

CORPORATE LITIGATION:

ADVANCEMENT OF LEGAL EXPENSES

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Corporate indemnification and advancement of legal expenses are distinct rights, with advancement being a narrower and more provisional contractual benefit. By relieving corporate officials from the personal financial burden of paying ongoing expenses arising from lawsuits and investigations, advancement is widely recognized as an important corollary to indemnification as an inducement to secure able individuals to corporate service. The decision by a corporation to grant advancement of expenses incurred by an officer or director (and sometimes other employees and agents) in defending civil, criminal, administrative or investigative actions is essentially a decision to advance credit to corporate officials, because amounts advanced to them must be repaid if it is subsequently determined that they are not entitled to be indemnified.

Delaware law does not require corporations to advance legal expenses, but most corporations provide broad and mandatory advancement rights to any covered person who must defend a proceeding for which indemnification ultimately could be available. Corporations routinely include mandatory advancement provisions in the bylaws, but they may also sign individual indemnification agreements with officers and directors that cannot be amended without mutual consent. Where advancement rights are provided in both corporate bylaws and an indemnification agreement, and the scope of the advancement rights provided therein differs, the question arises whether the two agreements should be read together or separately. Delaware Court of Chancery Vice Chancellor Tamika Montgomery-Reeves' July 5 decision in *Narayanan v. Sutherland Global Holdings* concluded that different sources of advancement rights need not be considered together; rather, each document conferring advancement rights is a separate and independent source of advancement rights.¹

Prior Delaware Case Law

Prior to the *Sutherland* decision, Delaware lacked clarity regarding whether multiple instruments providing advancement rights should be read together or separately. In 1992, for example, where the Delaware Supreme Court in *Citadel Holding Corp. v. Roven* confirmed the entitlement of a former director to advancement of attorney fees and related expenses, it considered both the company's bylaws and an indemnification agreement entered into by the parties but did not indicate whether it read those documents conjunctively or disjunctively.²

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In *Citadel*, the bylaws granted indemnification “to the full extent permitted by” Delaware law. The relevant indemnification agreement not only provided more detail as to the right to indemnification, but also stated that “[c]osts and expenses (including attorneys’ fees) incurred” in defending any action “shall be paid by [the company] in advance of the final disposition of such matter,” upon the individual’s provision of the statutorily required undertaking to repay amounts advanced if it was ultimately determined that the individual was not entitled to indemnification under the terms of the agreement.

The action against the director, Alfred Roven, alleged that Roven violated Section 16(b) of the Securities Exchange Act of 1934, by obtaining profits on the purchase and sale of the same security within six months. *Citadel* contended the agreement did not cover such an action because a Section 16(b) claim does not arise “by reason of” one’s service as a director, as was required under the indemnification agreement, and because the agreement specifically excluded Section 16(b) actions from indemnification.

Addressing the company’s argument that the advancement provision in the indemnification agreement was never intended to cover the underlying federal action, the court ruled that the meaning of the phrase “any action” in the advancement provision was ambiguous. The court explained that “[r]ead literally, that phrase would require the corporation to advance the costs of defending any type of legal proceeding in which Roven was embroiled, no matter how tenuous its relationship to the business of” the company—a reading that the court viewed as “clearly unreasonable.” Accordingly, to determine the parties’ intent, the court consulted certain recitals contained in the indemnification agreement, which specified “that the purpose of the Agreement was to provide Roven with greater protection than he already enjoyed under the Certificate of Incorporation, Bylaws and insurance provided by *Citadel*.” The court concluded that the advancement provision in the indemnification agreement “must therefore provide Roven with a right to advances broader than that provided by these existing sources.”

In *Levy v. Hayes Lemmerz International*, decided in 2006, the Delaware Court of Chancery interpreted *Citadel* as implying that corporate bylaws and an indemnification agreement should be read together.³ In a footnote, the *Levy* court rejected the plaintiffs’ argument that the company’s bylaws and the indemnification agreements at issue “provide two entirely independent sources of indemnification, and that therefore any procedural requirements for indemnification under the agreements are irrelevant to indemnification under the bylaws.”⁴

Citing *Citadel*, the court explained that “[n]ot only does such a construction of the two documents make nonsense of the indemnification agreements, but it is plainly contradicted by our cases.” The *Levy* court inferred that *Citadel* assumed that the company’s bylaws and the indemnification agreement “would be read together, and firmly rejected the defendant’s position that the indemnification agreement somehow left the advancement provision, at issue in that case, entirely unchanged.”

Though not addressing the issue head on, a decision from Chancellor Andre Bouchard last year suggested that different sources of advancement rights should be evaluated independently of one another. In *Charney v. American Apparel*, the company’s charter required indemnification “to the full extent permitted” by Delaware law and provided for the advancement of expenses incurred by an indemnitee in any proceeding which may ultimately be indemnifiable.⁵ Introducing the relevant indemnification agreement, the court stated that “separate from and in addition to” this charter provision, “the Company agreed to indemnify and to advance certain of [the plaintiff’s] expenses under his Indemnification Agreement.”

‘Sutherland’

In *Sutherland*, Vice Chancellor Tamika Montgomery-Reeves clarified Delaware’s position on how two sources of indemnification and advancement should be read. Underlying *Sutherland* were three actions involving a former director of Sutherland Global Holdings, Inc. and its India subsidiary. The first was a civil lawsuit initiated by this former director, Muthu Narayanan, against Sutherland for breach of contract and unjust enrichment; the other two actions were criminal proceedings in India against Narayanan. After Sutherland ignored Narayanan’s request for indemnification and advancement of legal fees, Narayanan sued Sutherland in Delaware. Narayanan submitted a supplemental demand for indemnification and advancement for fees incurred in pursuing the Delaware action.

In its analysis regarding Narayanan’s entitlement to advancement, the Court of Chancery parsed three instruments implicating the director’s “disputed right to advancement.”⁶ The first was Sutherland’s certificate of incorporation, which authorized the company, to the fullest extent permitted by law, “to provide indemnification of (and advancement of expenses to) [Narayanan] . . . through bylaw provisions, agreements . . . , vote of stockholders or disinterested directors or otherwise, in excess of the indemnification and advancement otherwise permitted by Section 145” of the DGCL, subject to certain limitations outlined in the DGCL or other state laws, “with respect to actions for breach of duty to a company, its stockholders, and others.”

Second, Sutherland’s bylaws conferred such expanded rights, providing indemnification and mandatory advancement of expenses. The bylaws further indicated that if a claim for indemnification or advancement of expenses is not paid in full within 30 days, an individual who pursues a successful claim to enforce these rights is entitled to “fees on fees.” The bylaws explicitly provided that the indemnification and advancement rights therein are not exclusive of any other rights to which the covered person may be entitled.

Third, Sutherland and Narayanan entered into an indemnification agreement, expanding Narayanan’s rights beyond those conferred by the certificate of incorporation and bylaws. The agreement included both an indemnification clause and a provision mandating advancement. Notably, the agreement also contained a provision, which did not appear in the company’s bylaws, stating that “as a condition precedent” to Narayanan’s right to be indemnified or to receive expense advances under the agreement, Narayanan is required to (1) “give the Company notice in writing as soon as practicable of any Claim made against [him] for which indemnification, exoneration or hold harmless right will or could be sought under this Agreement”; and (2) “give the Company such information and cooperation as it may reasonably require and as shall be within [his] power.”

Finally, like the company’s bylaws, the indemnification agreement provided that the indemnification and advancement rights contained in the agreement were non-exclusive of any rights conferred by the company’s certificate of incorporation, bylaws, other agreements, or the DGCL.

Because of the condition precedent contained in the indemnification agreement but not in the bylaws, the Court of Chancery grappled with whether the two instruments “must be read conjunctively or disjunctively.” Sutherland asserted that Narayanan was not entitled to advancement because he did not adequately cooperate with Sutherland’s 2013 internal investigation into certain land acquisition projects or with Sutherland’s attempts to recover funds advanced to a particular land aggregator.

“[B]ecause the parties entered into the agreements contemporaneously and thereby intended the Bylaws and Indemnification Agreement to be read conjunctively,” Sutherland argued, the court should enforce the Cooperation Provision as a condition precedent to Narayanan’s right to receive advancement under either source.” Narayanan responded that the company’s bylaws were “a separate and independent source of advancement rights” and included no cooperation requirement.

The court began its analysis with Section 145(f) of the DGCL, which states, in relevant part, that the indemnification and advancement of expenses provided by or granted pursuant to the DGCL “*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,” etc.⁷ The court further noted that, in modernizing the DGCL in 1967, the legislative drafting committee explained that “the power to indemnify was ‘non-exclusive so that other rights to indemnification may still exist by contract, by-law or charter within such limits of public policy as the courts may establish.’” The court confirmed that an express contract can provide indemnification and advancement outside the terms of the statute.

The court then addressed previous Delaware case law touching on the issue. From *Charney*’s statement that the parties in that case entered into an indemnification agreement “separate from and in addition to” the company’s charter, the court reasoned that the *Charney* court “recognized that the company validly had exercised its authority under Section 145(f) to grant the director multiple sources of separate and independent advancement rights.” “In other words,” added the *Sutherland* court, “*Charney* stands for the proposition that the unavailability of advancement under one source of rights does not foreclose the possibility of advancement under another.”

Turning to *Levy*, *Sutherland* found the footnoted rejection in that decision of the argument that corporate bylaws and indemnification agreements provide two independent sources of indemnification to be “dicta and not controlling.” Notably, the *Sutherland* court also interpreted *Citadel* differently than the *Levy* court did. The *Sutherland* court explained that in *Citadel*, the Delaware Supreme Court “determined that, although the directors there were not entitled to mandatory advancement under the DGCL or the company’s bylaws, the directors were entitled to mandatory advancement under an indemnification agreement.” According to *Sutherland*, “[t]he Supreme Court’s recognition of a contract that provides unique advancement rights not provided elsewhere—like a statute, certificate, or bylaws—supports the proposition that, in the absence of evidence to the contrary, contractual advancement rights are separate and independent from those found in other sources.”

The court then examined the specific advancement provisions in the case before it and found them unambiguous. Sutherland’s certificate of incorporation authorized the company to grant Narayanan the advancement rights set forth in the company’s bylaws and the indemnification agreement. Each of these latter two documents, in turn, employed language substantially similar to Section 145’s non-exclusivity clause, declaring that the document is not exclusive of any other source of rights. The non-exclusivity provision in each of these documents, the court found, “manifests the parties’ express intent for each instrument to provide rights and obligations independent of the other.”

In response to Sutherland’s reliance on the rule that contracts executed by the same parties in a single transaction must be construed together, the court explained that “[c]onspicuously absent from Sutherland’s recitation” of this rule is “the rule’s qualifying condition, ‘in the absence of evidence to the contrary.’” Finding that the relevant contractual provisions in the case before it “present ample evidence to the contrary,” the court declined to apply the rule cited by Sutherland.

Concluding that Sutherland failed to prove that the company's bylaws and the indemnification agreement were intended to operate conjunctively, the court held that the two instruments were "separate and independent sources of advancement rights." The court ruled that Narayanan was entitled to the advancement of fees and expenses he incurred in connection with both the underlying proceedings and the Delaware action, plus pre-judgment interest.

Significance of 'Sutherland'

Unlike prior Delaware decisions, *Sutherland* directly addresses the treatment of separate instruments that confer advancement rights to the same corporate official, bringing clarity to an issue that arises with some frequency. In light of *Sutherland's* conclusion that, absent evidence of intent to the contrary, instruments containing advancement provisions should be read separately, Delaware courts will likely apply the most expansive among conflicting advancement provisions.

In the drafting of indemnification agreements, attention to aligning the scope of all potential sources of indemnification-related rights is essential. Corporate counsel should bear in mind that a more restrictive or conditional right to advancement than that provided in the company's bylaws is unlikely to be enforced in the face of broader rights set forth in another instrument. Counsel wishing to create an enforceable right to advancement that is narrower than that contained in the company's bylaws must ensure that the indemnification agreement unambiguously expresses the parties' intent that the agreement operate in conjunction with the company's bylaws.

¹ 2016 WL 3682617 (Del. Ch. July 5, 2016).

² 603 A.2d 818 (Del. 1992).

³ 2006 WL 985361 (Del. Ch. April 5, 2006).

⁴ Id. at *7 n.24.

⁵ 2015 WL 5313769, at *6 (Del. Ch. Sept. 11, 2015) (quoting the defendant company's charter).

⁶ *Sutherland*, 2016 WL 3682617, at *5.

⁷ Id. at *9 (quoting 8 Del. C. §145(f)) (emphasis added by court).

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