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No Surprises: The Mandatory Nature of Mandatory Advancement and Indemnification

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The Delaware Court of Chancery recently issued two opinions (*Thompson* and *Levy*) interpreting the nature and scope of indemnification and advancement provisions.[1] Though *Thompson*'s holding is interesting, almost as interesting is the subtext of the Court's discussion—the Delaware courts will give boards of directors significant leeway in regulating advancement when the relevant bylaw or other contractual provision provides for discretion, but boards may have little chance of succeeding in a contest regarding a mandatory-advancement provision.

In addition, the key teachings from *Levy*, if not surprising, are somewhat illuminating. First, the *Levy* Court stated that a corporation (even if required under a mandatory indemnification provision to indemnify its officers, directors, employees, or agents for the full amount of their costs, expenses, and other amounts) may seek contribution from another entity that is similarly obligated to provide indemnification. The opinion thus sends a clear signal to venture capital funds and private equity groups who nominate and elect directors to serve on the corporations in which they invest. Second, the *Levy* Court held that a potential indemnitee seeking indemnification for fees incurred in bringing an action to enforce its rights to indemnification and advancement (*i.e.*, "fees on fees") must be successful in the underlying action in order to receive fees on fees. The Court's holding thus seems an attempt to encourage meritorious suits and discourage others.

Advancement Rights

Section 145(e) of the General Corporation Law of the State of Delaware (DGCL) provides for the advancement of attorneys' fees and other legal expenses to officers and directors in connection with civil, criminal, administrative, or investigative proceedings.[2] Advancement helps corporations attract "capable individuals into corporate service" by providing those individuals with the certainty that they will receive "interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings."[3]

Corporations often spell out their advancement policies in their bylaws or certificate of incorporation (and, to a lesser degree, and generally only with respect to directors and senior officers, in separate indemnification agreements), and the wording of the relevant indemnification provisions may be dispositive of any advancement issues that arise in later litigation. For example, section 145(e) itself is permissive; it "leaves to the business judgment of the board the task of determining whether the undertaking proffered in all of the circumstances, is sufficient to protect the corporation's interest in repayment and whether, ultimately, advancement of expenses would on balance be likely to promote the corporation's interests."[4] If, on the other hand, the advancement bylaw or contractual right provides for mandatory advancement, without qualification, a corporation's board will have no such freedom of choice.[5]

While this proposition should not be surprising, it bears mentioning that, if a corporation that provides mandatory advancement wishes to impose any conditions on that right, it must do so in the relevant bylaw or other instrument creating the right. Otherwise, a right to mandatory advancement is enforceable upon the advancement seeker's satisfaction of any preconditions.[6] For example, section 145(e) conditions advancement to current officers and directors "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 he is not entitled to be indemnified by the corporation,"[7] and provides that the corporation may advance expenses to former officers and directors and other employees and agents "upon such terms and conditions, if any, as the corporation deems

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appropriate."[8] Thus, employees and agents, as well as former officers and directors, are not required by law to provide an undertaking before receiving advancement.

The statute requires neither that the undertaking be secured nor that the director or officer be financially able to repay the corporation.[9] Thus, while a corporation has the "undoubted power to require, either in its by-laws or in a private contract authorized by applicable law, that the recipient of advance indemnification furnish appropriate security or demonstrate financial responsibility as a condition to receiving advances," it cannot require security if the advancement provision set forth in its bylaws or other instrument contains no such requirement.[10]

The *Thompson* Case

The Court of Chancery's recent *Thompson* opinion dealt with an advancement bylaw that was expressly non-mandatory with respect to employee advancement. Scott Thompson, a former employee of Williams Power Company, worked at the company's natural gas trading desk.[11] Indicted in 2006, Thompson was alleged to have participated in a conspiracy to manipulate the price of natural gas and to commit wire fraud.[12] Thompson sought advancement from Williams Power.[13]

Williams Power's bylaws stated, in relevant part, that "[s]uch expenses incurred by other employees and agents shall be paid upon such terms and conditions, if any, as the Board of Directors deems appropriate."[14] The Williams Power board considered Thompson's request and resolved to grant him advancement on the condition that he sign a fully secured undertaking.[15]

The undertaking contained two relevant requirements. The first was that Thompson represent to the board his personal belief that he met the standard for indemnification set forth in the company's bylaws (that he acted in good faith and in a manner he reasonably believed to be in the company's best interests and that he had no reasonable cause to believe his conduct was unlawful).[16] The second was that Thompson provide full security, such as a bond, in case the company determined that he was not entitled to indemnification.[17] Thompson rejected those terms, refused to sign the undertaking, and sued the company.[18]

The Court held that Thompson was not entitled to advancement.[19] The bylaws granted the Williams Power board the ability to place reasonable conditions on the credit it advanced to Thompson—he was never promised unconditional, unsecured advancement.[20] Because the bylaws granted the board the power to fix appropriate terms and conditions, the Court held that Williams Power was not obligated to provide advancement to its employees, even though the bylaws used the word "shall."[21] Moreover, the Court held that the Williams Power board's conditions were rational (even the requirement of full security), especially because Thompson admitted that he lacked the funds to repay his advancement, noting that the board "could not condition Thompson's right to advancement on arbitrary terms not rationally related to a proper corporate interest."[22] Thus, even though Thompson could not afford the security required by the Williams Power board, the Court held that the board did not breach any contractual duty to him by requiring such a security.[23] The Court also did not think it inappropriate for the board to require Thompson to attest to his good faith before granting him advancement.[24]

When Advancement is Mandatory

The *Thompson* Court also alluded to the fact that, by approving mandatory-advancement bylaws, many corporations are put at a "mandatory, unsecured risk of non-repayment."[25] This statement was coupled with several references to the principle that the Court would construe advancement bylaws according to their terms.[26]

The statements in the *Thompson* case, and Vice Chancellor Strine's comments at a recent scheduling conference (held the day after *Thompson* was issued), suggest that the Delaware courts are generally unwilling to let corporations escape their mandatory-advancement obligations. Vice Chancellor Strine stated at the scheduling conference, "[Y]ou know, there is an easy way not to grant advancement, which is don't put it in the bylaws, don't put it in the contract. People need to stop signing things they don't intend to live up to. I don't say that lightly."[27]

The Court of Chancery has before stated that "[m]andatory 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."[28] That is, mandatory-advancement bylaws are beneficial to corporations and are enacted with good reason. The Court's recent statements simply serve to remind corporations and their counsel that the benefit of mandatory-advancement bylaws comes with a corresponding burden—they are *mandatory*, regardless of whether the director or officer is good or bad.

The *Levy* Case: Contribution and Fees on Fees

The Court of Chancery's decision in *Levy* dealt with claims for indemnification brought by the former directors of HLI Operating Company (HLI), a corporation that emerged from Chapter 11 as the operating company of Hayes Lemmerz International, the new parent corporation.[29] In late 2001, HLI publicly announced that it would be restating its financial results for certain periods.[30] Following that announcement, stockholders and bondholders filed suit against the directors, alleging various federal securities law violations.[31] The parties in that lawsuit entered into settlement agreements, under which the insurance carriers contributed approximately $20.3 million toward the settlement and the six former directors of HLI paid $7.2 million.[32] The directors sought indemnification from both HLI and Hayes Lemmerz under various indemnification arrangements[33] but were informed that indemnification would not be forthcoming. In response, the directors sued HLI and Hayes Lemmerz[34] to enforce their right to indemnification.

At first, HLI advanced the attorneys' fees and costs associated with the former directors' pursuit of the claims, subject to a customary undertaking to repay the advanced amounts.[35] In the course of discovery, however, HLI learned that the JLL Fund (which owned approximately 34% of HLI's stock immediately prior to the bankruptcy and which had nominated four of the six directors involved in the suit) had contributed $4.8 million of the settlement amount pursuant to an indemnification obligation of its own.[36] HLI thereupon ceased advancing expenses and sought an order declaring that it was not required to indemnify the JLL-nominated directors for the $4.8 million paid on their behalf by JLL Fund and that those directors were liable for fees already advanced to them.[37]

The Court dismissed the JLL-nominated directors' claims for indemnification against HLI, noting that the directors had already been made whole by the JLL Fund and were not the proper parties to bring the suit.[38] In reaching this conclusion, the Court discussed in some detail the distinctions between indemnification, contribution, and subrogation.[39] The Court noted that, where a director enjoyed mandatory "fullest-extent-of-the-law indemnification rights under two separate contracts—one with the corporation and one with the stockholder responsible for his election to the board"—the co-indemnitors are jointly liable for the claim; but if one of the co-indemnitors pays more than its share of the claim, that co-indemnitor may seek contribution from the other co-indemnitor (and is the proper party to do so).[40]

The Court next addressed whether a provision of the former JLL-nominated directors' indemnification agreements permitted them to retain the fees and expenses advanced to them in connection with their unsuccessful claims for indemnification. The provision in question purported to provide indemnification of fees and expenses regardless of whether the indemnitee was ultimately found to be entitled to indemnification.[41] While noting that the Delaware courts had not previously addressed a corporation's power to provide such expanded rights by contract, the Court stated that the "relevant precedent, as well as the statutory framework of section 145, strongly suggest that such a provision is void"[42] and found the relevant fees-on-fees provision at issue to be invalid.[43] Expressing the public policy behind its conclusion, the Court stated that allowing such a contractual provision to stand would "encourage directors and officers to bring non-meritorious claims against the corporation."[44]

Implications for Practitioners

The problem with mandatory advancement is that, when it is triggered, the director or officer entitled to advancement is often no longer in the corporation's good graces. Like in a marriage, the director and the corporation enter into their relationship on the highest hopes. Then, if things go sour, the corporation may no longer wish to live up to the promises it made when things were going smoothly.[45]

Corporations and their advisors need to think carefully before drafting mandatory-advancement provisions. While such provisions may be necessary to attract qualified and desirable officers, directors, employees, or agents, the corporation should fully appreciate the extent of the commitment it is making. The Delaware courts have made no secret in the past that they will force corporations to live up to those promises, and the courts seem unlikely to change this practice anytime soon. As Vice Chancellor Strine said recently, "I have had many cases where people fight about advancement, and you ask them if they changed their mandatory bylaw to be discretionary, and they say, 'Oh, no. We haven't done that,' but then they are complaining because they have to live up to the plain language of a contract that nobody made them execute."[46] As long as corporations and their counsel know exactly what they are getting into, mandatory advancement raises few concerns. But everyone involved must be aware that the Delaware courts are likely to hold everyone to their agreements, whether they like it or not and without regard to any change in circumstances. One way in which practitioners may strike a balance is to include permissive or qualified advancement provisions in the certificate of incorporation or bylaws, while only providing for mandatory, unqualified advancement in individual agreements.

Furthermore, as the Court in *Thompson* held, conditions need not be spelled out explicitly. By "set[ting] forth the right of the board to impose terms and conditions, [a bylaw] gives fair notice to anyone hoping to rely on that provision that prerequisites to a grant of advancement might be demanded."[47] The Court of Chancery has previously noted that, where a corporation intends to condition the advancement of expenses upon the receipt of a secured undertaking or other proof of the recipient's ability to repay the advanced amounts, it must specify that condition in its bylaws or the other instrument providing the right to advancement.[48] Under the teaching of *Thompson*, a provision granting advancement "on such terms and conditions as the board deems appropriate" will suffice to allow the board to exercise its discretion to determine, based on the unique facts and circumstances that any request for advancement will inevitably present, whether the corporation should require security for an undertaking or impose other prerequisites to the advancement of expenses, so long as those prerequisites are rationally related to a proper corporate interest.

When considering its obligation to indemnify or advance expenses, the corporation should be aware that other parties may have a concurrent obligation and that the corporation may be entitled to contribution. In determining whether it is entitled to contribution for indemnification or advancement that it was obligated to provide, the corporation must determine whether the potential co-indemnitor's indemnification or advancement provisions are similarly mandatory. To the extent a potential co-indemnitor's indemnification or advancement provisions are permissive, or are subject to different or additional conditions, the corporation seeking contribution may have a difficult time establishing its right to any contributed amounts.

Corporations should also review their bylaws and other indemnification instruments to determine whether their fees-on-fees provisions are overbroad and potentially invalid. To the extent that a bylaw or other provision sets forth an unqualified right to fees on fees, the corporation should consider modifying it such that it applies only to the fullest extent permitted by law.

Practitioners should also remember that, if they wish to require undertakings from everyone seeking advancement, they must specify such a requirement in the bylaws or agreement, because the law does not require an undertaking for employees, agents, or former directors or officers. Moreover, if corporations wish these undertakings to be secured, they must affirmatively require this, because the law does not, and the Delaware courts will not allow corporations to require secured undertakings if the corporations' bylaws or agreements do not so provide.

Notes

1. *Thompson v. Williams Cos.*, 2007 WL 2215953 (Del. Ch. July 31, 2007); *Levy v. HLI Operating Co.*,924 A.2d 210 (Del. Ch. 2007).

2. 8 *Del. C.* § 145(e).

3. *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005).

4. *Advanced Mining Sys., Inc. v. Fricke*, 623 A.2d 82, 84 (Del. Ch. 1992).

5. *See id.* (A by-law mandating the advancement of funds on the receipt of an undertaking to repay deprives the board of an opportunity to evaluate the important credit aspects of a decision with respect to advancing expenses.). Section 145(f) of the DGCL provides: "The indemnification and advancement of expenses provided by, or granted pursuant to, the other

subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders, disinterested directors or otherwise . . . ." 8 *Del. C.* § 145(f).

6. *See, e.g.*, *DeLucca v. KKAT Mgm't, LLC*, 2006 WL 224058, at *15–16 (Del. Ch. Jan. 23, 2006); *In re Cent. Banking Sys., Inc.*, 1993 WL 183692, at *3 (Del. Ch. May 11, 1993).

7. 8 *Del. C.* § 145(e).

8. *Id.* Section 145(e) was amended in 1983 to clarify that former directors and officers, as well as employees and agents—unlike current directors and officers—do not have to provide an undertaking to the corporation to repay advanced amounts, but that the board may set the terms and conditions applicable to the advancement of such employees. 63 Del. Laws. ch. 112, § 7 (1983).

9. *In re Cent. Banking*, 1993 WL 183692, at *3.

10. *Id.* at *4.

11. *Thompson v. Williams Cos.*, 2007 WL 2215953, at *1 (Del. Ch. July 31, 2007).

12. *Id*.

13. *Id*.

14. *Id.* (emphasis omitted).

15. *Id*.

16. *Id.* at *2.Note that the standard of conduct for indemnification set forth in Williams Power's bylaws is the same standard set forth in section 145(a) of the DGCL. *See* 8 *Del. C.* § 145(a).

17. *Thompson*, 2007 WL 2215953, at *2.

18. *Id*.

19. *Id*.

20. *Id*.

21. *Id.* at *3.

22. *Id.* at *2; *see also id.* at *4 (stating that the term "appropriate" was "best understood as enabling the board to condition a grant of advancement on terms and conditions that rational directors might believe necessary to protect [Williams] Power's legitimate interests").

23. *Id.* at *4.

24. *Id.* at *6.

25. *Id.* at *5.

26. *Id.* at *3 ("[O]ur law is clear: 'any agreement on the part of a corporation to provide advancement rights should be construed according to its terms.'") ("[I]t is also settled that advancement bylaws are strictly construed according to their terms.").

27. *Zaman v. Amadeo Holdings, Inc.*, C.A. No. 3115-VCS, at 15 (Del. Ch. Aug. 1, 2007) (TRANSCRIPT).

28. *In re Cent. Banking Sys., Inc.*, 1993 WL 183692, at *3 (Del. Ch. May 11, 1993).

29. *Levy v. HLI Operating Co.*, 924 A.2d 210, 213–14 (Del. Ch. 2007).

30. *Id.* at 214.

31. *Id*.

32. *Id*.

33. The former directors had rights to indemnification and advancement under separate indemnification agreements, HLI's bylaws, and certain provisions of HLI's bankruptcy reorganization plan. *Id.* at 214-15.

34. The Court dismissed plaintiffs' claims against Hayes Lemmerz. *Levy v. Hayes Lemmerz Int'l, Inc.*, 2006 WL 985361, at *5–6 (Del. Ch. Apr. 5, 2006).

35. *Levy v.HLI*, 924 A.2d at 217.

36. *Id.*

37. *Id.*

38. *Id.* at 222.

39. *Id.* at 219–21.

40. *Id.* at 222.

41. Section 4 provided as follows:

> The Company shall indemnify Indemnitee against any and all expenses (including attorneys' fees) and, if requested by Indemnitee, shall (within two business days of such request) advance such expenses to Indemnitee, which are incurred by Indemnitee in connection with any action brought by Indemnitee for (i) indemnification or advance payment of Expenses by the Company under this Agreement or any other agreement or Charter or By-law provision now or hereafter in effect relating to Claims for Indemnifiable Events and/or (ii) recovery under any directors' liability insurance policies maintained by the Company, regardless of whether Indemnitee ultimately is determined to be entitled to such indemnification, advance expense payment or insurance recovery, as the case may be.

Id. at 217.

42. *Id.* at 225.

43. *Id.* at 226. The Court noted that the provision should be read "as though 'regardless of whether indemnitee ultimately is entitled to such indemnification, advance expense payment or insurance recovery' did not exist." *Id.* at 227 n.61.

44. *Id.* at 226. In his scheduling conference, Vice Chancellor Strine mentioned fees on fees as another unwelcome fact of life for advancement defendants. He seemed to suggest that, now that fees on fees are available, advancement plaintiffs are not artificially constrained in making their cases. *See Zaman v. Amadeo Holdings, Inc.*, C.A. No. 3115-VCS, at 11 (Del. Ch. Aug. 1, 2007) (TRANSCRIPT).

The Delaware Supreme Court, in 2002, reversed a line of Chancery decisions holding fees on fees unavailable unless a corporation's bylaws expressly provided for them. *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002). Now, a corporation's bylaws must expressly *exclude* fees on fees to

avoid paying them. *SeeFasciana v. Elec. Data Sys. Corp.*, 829 A.2d 178, 182 (Del. Ch. 2003).

45. *See DeLucca v. KKAT Mgm't, LLC*, 2006 WL 224058, at *2 (Del. Ch. Jan. 23, 2006) ("In other words, this is yet another case in which defendants in an advancement case seek to escape the consequences of their own contractual freedom. Regretting the broad grant of mandatory advancement they forged on a clear day, they seek to have the judiciary ignore the plain language of their contracts and generate an after-the-fact judicial contract that reflects their current preference. But it is not the job of a court to relieve sophisticated parties of the burdens of contracts they wish they had drafted differently but in fact did not. Rather, it is the court's job to enforce the clear terms of contracts.").

46. *Zaman*, C.A. No. 3115-VCS, at 15–16; *see also DeLucca*, 2006 WL 224058, at *13 ("Time and again, this court, and recently our Supreme Court in *Tafeen*, has pointed out that sage businesspersons who wish to avoid situations like this must exercise the contractual freedom afforded to them under Delaware law to delimit the circumstances in which they are obliged to advance funds to, or ultimately indemnify, employees and other officials. There is no requirement that advancement provisions be written broadly or in a mandatory fashion. But when an advancement provision is, by its plain terms, expansively written and mandatory, it will be enforced as written.").

47. *Thompson v. Williams Cos.*, 2007 WL 2215953, at *4 (Del. Ch. July 31, 2007).

48. *See, e.g.*, *In re Cent. Banking Sys., Inc.*, 1993 WL 183692, at *4 (Del. Ch. May 11, 1993).

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