

Client Alert

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Less is More: Why Private Equity Firms Should Limit Indemnification Rights to Their Director-Representatives

With the increase in private securities, derivative and bankruptcy-related litigation against portfolio companies, private equity firms need to maximize the protections for the private equity firm, the funds they organize and the individuals who agree to serve as their representatives on portfolio company boards. Ironically, however, a private equity firm's effort to provide "more" protection to its director-representatives may be far more expensive than the firm expects or intends.

Typically, private equity firms and the funds they organize grant their representatives serving on portfolio company boards broad indemnification rights—"to the fullest extent permitted by law." Typically, too, private equity firms and their funds require that their portfolio companies provide "fullest extent of the law" protections to these same directors. Each of the firm, the fund and the portfolio company likely will have separate insurance policies to satisfy their respective indemnification obligations. Optimally, the firm and the fund will be entitled to indemnification rights from the portfolio company pursuant to the terms of a management services agreement.

Absent thoughtful drafting, however, the broader the indemnification rights provided by the private equity firm or its fund to the individual director, the more

likely it is that the firm or its fund will be liable for a disproportionate share of defense and settlement costs incurred by the director in litigation involving the portfolio company and the less likely that such costs can be fully recovered from the portfolio company or its insurer. Moreover, the broader the terms of the insurance provided by the private equity firm, the greater the chances that the portfolio company's insurers will resist paying out the full proceeds of the portfolio company's policy before other sources of insurance are tapped.

Often times, the allocation of responsibility for indemnification and advancement obligations as between the portfolio company and the private equity firm and the fund that holds the investment in the portfolio company are not considered until after litigation has been filed. The same holds true with respect to the terms and amount of available insurance, especially at the portfolio company level.

As the foregoing suggests, there are a number of issues that every private equity firm that designates directors on its portfolio companies' boards must consider to maximize protection against liability to plaintiff shareholders (or trustees in bankruptcy) and minimize the risk of paying the cost of defending against such claims.

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Allocation of Indemnification and Advancement Obligations

It is critical that a private equity firm's contractual arrangements with its director-representatives serving on the boards of its portfolio companies provide clearly that the private equity firm's indemnification and advancement obligations to its director-representatives are *secondary* to the indemnification and advancement obligations of the portfolio companies. Otherwise, the Delaware courts will deem such obligations to be co-equal. This result is not only contrary to intentions and expectations, but also can be exceedingly costly.

The Delaware courts have held that where both the private equity firm and the portfolio company agree to indemnify directors to the "fullest extent of the law," both entities are co-equally liable. If the firm steps in and honors its indemnification obligations to its director-representative, its ability to recover those amounts from the portfolio company will be limited. Once the directors' liability is extinguished by the private equity firm, the director has no claim for indemnity that remains to be indemnified by the portfolio company. Ironically, the payment of the director's claim eliminates the director's claim for indemnification against the portfolio company to which the firm—which paid more than its co-equal share—can be subrogated. At best, because the portfolio company's indemnification obligations are co-equal, the firm can only seek to require the portfolio company to contribute one-half of the total amount paid on the director-representative's behalf.

The Delaware Chancery Court expressed these principles in several recent cases: *Levy v. HLI Operating Company*; *Schoon v. Troy*; and *Sodano v. American Stock Exchange*.

Levy v. HLI

In *HLI*, several former directors, including several investment fund representatives, were named as defendants in securities lawsuits relating to HLI's financial restatements. The fund, pursuant to its indemnification agreements, paid to settle the securities litigation on behalf of its director-representatives. HLI then argued, and the court agreed, that HLI was not required to indemnify the directors. The court stated that "once a co-indemnitor fully reimburses its indemnitee for indemnifiable liabilities, the indemnitee lacks standing to assert an indemnification claim against the other indemnitor in the indemnitee's own right."¹ The *HLI* court further stated that while the fund could seek contribution from its co-indemnitor (the portfolio company), because the fund's and the portfolio company's indemnification obligations were co-equal, the fund could only seek to recover one-half of the total amount paid in settlement on the director-representatives' behalf.²

All of these unintended results can be easily avoided by ensuring that the rights and priorities of indemnification obligations as between the private equity firm, the fund and the portfolio company are clearly defined and properly aligned. Where the private equity fund's indemnification obligations are not primary or co-equal to the obligations owed by the portfolio company, then the private equity firm or fund can seek full recovery of any amounts it pays on the director-designee's behalf.

The Chancery Court's more recent decisions in *Schoon v. Troy* and *Sodano v. American Stock Exchange*, discussed later in this *Alert*, clearly express this principle.

Schoon v. Troy

In *Schoon*, a director of Troy was sued for alleged breaches of fiduciary duties. When Troy refused to honor its indemnification obligations, the investment fund which had designated the director to serve on Troy's board advanced the director's fees and costs, although it had no legal obligation to do so. The director agreed to repay the fund for any amounts he later received as advancement or indemnification from Troy. Troy claimed that the fund's payments extinguished the director's claims for indemnification, citing *HLI*.

The *Schoon* court rejected that argument because, unlike the fund in *HLI*, the investment fund in *Schoon* "was not obligated to advance [the director's] costs."³ Rather, the fund in *Schoon* was "voluntarily undertaking to pay the fees and expenses" that Troy was *required* to indemnify.⁴ Thus, the director was entitled to enforce Troy's obligation to provide advancement and indemnification for both past and future costs.⁵ Moreover, the director was entitled to "fees on fees," *i.e.*, to recoup the costs it incurred in the litigation seeking to enforce its indemnification rights.⁶ The director would then be able to repay the fund as promised for the amounts the fund voluntarily advanced.

Too Much, Too Little, Just Right

As we have seen, the fund in *HLI* was left with only the hope of contribution of one-half of the amounts paid where its indemnification obligations to its director-representatives were coextensive with those of the portfolio company. In *Schoon*, the fund had *no* obligation to indemnify its director-representatives and the fact that it voluntarily paid the director-representative's fees and costs was critical to the court's determination that the portfolio company's obligations to provide advancement and indemnification continued and could be enforced. While it will not be commercially acceptable

to ask a director-representative to forego indemnification, a stipulation between and among the fund, its portfolio companies and its director-representatives that the fund's indemnification obligations are only *secondary* to the obligations of the portfolio company should achieve the desired result of protecting both the fund and its director-representative.

Secondary Liability—*Sodano v. American Stock Exchange*

The merits of the "secondary liability" approach were upheld in *Sodano v. American Stock Exchange*. In that case, the NASD requested that a senior executive, Sodano, serve as the CEO and Chairman of Amex, after Amex was acquired by the NASD. Sodano was entitled both to advancement and ultimate indemnification under the NASD's and Amex's governance documents as well as pursuant to specific agreements. The NASD granted Sodano advancement and indemnification rights related to his conduct at Amex "because he was serving at the Amex at the request of the NASD" but stated "that its advancement obligation . . . 'shall be reduced by any amount [Sodano] may collect as indemnification or advancement from' the Amex."⁷ In light of this language, Vice Chancellor Strine of the Delaware Court of Chancery held that:

[T]he NASD is only secondarily liable for advancement in situations where the advancement obligation arises solely from the NASD's request that an individual serve at another entity. The NASD's Certificate provision creates a *hierarchical obligation* such that Sodano must first seek to collect from the Amex and the NASD will only be responsible to the extent Sodano is unable to collect from the Amex.^{8,9}

Similar provisions should be included in every indemnification agreement between a private equity firm or fund and its director-representatives. To the

extent that indemnification documents cannot be modified, funds should seek an assignment of their director-representative's rights to indemnification and advancement from the portfolio company prior to the fund paying out defense or settlement costs on their director-designees' behalf.¹⁰

Advancement of Expenses

As *Sodano* demonstrates, even sophisticated practitioners are often confused about the difference between "indemnification" and "advancement," assuming that a right to indemnification includes a right to advancement. Not so. Indemnification contemplates payment of liabilities, including defense costs, *once a right to indemnification is established, i.e., typically after litigation alleging wrongdoing is successfully resolved*. Before the conclusion of such a proceeding, however, significant defense costs may be incurred. The right to have such fees and costs advanced is *not automatic*. The indemnification agreements and governance documents of the portfolio company should be examined to be certain that advancement is contractually required and that any advancement obligations owed by the private equity firm or its fund are secondary to the obligations of the portfolio company.

Moreover, as *Schoon* illustrates, it is important that advancement rights be stated as vested rights in the portfolio company's bylaws and included in a separate indemnification agreement between the portfolio company and the director-representative as well if possible. In *Schoon*, after a director-representative resigned, the board amended its bylaws and removed the word "former" from its definition of directors entitled to advancement. The former director had no separate indemnification agreement providing for advancement. The Chancery Court held that as a result of the amendment, former directors were not entitled to

advancement for any claims relating to their prior service as a director which were initiated after the amendment was adopted.¹¹

Insurance

Typically, the director-representative will look to the portfolio company's D&O insurance policies to defend and settle any claims. Typically, also, neither the director nor the private equity firm will look at the portfolio company's D&O insurance policies until *after* the director needs to defend and/or settle such claims. Thus, at the threshold, the terms and conditions of the portfolio company's insurance policies are of extreme importance. These terms vary widely among insurance carriers. Moreover, insurance policies are subject to negotiation that may significantly improve standard terms. Private equity firms and funds should review such policies and ensure that they are adequate to protect their director-representatives.

Also, typically, the private equity firm's executive liability policies provide excess, not primary, coverage for the firm's representatives serving on portfolio company boards. Such policies are intended to be activated if, and only if, the portfolio company's policies are exhausted or its carriers refuse to pay. These provisions should be understood. Not infrequently, the portfolio company's carriers or a bankruptcy trustee will suggest that some portion of the costs of defense and settlement paid on behalf of directors designated by the private equity firm should be satisfied by the firm's insurer. This is rarely, if ever, the correct result. The language of the policies should be reviewed to minimize the ability of the portfolio company's carrier to seek to access the private equity firm's policy.

In addition, in the case where the private equity firm or fund itself is named as a defendant, there is an opportunity for allocation arguments

among the insurers that can impede reimbursement of fees or a reasonable settlement. Again, a review of the interplay between the portfolio company's and private equity firm's or funds' insurance policy terms in advance will limit, if not prevent, a battle of the insurance carriers.

Private equity firms should also strongly consider having the same carrier write the primary policies at both the firm and at each of its portfolio companies. Where the same insurer is on the hook for both the firm and the portfolio company, the incentive to argue that the "other guy's" policy should pay first or pay more is eliminated. Moreover, if the carriers' incumbency at several portfolio companies is evaluated on the basis of performance at each of those companies, there may well be advantages to be gained with respect to premiums, terms and claims handling.

Conclusion

In sum, an ounce of prevention can avoid expensive surprises should a private equity firm or fund or its director-designees be sued in connection with a portfolio company's problems. Private equity firms should:

- Review contractual arrangements, governance documents and indemnification agreements at the firm and portfolio company level.
- Ensure that the portfolio company's indemnification and advancement obligations are primary and those of the firm and its funds are secondary.
- Ensure that insurance at the fund is in excess of the portfolio company's insurance.
- Ensure that rights to advancement of expenses are explicit and reflected in agreements between the portfolio company and director-designees.
- Ensure that the firm is subrogated to a director-designee's right against the portfolio company if the firm discharges the director's liabilities.

Endnotes

¹ *Levy v. HLI Operating Co., Inc.*, 924 A.2d 210, 223 (Del. Ch. 2007).

² *Id.* at 222, 224.

³ *Schoon v. Troy Corp.*, 948 A.2d 1157, 1175 (Del. Ch. 2008).

⁴ *Id.*

⁵ *Id.* at 1176.

⁶ *Id.*

⁷ *Sodano v. AMEX LLC*, 2008 Del. Ch. LEXIS 92 at *5, (Del. Ch. July 15, 2008)

⁸ Vice Chancellor Strine reserved the issue of "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," since in *Sodano*, that issue was not before the Court. *Id.* at *53, n. 77.

⁹ *Id.* at *6.

¹⁰ Directors, as indemnities, are also entitled to recover fees incurred in enforcing their rights to indemnification—so called "fees on fees." Those rights should also be assigned to the fund.

¹¹ *Schoon*, 948 A.2d at 1165-66.

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