (as discussed more fully in our August, 2008 article) are also available and should be considered.

NOTES

1. *Levy* v. *HLI Operating Co., Inc.*, 924 A.2d 210 (Del. Ch. 2007).
2. *Sadona* v. *American Stock Exch. LLC*, C.A. No. 3418-VCS, 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008).
3. *Id.* at *29.
4. *Id.* at *30–31, 53.
5. *See Chamison v. HealthTrust, Inc.*, 735 A.2d 912 (Del. Ch. 1999).
6. *Sadona*, 2008 Del. Ch. LEXIS 92 at *52.
7. *Id.* at *51–57.
8. *Id.* at *55.
9. *Sadona*, 2008 Del. Ch. LEXIS 92 at *53 n.77. Although it is *dicta*, footnote 77 suggests an additional potential workaround to the issue raised by the *Levy* decision. In the footnote, Vice Chancellor Strine suggests that a parent/sponsor may be able to make payment of loss that is otherwise indemnifiable by the subsidiary/portfolio company and, thereby, be subrogated to the director designee's rights to pursue a claim for advancement and indemnification against the subsidiary/portfolio company. As discussed in our prior article, contractual subrogation provisions also may be advisable.
10. *Id.* at *59.
11. In addition to raising the question of the appropriate order of indemnification as between a private equity fund and its portfolio company, the *Levy* decision also potentially applies to the order of indemnification as between a private equity fund and its general partner and management company. For a private equity sponsor, venture capital firm, or hedge fund, therefore, it may be worth considering including prioritization provisions, along the lines suggested by Vice Chancellor Strine in *Sadona*, in the organizational documents of the fund's general partner(s) and management company/ies to clarify which of the organization's entities has the primary obligation to indemnify the firm's principals.