

ADVANCEMENT RIGHTS IN OFFICER AND DIRECTOR LIABILITY CASES

Jennifer M. Barbour Middleton Reutlinger

Advancement and indemnification rights can radically change the analysis and strategy in bringing or defending officer and director liability cases. As such, it is critical to understand the potential rights and liabilities in such cases. Indemnification and advancement rights are corollary rights, both providing mechanisms by which a company may reimburse its officers, directors, or managers for expenses incurred in legal proceedings.

Indemnification provides for an officer, director or member to have his or her legal fees and expenses, and perhaps a judgment against him or her, paid by the company at the conclusion of the legal proceeding. Most statutes governing corporations provide for mandatory indemnification of an officer or director who is successful in defending an action. In contrast, most limited liability company statutes lack similar mandatory indemnification provisions.

However, all states grant corporations and limited liability companies discretion to expand indemnification and advancement rights. Thus, companies can assume obligations to indemnify an officer, director or manager even if not successful on the merits. Companies may also elect to provide advancement rights to officers and directors pending the outcome of the legal matter. Unlike indemnification rights, advancement rights provide for interim relief

from the legal costs to an officer, director or manager during the pendency of a legal matter. Because the costs associated with a legal matter can be staggering, any attorney representing an officer, director or manager should consider whether advancement rights are available.

Companies frequently exercise their discretion to offer expanded indemnification and advancement rights to officers, directors, managers, and sometimes even other employees. When recruiting competent and capable officers, directors, managers and employees, indemnification and advancement rights can be a recruiting enticement. Additionally, indemnification and advancement rights can deter frivolous claims by shareholders or corporate officials against officers, directors or managers because of the knowledge the fees and expenses of the officer, director or manager would be borne by the corporation.

WHAT IS AN ADVANCEMENT RIGHT?

Advancement refers to the right provided to an officer, director or manager to have certain legal fees and expenses paid by the company in specific circumstances when the officer, director or manager becomes involved in a legal matter. While similar to indemnification rights in many respects, advancement rights are distinct rights. Unlike indemnification rights, advancement rights do not require the officer, director or manager to be successful in the legal proceeding before she may enforce her advancement rights. The primary goal of advancement rights is to provide interim relief from the financial pressures a legal action may put on a company official.

The scope of the advancement right is determined by the governing documents of the company that provide the right. Companies frequently provide advancement rights in their articles of organization, articles of incorporation, by-laws and/or operating agreement. If those documents are silent as to whether the company has assumed advancement obligations, there may be other documents affording the rights to the officer, director or manager. Attorneys should inquire into the existence and contents of other contracts or agreements between the company and the official, such as employment contracts or director indemnification agreements.

Companies considering adopting advancement rights should ensure their governing documents are carefully crafted to afford rights as intended. This is particularly important given two things. First, the only prerequisite to receipt of the advance-

ment rights is a written document whereby the officer or director agrees to repay the advanced expenses and attest that the facts known to him or her at the time would not preclude indemnification. The obligation to repay triggers only if he or she is later determined not to have met the appropriate standard of conduct for an officer or director. Further, the officer or director need not demonstrate he has the means to repay the company. Second, advancement rights are enforced in summary proceedings with many presumptions afforded the officer or director in favor of advancement.

Because of the summary nature of the proceeding, the scope of it is narrow. The court will only inquire into whether the claims asserted against an officer or director fall within the category of claims that the corporation agreed to advance. The officer or director is not required to prove that he or she will be indemnified in order to obtain advancement. Therefore, if the advancement right is not carefully crafted, the company could find itself extending advancement for claims or expenses that were not intended due to the nature of the enforcement proceeding.

Companies and their attorneys should also consider whether advancement or indemnification rights afforded to officers and directors may extend to wholly owned subsidiaries of the company. Some courts have held a parent company's advancement provisions applied to officers and directors of a wholly owned subsidiary when corporate formalities are not well-observed between the parent and subsidiary.

Beyond drafting corporate documents, a company considering a claim against an officer or director should consider whether any of the claims asserted would be subject to advancement. If so, the company and its shareholders or members could be responsible for not only its own litigation costs, but also those of the officer or director it is suing. Companies can minimize some of those costs by obtaining Director and Officer liability insurance, but the economic impact of litigation can extend beyond those limits.

Additionally, shareholders or members of a company considering claims against an officer, director or manager should be aware that advancement of expenses may be due to the officer, director or manager. This potentially results in the shareholder or member depleting cash or assets available for distributions.

Finally, companies and attorneys should carefully consider whether to challenge an officer or director's request for ad-

vancement. Courts tend to resolve disputes in favor of advancement benefitting the officer or director, despite the nature of the alleged misconduct on the part of the officer or director. Importantly, an officer or director who brings an advancement action to enforce her rights is frequently awarded her fees in bringing the advancement action, resulting in an award of fees on fees. Accordingly, unless fees on fees are expressly excluded under the organizational documents or agreements giving rise to the advancement rights, companies should carefully consider the benefits versus costs of denying a request for advancement.

CONCLUSION

As one court aptly stated: "Litigation is an occupational hazard for corporate directors." Thus, savvy individuals considering service on a company's board or as an officer will frequently ensure the company affords not only indemnification rights, but also advancement rights. Companies seeking to attract talented leaders often choose to provide these rights to attract the best managers, officers and directors. Companies should carefully craft advancement provisions to ensure the scope of advancement obligations is considered. Further, any attorney involved in a legal proceeding involving companies should be aware of the advancement right and its implications for the official and the company. Any attorney representing an officer or director in a legal proceeding should carefully determine whether advancement rights are available. If so, those rights can provide a significant financial benefit to the officer and director to avoid out-of-pocket expenses in defending the proceeding. Similarly, a company considering any claim against an officer or director should weigh the costs and benefits of pursuing the claim if advancement rights are afforded. Otherwise, the company may find itself fronting not only its own litigation expenses, but also those of the individual against whom the claim is asserted. It is important, therefore, for attorneys to carefully investigate the existence and scope of advancement rights for their clients.



Jennifer M. Barbour is a member of the litigation practice group, focusing on health care and commercial litigation. She can be reached via JBarbour@MiddletonLaw.com.