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Negotiate With Care: Recent Delaware Developments Relating to Indemnification and Advancement

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In the first half of 2008, the Delaware Court of Chancery rendered a number of decisions addressing the indemnification and advancement rights of officers and directors under Delaware law. Two of those decisions—*Schoon* v. *Troy Corporation*[1] and *Jackson Walker L.L.P.* v. *Spira Footwear, Inc.*[2] —are particularly noteworthy from the perspective of a M&A lawyer. In *Schoon*, the Court found that a bylaw amendment eviscerated a former director's right to mandatory advancement with respect to a proceeding commenced after the effectiveness of such amendment. In *Jackson Walker*, the Court determined that a law firm acting as local litigation counsel for a corporation was an agent of the corporation and thus was entitled to mandatory advancement of expenses under the corporation's bylaws in connection with a suit brought by the corporation against the law firm. Each of those decisions has a direct bearing upon the negotiation of indemnification provisions in acquisition agreements and leads to certain practical lessons that should be considered by counsel when negotiating such provisions.

Indemnification Provisions Generally

Merger agreements typically provide for the continuation, following the effective time of a merger, of indemnification and advancement rights of those persons who were serving as officers and directors of a selling corporation immediately prior to the effective time of the merger.[3] Although the protections in such provisions vary widely depending upon the outcome of the negotiations, the typical provision generally provides that the rights to indemnification and advancement under the seller's certificate of incorporation, bylaws or indemnification agreements will survive the merger and be observed by the surviving corporation, to the fullest extent permitted by Delaware law, for an agreed period of time (often six years) following the effective time of the merger. In addition, such provisions often provide that the surviving corporation will maintain in effect, for the benefit of the officers and directors of the selling corporation, the existing directors' and officers' liability insurance policy or an equivalent replacement policy, in each

1 2008 WL 2267034 (Del. Ch. Mar. 28, 2008).

2 2008 WL 2487256 (Del. Ch. June 23, 2008).

3 The General Corporation Law of the State of Delaware generally provides that obligations (*e.g.*, indemnification and advancement obligations) will vest in a corporation surviving a merger. *See 8 Del. C.* §§ 145(h), 259.

case often capped at a premium in the range of 150-300% of the current premium, with respect to acts or omissions occurring prior to the effective time of the merger.

A selling corporation may also seek to negotiate for additional protections, including (i) a specific prohibition, for a period of six years following the consummation of the merger, of any amendment of the surviving corporation's constituent documents that would have an adverse effect on the indemnification and advancement rights of a seller's current or former officers and directors, or (ii) a primary obligation by the parent buyer, in a triangular merger, to provide direct contractual indemnification and advancement rights to the seller's officers and directors with respect to acts or omissions occurring prior to the effective time of the merger. It is with respect to these additional protections that the recent Delaware case law has a direct bearing.

Recent Delaware Developments

Schoon v. *Troy Corporation*

In *Schoon*, Vice Chancellor Lamb considered, among other things, the advancement rights of William J. Bohnen ("Bohnen"), a former director of Troy Corporation ("Troy"). Bohnen was the board nominee of Steel Investment Company ("Steel") from 1988 until February 2005, at which time Richard W. Schoon ("Schoon") replaced Bohnen. In 2004, Steel decided to sell its interest in Troy and agreed to make incentive payments to Bohnen and Schoon if they could effectuate the sale by December 2005.

In order to value its stake in Troy, Steel made a books and records demand on Troy. After replacing Bohnen as a director, Schoon made a separate demand, alleging that his purpose was to "fulfill [his] fiduciary duties as a director of Troy."[4] Steel and Schoon deemed Troy's response to their demands unsatisfactory and proceeded to file separate actions under Section 220 of the General Corporation Law of the State of Delaware, which the Court later consolidated (the "Section 220 Action"). Although Troy initially attempted to interject fiduciary duty claims against both Schoon and Bohnen in the Section 220 Action, the Court denied that attempt, which encouraged Troy to bring the fiduciary duty claims in a separate action (the "Fiduciary Duty Action").

Before Troy asserted the fiduciary duty claims, its board of directors amended Troy's bylaws to remove the word "former" from the definition of the directors entitled to advancement of expenses. It also added language that attempted to limit the right to advancement by providing that Troy would not indemnify or advance expenses to any person in connection with any

4 *Schoon*, 2008 WL 2267034, at *1.

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proceeding (other than any counterclaim, cross-claim, or third-party claim brought in such proceeding) that was initiated against Troy by such person unless the proceeding had been authorized by the board of directors.

While the proceedings were pending, Bohnen and Schoon formally demanded advancement of their expenses in defending the fiduciary duty claims, both in connection with Troy's attempt to assert the claims in the Section 220 Action and later in the Fiduciary Duty Action. After making several requests, Bohnen and Schoon filed suit in the Court of Chancery seeking advancement of their expenses. Troy contended that only Schoon was entitled to any advancement, and further argued that Schoon's expenses should be reduced by 80% because his invoice included costs incurred in connection with the legal fees of defendants who were not entitled to indemnification or advancement from Troy.

The Court determined that, as a former director, Bohnen was not entitled to advancement under Troy's amended bylaws. In reaching that conclusion, the Court rejected several arguments asserted by Bohnen.

First, Bohnen argued that his rights in the pre-amendment bylaws, which granted former directors the right to advancement, vested before the adoption of the amendment. For that proposition, Bohnen cited *Salaman* v. *National Media Corp*.[5] In *Salaman*, a corporation, after advancing to a director a portion of the fees incurred in defending a fiduciary duty claim, amended its bylaws to repeal the basis for the claimed right to advancement and then refused any further advancement. The Court held that the director's contract rights, embodied in the pre-amendment bylaws, vested when the defendant's obligations were triggered—the date of the filing of the pending action. In rejecting Bohnen's reliance on *Salaman*, Vice Chancellor Lamb noted that Bohnen "fail[ed] to acknowledge that the court only upheld Salaman's right to advancement because he was named as a defendant before the bylaw was amended."[6] Thus, even though the alleged breaches occurred before the bylaw amendments limiting advancement rights, Bohnen's rights under the pre-amendment bylaws had not been triggered because he was not named as a defendant until *after* the Troy board amended the bylaws (nor was there any evidence that Troy was even contemplating claims against Bohnen prior to the amendments).

Alternatively, Bohnen argued that even if his rights to advancement were to be determined under the amended bylaws, language in those bylaws clearly provided that "rights conferred . . . shall continue as to a person who has ceased to be a director."[7] The Court also rejected this argument. The language was better understood, the Court explained, as ensuring that a director whose advancement rights are triggered while in

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5 1992 WL 808095 (Del. Super. Oct. 8, 1992).

6 *Schoon*, 2008 WL 2267034, at *5.

7 *Id.* at *6.

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office will not lose such rights by ceasing to serve as a director. Bohnen's rights were never triggered, and therefore such language was not applicable. Further, the provision Bohnen referenced was contained in a section entitled "Non-exclusivity and Survival of Indemnification" and related to indemnification only.[8] Noting that Delaware case law has "consistently held that advancement and indemnification, although obviously related, are 'distinct types of legal rights,'" the Court held that "the language of the bylaws deliberately and unambiguously provides for unequal treatment of current and former directors in receiving advancement."[9] As such, Bohnen was not entitled to advancement under Troy's bylaws.

Jackson Walker L.L.P. v. *Spira Footwear, Inc.*

In *Jackson Walker*, the central issue was whether, based upon its status as former outside litigation counsel for Spira Footwear, Inc. ("Spira"), Jackson Walker L.L.P. ("Jackson Walker") qualified as an "agent" eligible for mandatory advancement under Spira's bylaws and Section 145 of the General Corporation Law of the State of Delaware ("Section 145"). The Court concluded that Jackson Walker was an "agent" and was therefore entitled to the advancement of its reasonable expenses incurred in an action brought against Jackson Walker by Spira.[10]

The circumstances out of which the action arose involved a dispute between Andrew Krafsur ("Andrew"), then CEO of Spira and owner of 22% of Spira's outstanding shares, and his brother David Krafsur ("David"), who along with Francis LeVert ("LeVert") controlled a majority of Spira's outstanding shares. After relations soured between Andrew and David, Spira initiated litigation against David and LeVert for breaches of fiduciary duty. David and LeVert responded in kind by terminating Andrew from his position as CEO of Spira and causing Spira to dismiss the action against them. David and LeVert also filed a separate action in Texas state court (the "El Paso Action") seeking to have the Court invalidate a stockholders agreement that had been entered into between the three stockholders.

Spira, now under the control of David and LeVert, retained Jackson Walker as its counsel for the El Paso Action. Thereafter, Jackson Walker filed a Plea of Intervention on Spira's behalf in the El Paso Action, seeking a declaratory judgment that the stockholders agreement was unenforceable and that various actions subsequently taken by David and LeVert were proper. Thereafter, a settlement was reached in the El Paso Action under which Andrew purchased David and LeVert's controlling interest in Spira.

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8 *Id.*

9 *Id.* (citing *Senior Tour Players 207 Mgmt. Co. LLC* v. *Golftown 207 Holding Co.*, 853 A.2d 124, 128 (Del. Ch. 2004)).

10 2008 WL 2487256, at *6.

Upon regaining control of Spira, Andrew ordered Jackson Walker to cease all work for Spira and then amended Spira's plea in the El Paso Action, adding Jackson Walker as a defendant. The amended plea claimed Jackson Walker had breached its fiduciary duties by wrongfully filing the Plea in Intervention on behalf of Spira, which allegedly was "blatantly designed to further the interests of . . . David Krafsur and Francis LeVert to the detriment of Spira."[11] Jackson Walker responded by filing an advancement action in the Delaware Court of Chancery.

The Court began its analysis by noting that a corporation's bylaws are contractual in nature and advancement rights are thereby conferred by contract, with Section 145 providing the statutory framework for when and how a corporation may provide such rights to its officers, directors, employees or agents. Spira's mandatory advancement provision read as follows: "[E] xpenses . . . incurred in defending a civil or criminal action, suit or proceeding shall be paid by the Corporation in advance of the final disposition . . . on behalf of the Director, officer, employee or agent."[12] In addition, Spira's bylaws provided for mandatory indemnification rights to the fullest extent permitted by law, stating that Spira was obligated to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding "by reason of the fact" that such person was a director, officer employee or agent of Spira.[13] Thus, to qualify for advancement, Jackson Walker was required to prove to the Court that it was a party to the El Paso Action by reason of the fact that it was an agent of Spira. With there being no dispute that Jackson Walker was a party to the El Paso Action through its role as outside counsel for Spira, the sole question was whether Jackson Walker was an "agent" within the meaning of Spira's bylaws by virtue of its role as outside counsel. Framing its analysis around the decision in *Fasciana* v. *Electronic Data Systems Corp.,*[14] the Court found that a person serves as an agent only when such person acts on behalf of another in relations with third parties.[15] The Court determined that the alleged wrongs for which Spira had brought suit against Jackson Walker were all instances in which Jackson Walker acted on Spira's behalf in relations with third parties. Noting that attorneys have the ability to bind their clients in

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11 *Id.* at *2.

12 *Id.* at *4.

13 *Id.*

14 829 A.2d 160 (Del. Ch. 2003).

15 The *Fasciana* Court had concluded that "agent" under Section 145 does not include a lawyer who acts as legal advisor to a corporate client but does not take any actions on the corporate client's behalf in relation to third parties. The *Fasciana* Court did, however, carve out an exception for attorneys who act as agents when communicating on a corporation's behalf with a corporation's customers.

dealings with a court and opposing parties, the Court concluded that Jackson Walker was "'act[ing] as an arm of the corporation vis-a-vis the outside world.'"[16]

Importantly, the Court noted that the case before it did not involve a situation in which the lawyers were being sued for legal malpractice. The Court suggested that a lawyer sued for legal malpractice likely would not be before the Court by reason of the fact that the lawyer was an agent of the corporation, but more likely by reason of the fact that the lawyer was an independent contractor. As such, the Court suggested that a lawyer would not be able to seek and obtain indemnification and advancement for a malpractice claim. [17]

Practical Implications for M&A Transactions

When negotiating merger agreements, counsel should be mindful of the Court of Chancery's recent indemnification and advancement decisions. Those recent decisions hold lessons for both sellers and buyers.

From the perspective of a seller, the recent case law heightens the concerns with respect to the protection of the indemnification and advancement rights of a seller's officers and directors following the effective time of a merger. Although seller's counsel often diligently negotiates for provisions that restrict the ability of a surviving corporation to amend the indemnification provisions in its constituent documents following the effective time of a merger, the buyer often successfully argues that such provisions unduly restrict the surviving corporation going forward and otherwise are not advisable to the extent such restrictions purport to restrict the surviving corporation's board of directors from acting in accordance with its fiduciary duties following the merger. In the past, sellers were often more willing to relinquish requests for such a provision because it was thought (based on the contractual nature of indemnification provisions and the reading many corporate practitioners had given to the *Salaman* v. *National Media Corp.* decision) that the former officers and directors would still retain their right to indemnification and advancement for any acts or omissions occurring during the time that they were in office, and that any later amendment of the surviving corporation's constituent documents would have no effect on that vested right.

16 2008 WL 2487256, at *6 (quoting *Fasciana*, 829 A.2d at 163). The Court of Chancery reached a similar conclusion in another recent case. *See Zaman v. Amedeo Holdings, Inc.,* 2008 WL 2168397, at *17 n.65 (Del. Ch. May 23, 2008) (finding that lawyers entrusted with broad managerial and financial authority over the corporation were agents under Section 145).

17 2008 WL 2487256, at *8.

The Court of Chancery's decision in *Schoon* has now changed that dynamic. Rather than resting upon the belief that the former officers and directors will be protected regardless of any amendment of the surviving corporation's constituent documents following the effective time of the merger, seller's counsel should now negotiate diligently to ensure that the seller's officers and directors are protected and retain their rights to indemnification and advancement.[18] As a result, seller's counsel could insist on a contractual provision preventing the surviving corporation from amending its constituent documents for a specified period of time following the effective time of the merger to the extent such an amendment would adversely affect the indemnification and advancement rights of the seller's officers and directors.

Seller's counsel should also pay particular attention to the indemnification and advancement provisions that will be in the constituent documents of the surviving corporation immediately following the merger. Those provisions should provide state of the art protection for the current and former officers and directors of the surviving corporation. In addition, those provisions should include a properly drafted savings clause that makes it clear, among other things, that the right to indemnification and advancement is a vested contract right and that the amendment of those provisions will not adversely affect the rights of any current or former officers and directors with respect to acts or omission prior to the amendment, regardless of whether any proceeding is commenced against those persons before or after any amendment to those provisions.[19]

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18 The Delaware courts generally have not been critical of targets' efforts to negotiate for merger agreement provisions bestowing indemnification rights upon former directors. *Globis Partners, L.P.* v. *Plumtree Software, Inc.,* 2007 WL 4292024, at *8 (Del. Ch. Nov. 30, 2007) (finding that the receipt of indemnification benefits by target directors in a merger did not make the directors interested in the merger because there was no basis "for inferring the receipt of indemnification benefits is material, or likely to taint the Individual Defendants' judgment"); *see also In re Sea-Land Corp. S'holders Litig.,* 642 A.2d 792, 804 (Del. Ch. 1993) ("Normally, the receipt of indemnification is not deemed to taint related director actions with a presumption of self-interest. That is because indemnification has become commonplace in corporate affairs . . . and because indemnification does not increase a director's wealth.") (citations omitted). *But cf. Louisiana Municipal Police Employees' Retirement System v. Crawford,* 918 A.2d 1172, 1180 n.8 (Del. Ch. 2007) (raising some question with respect to an acquiror's agreement to provide indemnification (which arguably extended beyond the restrictions of Section 145) to former directors and officers of a target corporation that were at risk for claims relating to options backdating).

19 The *Schoon* decision also highlights the general need for corporations to revisit their indemnification and advancement provisions to ensure that their officers and directors have adequate protection and are sufficiently incentivized to serve. Although it is possible to provide additional protection by including a properly drafted savings clause, the only certain protection is a properly drafted indemnification agreement that can be amended only with the indemnitee's consent.

Out of an abundance of caution, seller's counsel also may request, in the context of triangular mergers, that the buyer parent agree in the merger agreement or in separate indemnification agreements to provide the seller's officers and directors with indemnification and advancement for their acts or omissions while serving the selling corporation. Such an agreement would provide the officers and directors with a contractual right to indemnification that arguably would not be subject to the limitations of, and the standards of conduct set forth in, Section 145, but would be subject only to the limits of public policy.[20] To the extent that the directors or officers are not parties to the agreement, as would be the case in a typical merger agreement, the agreement should expressly provide that the directors and officers are intended third party beneficiaries to the agreement.

From the perspective of a buyer, the case law also holds important lessons. The Court's conclusions in *Jackson Walker* should stand as a warning to buyers that a surviving corporation's indemnification and advancement obligations could be broader than anticipated. Buyer's counsel should determine during due diligence whether the seller's constituent documents contain broad mandatory indemnification and advancement for persons such as employees and agents and, if so, assess the risks of such broad rights. If mandatory indemnification and advancement of such persons is required, the surviving corporation may have the obligation to provide indemnification and advancement to persons such as lawyers, accountants, and other professionals, as well as non-professionals, that, prior to *Jackson Walker*, many corporate practitioners might not have considered to be agents of the corporation for purposes of Section 145. For example, accounting scandals, stock option backdating and other conduct giving rise to restatements of financial reports may lead to claims against agents of a corporation that survive the acquisition of a corporation, and a subsequent obligation on the part of the surviving corporation to advance expenses to, and possibly indemnify, agents in connection with such events. As such, the buyer should be aware of the increased risks that such provisions may impose on the surviving corporation in the future.

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20 Although a corporation's grant of additional indemnification rights pursuant to Section 145(f) must be consistent with Delaware public policy and the substantive limitations of Section 145, *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87, 91 (2d Cir. 1996), the agreement by the parent acquiror arguably would be to provide contractual indemnification and advancement protection to an individual pursuant to the terms of such contractual provision and not necessarily "by reason of the fact" that the individual served as an officer, director, employee or agent of the parent corporation or at the request of the parent corporation as an officer, director, employee or agent of any other entity. *See, e.g., Crawford*, 918 A.2d at 1180 n.8 (noting that a merger agreement provision requiring the indemnification of former directors of a target corporation to the fullest extent permitted by law "arguably arises under contract law and outside the restrictions of statutory corporate law").

The *Jackson Walker* case also raises an interesting question with respect to the breadth of a financial advisor's contractual indemnification rights. Although financial advisors, as a matter of course, require corporations to sign engagement letters that provide for a broad obligation on the part of the corporation to indemnify the financial advisor in connection with its services and typically provide in such engagement letters that the financial advisor is acting as an independent contractor and not an agent of the corporation, the possibility that the financial advisor could be deemed to be an agent of the corporation (when the financial advisor is acting on behalf of the corporation in relations with third parties) and thus subject to the limitations and requisite standards of conduct for indemnification set forth in Section 145 could provide a corporation with a potential argument to limit its indemnification obligations to financial advisors in certain circumstances.[21] If a financial advisor is deemed to be an agent of the corporation, the financial advisor (as an agent) may not be entitled under Section 145 to indemnification if it did not act in good faith and in a manner the financial advisor reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable cause to believe its conduct was unlawful.[22] Although an argument could be made that the contractual indemnification provisions set forth in a financial advisor's engagement letter should provide broader indemnification, a corporation could argue that it will simply not have the corporate power to indemnify the financial advisor (as an agent) if the advisor does not meet the requisite standards of conduct set forth in Section 145.[23]

Conclusion

Recent Delaware case law highlights the importance of closely considering provisions in acquisition agreements that provide for indemnification and advancement rights of a seller's officers and directors. Those decisions provide practical lessons that should be considered by counsel when negotiating such provisions.

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21 The circumstances in which a financial advisor might be deemed to be acting as an agent of a corporation would be limited in a manner similar to that discussed in *Jackson Walker* with respect to outside litigation counsel. On the reasoning articulated in *Jackson Walker,* one could argue that in circumstances in which a financial advisor was acting on behalf of the corporation in relations with a third party (and not merely when a financial advisor was providing advice to a corporation and/or rendering a fairness opinion) the financial advisor potentially would be acting as an agent for purposes of Section 145.

22 *8 Del. C.* § 145 (a), (b).

23 *Waltuch*, 88 F.3d at 91 ("There would be no point to the carefully crafted provisions of Section 145 spelling out the permissible scope of indemnification under Delaware law if subsection (f) allowed indemnification in additional circumstances without regard to these limits. The exception would swallow the rule.") (citation omitted).