DIRECTOR AND OFFICER LIABILITY

Indemnification and Advancement Claims Where a Director Has Multiple Sources of Advancement and Indemnification Available

Since the Delaware Court of Chancery decided Levy v. HLI Operating Co., *in 2007, a series of cases in Delaware have examined indemnification and advancement rights involving multiple indemnitors. In the most recent of these cases,* Pontone v. Milso Industries, *Vice Chancellor Parsons held that a director did have standing to pursue advancement for incurred but unpaid, and for future fees and expenses.*

By Peter L. Welsh, C. Thomas Brown, and Elizabeth D. Johnston

In *Levy v. HLI Operating Co.*,[1] the Delaware Court of Chancery held that an indemnified director who had been fully reimbursed for litigation and settlement expenses by one indemnitor lacked standing to pursue indemnification from another indemnitor, because the director could not show financial loss. In that case, the director was the designee of the company's private equity sponsor, and the private equity fund's limited partnership agreement provided for mandatory advancement and indemnification. The fund had paid his expenses after the portfolio company refused. Soon after *Levy* was decided, in *Schoon v. Troy Corp.*,[2] the Court declined to extend *Levy*'s reasoning to circumstances where a shareholder voluntarily undertakes to advance defense expenses for the benefit of its board designee, where the designee was obligated to repay such amounts to the shareholder. The *Schoon* Court held that a party receiving voluntary advancement from one source had standing to pursue mandatory advancement from another source.[3]

The *Levy* and *Schoon* decisions led a number of large investors, private equity sponsors in particular, to refine their approach to advancement and indemnification provisions at both portfolio companies and at the fund level. Key areas of concern included whether advancement provisions were mandatory or voluntary, and the priority of indemnification obligations. *Levy* prompted surprise among many private equity sponsors who had presumed that company-level indemnification was primary to fund-level indemnification. But the relevant indemnification provisions were, in fact, written in a way that did not establish priority, leaving the fund standing as a primary indemnitor. This despite the fact that it had presumed it was merely a backstop to company-level indemnification. Many sponsors quickly revised their indemnification and advancement provisions.

Variations on the *Levy* pattern—situations where a director has multiple potential sources of advancement and indemnification—continue to appear in Delaware courts.[4] In the most recent of these cases, *Pontone v. Milso Industries Corp.*,[5] the Delaware Court of Chancery last month considered whether, under both 8 *Del. C.* ¶ 145 and the applicable agreements among the parties, a former officer and director of two Delaware companies

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had standing to assert a claim for advancement for legal fees and expenses he incurred in litigation against those companies, where the director had another source of potential advancement. In a lengthy opinion, Vice Chancellor Parsons held that (1) a director has standing to assert a claim for advancement as to expenses, both incurred but unpaid and not yet incurred, for which he has not yet received advancement from another source that is obligated to advance (2) a director does not have standing to assert an advancement claim against the companies as to expenses for which the director has already received payment of advancement from the other source and (3) a director may obtain a pro-rated portion of "fees on fees," as well as prejudgment interest, for his attempts to prosecute an advancement claim, notwithstanding the fact that he has not been 100 percent successful in prosecuting his claims.

The *Pontone* opinion highlights how crucial the wording of advancement and indemnification provisions can be to a director's ability to pursue his or her rights in the midst of litigation. The decision also highlights the need for directors, companies, and sponsors to consider the contractual terms that govern alternative sources of indemnification.

Case Background

Scott Pontone was until mid-2005 the Vice President of Old Milso, a casket company (styled a "death services business") founded by his grandparents in the 1930s. Scott and his father, Harry Pontone, ran Old Milso. Matthews, seeking to break into the casket business, made a deal with the Pontones wherein Matthews would acquire Old Milso but with Scott and Harry remaining in similar leadership positions as those they held at Old Milso. Old Milso entered into an Asset Purchase Agreement (APA) with York and New Milso, a newly formed acquisition subsidiary. The APA provided that Harry and Scott would become officers and directors of Matthews' new business. On July 11, 2005, Scott became Executive Vice President of York and New Milso and director of both companies. In addition, Harry became the President and director of both companies.

In 2007, in litigation unrelated to the Delaware advancement and indemnification action, Scott and Harry brought suit to enforce their rights under employment agreements with York. The parties settled the employment suit in May 2007; and, as a result, Scott resigned from his positions with York and New Milso, and agreed not to compete with or solicit customers of York and New Milso for three years. Following the expiration of that period, Scott entered into a consulting contract (Consulting Agreement) with Batesville Casket Company (Batesville), a competitor of York and New Milso.

On August 16, 2010, York, New Milso, and Matthews (the Pennsylvania Plaintiffs) brought suit against Scott and Batesville in the United States District Court for the Western District of Pennsylvania challenging the Consulting Agreement (the Pennsylvania Action).[6] The Pennsylvania Plaintiffs alleged that Scott, using his access to York and New Milso's confidential information and trade secrets, and the other defendants wrongly schemed to induce several of their employees and customers to move to Batesville. In response, Scott asserted various counterclaims. The Pennsylvania Action is still pending.

On January 17, 2013, the Court of Chancery granted partial summary judgment in favor of Harry in a separate advancement action, finding he had a right to receive advancement from New Milso for expenses he had incurred in the Pennsylvania Action.[7] Because the Court found York's bylaws to be ambiguous as to whether they provided for mandatory or permissive advancement, the Court denied summary judgment with respect to Harry's claim for advancement from York. Thereafter Scott sought advancement from New Milso and York for the legal fees and

expenses he had incurred in the Pennsylvania Action since January 2013. Prior to submitting his demand for advancement, however, Scott executed a loan agreement with Batesville (the Loan Agreement), under which Batesville agreed to provide Scott with funds to pay his legal fees and expenses in the Pennsylvania Action and in any advancement proceeding against York or New Milso. On August 26, 2013, Scott filed an advancement proceeding in the Chancery Court against New Milso and York. Defendants moved to dismiss, arguing Scott lacked standing to pursue advancement from them because of his agreement with Batesville, which provides for mandatory advancement and also because Scott will be entitled to indemnification by Batesville under the terms of the Consulting Agreement and the Loan Agreement.

For the reasons explained below, the Vice Chancellor Parsons concluded that Scott had standing to pursue claims for advancement of fees incurred after January 2013, and thus denied defendants' motion to dismiss. At the same time, the Court concluded that with respect to fees incurred prior to January 2013, which Batesville had already advanced, Scott lacked standing.

The Relevant Indemnification and Advancement Provisions

Both York and New Milso have bylaws (which were differently worded from one another) addressing indemnification and advancement. Because the Vice Chancellor's decision rested, in part, on a close reading of those provisions, and of the provisions of the agreements between Scott and Batesville, we first describe the provisions in detail.

New Milso's bylaws include a "Right to Indemnification" provision, which provides:

> Except as prohibited by law, every director and officer of [New Milso] shall be entitled as of right to be indemnified by [New Milso] against all expenses and liability … incurred by such person in connection with any actual or threatened claim, action, suit or proceeding … whether brought by or against such person or by or in the right of the Corporation or otherwise, in which such person may be involved, as a party or otherwise, by reason of such person being or having been a director or officer of [New Milso] … (such claim, action, suit, or proceeding hereinafter being referred to as an "Action"); provided, however, that no such right to indemnification shall exist with respect to an action brought by an indemnitee … against [New Milso] (an "Indemnitee Action") except …. [if] the Indemnitee Action is instituted under Paragraph (c) of this Section and the indemnitee is successful in whole or in part ….

"Expenses" are defined as "all expenses actually and reasonably incurred, including fees and expenses of counsel." "Liability" means "all liability incurred, including the amounts of any judgments, excise taxes, fines or penalties and any amounts paid in settlement."

New Milso's bylaws also contain a "Right to Advancement of Expenses," which provides for mandatory advancement:

> Every indemnitee *shall be entitled as of right* to have the expenses of the indemnitee in defending any Action or in bringing and pursuing any Indemnitee Action under Paragraph (c) of this Section *paid in advance* by [New Milso] *prior to final disposition* of the Action or Indemnitee Action, provided that the Corporation receives a written undertaking by or on behalf of the indemnitee to repay the amount advanced if it should ultimately be determined that the indemnitee is not entitled to be indemnified for the expenses. (emphasis added)

New Milso's bylaws also include a "Right of Indemnitee to Bring Action" that permitted Scott to bring suit to enforce his claims.

York's bylaws, like Milson's, also provided for separate indemnification and advancement obligations. Specifically, York's bylaws include a section "Obligation to Indemnify in Actions, Suits or Proceedings by or in the Right of the Corporation," which provides:

> [York] shall indemnify any person who was or is a party to any threatened, pending, or completed action or suit by or in the right of [York] to procure a judgment in its favor by reason of the fact that he is or was a director, officer, employee or agent of [York]… except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to [York.]

In contrast to Milson's bylaws, the "Expenses Payable in Advance" provision in York's bylaws was ambiguous as to whether advancement was mandatory or discretionary, given two possibly contradictory clauses. The preamble to Article VII of York's bylaws suggests mandatory advancement, stating that "[York] *shall indemnify and advance expenses* under this Article VII to the fullest extent permitted by applicable law in effect on the date of adoption of these Bylaws and to such greater extent as applicable law may thereafter permit." (emphasis added). On the other hand, Section 7 of Article VII of York's bylaws, entitled "Expenses Payable in Advance," suggests that advancement is only permissive:

> Expenses incurred in defending or investigating a threatened or pending action, suit or proceeding *may be paid* by [York] in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of the director, officer, employee or agent to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by [York] as authorized in this Article VII. (emphasis added).[8]

Scott also had indemnification rights from Batesville under the Consulting Agreement. In addition, the Loan Agreement created what was, in effect, an advancement right. It explicitly stated that its purpose was to provide Scott with all funds necessary for Scott "to pay all fees, expenses, and costs previously incurred and to be incurred" by him and PCC in the Pennsylvania Action and by him in the advancement proceeding ("Qualifying Expenses"). The Loan consisted of an initial loan advance, as well as subsequent loan advances that Scott may request from Batesville. Specifically, the Loan Agreement provided:

> On the date hereof [April 7, 2013]…[Batesville] shall make a Loan Advance to [Scott Pontone] in the amount of $388,535.81 (the 'Initial Loan Advance'). The Initial Loan Advance represents the unpaid balance of fees and expenses incurred through January 31, 2013 by [Scott Pontone], plus a $15,000 retainer payable to Delaware counsel retained by [Scott Pontone] to act as local counsel in connection with the Advancement Proceeding.

The Loan Agreement also permitted Scott to make written requests for additional funds that Batesville was bound to honor. Finally, the Loan Agreement required Scott to use any surplus advancement obtained from York or New Milso to repay the Loan.[9]

The Court's Analysis

Defendants contended that Scott lacked standing to assert his advancement claims because, pursuant to the Consulting Agreement and the Loan Agreement, Batesville was obligated to (and in fact already had) advanced Scott's fees and expenses in connection with the Pennsylvania Action. Defendants described the Loan Agreement as

a sham disguise for a mandatory advancement and indemnification agreement, and that it had been structured to make the loan secondary to advancement/indemnification rights vis-a-vis the other indemnitors. Because Scott already had received and would continue to receive mandatory advancement from Batesville, and would ultimately be indemnified by Batesville, Defendants asserted that Scott could not demonstrate he *had suffered* or *would suffer* any out-of-pocket expenses, both of which they argued were prerequisites to assert standing for advancement claims under *Levy* and its progeny. Vice Chancellor Parsons accepted Defendants' argument that the Loan Agreement with Batesville effectively provided Scott with mandatory rights to advancement. Nonetheless, he found that Scott did have standing to pursue advancement against York and New Milso.

The Court's analysis began by construing York's and New Milso's advancement bylaw. Vice Chancellor Parsons concluded that the bylaws entitled Scott to advancement for any outstanding legal expenses incurred in the Pennsylvania Action since January 2013 for which Scott had not yet requested or received funding from Batesville. The fact that Scott had requested and received advancement from Batesville in the past did not preclude or undermine his independent contractual right to advancement under the byalws of York and New Milso. The Court noted that York and New Milso could have contracted around this issue by stating in their bylaws that they would provide advancement only to the extent that covered individuals are unable to obtain advancement from other sources.[10]

Having concluded that Scott had a contractual right to expenses incurred since January 2013, the Court turned to whether Scott had standing to assert his advancement claim under *Levy* and its progeny. Defendants argued that *Levy*'s reasoning applied because the Batesville advancement arrangement ensured that Scott not only had not suffered any actual loss, but also that he would not suffer any loss in the future. Vice Chancellor Parsons rejected this argument. Citing *Levy* and *Schoon*, as well as *DeLucca v. KKAT Mgmt., L.L.C.*,[11] he reasoned that to hold that depriving an indemnitee of standing to pursue mandatory advancement from one source, because another source of mandatory advancement was both available and meeting its obligations, would create a perverse incentive. It would encourage companies to delay paying advancement in the hopes they will be let off the hook by someone who is equally obliged to advance. Accordingly, the motion to dismiss Scott's advancement claims for unpaid and future expenses was denied. The holding in *Levy* did, however, deprive Scott of standing to pursue indemnification for legal expenses for which he has already received funding from Batesville up to January 2013. Those claims were dismissed. Under *Levy*, the opinion noted, Batesville was left to pursue a contribution action against its co-indemnitors York and New Milso for amounts already paid.

Because the Court concluded that Scott had standing to pursue fees for which he had not yet received funding, it addressed Scott's motion for partial summary judgment for fees related to specific claims. The Court first determined that only New Milso's bylaws were sufficiently straightforward to permit a conclusion at the summary judgment stage that advancement was mandatory, not permissive. On the other hand, York's bylaws were too ambiguous for the Court to make a determination at this stage. Thus, turning to New Milso's obligations pursuant to its mandatory advancement obligation, the Court concluded that Scott was entitled to advancement for his defamation counterclaim because it was essentially a compulsory counterclaim.[12]

Finally, because Scott had successfully demonstrated he had standing, at least with respect to advancement claims for fees post-January 2013, and because he had succeeded at the partial summary judgment stage, at least with respect to New Milso's bylaws and mandatory advancement for one of Scott's counterclaims, the Court awarded Scott 75 percent of "fees on fees," with prejudgment interest.

The Takeaways from *Pontone*

Pontone offers several lessons regarding indemnification and advancement under Delaware law.

First, the case is a reminder that scenarios involving multiple indemnitors (with equal or different priority) come in many different varieties. Indemnitors and indemnitees in contexts beyond the private equity/portfolio company context also need to be mindful of the importance of addressing up front any issues relating to multiple sources for advancement or indemnification.

Second, *Pontone* shows that indemnitors cannot use *Levy*'s standing requirements to shirk advancement liability for incurred but unpaid and for future expenses that are subject to advancement. This avoids the perverse incentive to dodge advancement obligations in the hope that they can be avoided when another party meets its obligation. And, it puts recalcitrant parties who owe advancement on notice of the risk of "fees on fees" awards.

Third, *Pontone* demonstrates the importance of pursuing advancement rights early on in litigation. By the time Scott Pontone established his rights against York and New Milso, Batesville already had shouldered eighteen months' worth of costs. With Scott lacking standing to pursue those costs under *Levy*, Batesville is left to pursue a contribution action against New Milso and York. Batesville would have done well to encourage Scott to bring his contribution action much earlier, thereby reducing the amount at issue in any contribution action.

Finally, *Pontone* provides an interesting example of the variety of approaches to contract around potential advancement and indemnification problems. Here, the Loan Agreement permitted Scott to pursue his advancement claim while protecting the ability of Batesville to recover any amounts that Scott ultimately received from the other indemnitors. Note also that the Loan Agreement included a forgiveness provision in case Scott could not ultimately collect any amounts from York or New Milso. An interesting twist in a future case would be a forgiveness provision that only provides for partial release, to the extent of the lending party's co-indemnity obligation. In that instance, an indemnitee like Scott might argue that he has a loss and therefore standing to pursue the co-indemnitor.

Conclusion

Just as *Levy* first drew sharper attention to questions of priority in advancement and indemnification cases, *Pontone* serves as yet another reminder that the case law is developing and that various iterations of the *Levy* scenario appear frequently. Parties, whether they be an indemnitor or an indemnitee, are well served in working through these issues in advance so they have some certainty as to their obligations in the future.

Notes

1. 924 A.2d 210, 214 (Del. Ch. 2007).
2. 948 A.2d 1157, 1159 (Del. Ch. 2008).
3. Both *Levy* and *Schoon* were discussed more fully in the August, 2008 and September, 2008 issue of *Insights*. *See* Randall W. Bodner and Peter L. Welsh, "Delaware Reinforces the Limits on Indemnification Claims," *Insights* (August 2008); Randall W. Bodner and Peter L. Welsh, "Advancement and Indemnification Update: *Sadona v. American Stock Exchange*," *Insights* (September 2008).
4. *See, e.g., Sadona v. American Stock Exchange LLC*, C.A. No. 3418-VCS, 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008). *Sadona* was discussed more fully in the September, 2008 issue of *Insights*. *See* Randall W. Bodner and Peter L. Welsh, "Advancement and Indemnification Update: *Sadona v. American Stock Exchange*," *Insights* (September 2008).
5. C.A. No. 8842-VCP (Del. Ch. Aug. 22, 2014).
6. *York Gp., Inc. v. Pontone*, 2014 WL 896632 (W.D. Pa. Mar. 6, 2014); *York Group v. Pontone*, 2012 WL 3127141 (W.D. Pa. July 31, 2012).
7. *Pontone v. Milso Indus. Corp.*., C.A. No. 7615-VCP (Del. Ch.).
8. *Pontone v. Milso Indus. Corp*., 2014 WL 4178303 at *18.
9. Slip. op. at 13, 2014 WL 4178303 at *6.
10. Slip. op. at 26-27, 2014 WL 4178303 at *11-12.
11. 2006 WL 224058 (Del. Ch. Jan. 23, 2006).
12. The Court reached the opposite conclusion with respect to Scott's counterclaim for false advertising.