

Advancement Rights in Officer and Director Liability Cases

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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. If successful in defending an action, the officer or director of a corporation is entitled to mandatory indemnification pursuant to KRS 271B.8-520. There are no similar mandatory indemnification provisions under Kentucky's Limited Liability Act. Both the Kentucky Business Corporation Act and the Kentucky Limited Liability Company Act provide companies with the discretion 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. One Delaware Court in *VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998) (citations omitted), described the purpose of advancement rights as follows:

We have long recognized that Section 145 [of the Delaware Code] serves the dual policies of: allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity.

This article will focus on understanding the nature of the advancement right and how to enforce such rights. Few Kentucky appellate decisions exist with regard to advancement and indemnification rights. However, Ken-

tucky courts frequently seek guidance from Delaware courts regarding corporate law. Thus, in the absence of Kentucky case law, this article will refer to Delaware law.

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.

While these documents may be drafted in numerous ways, they typically provide something similar to the following:

Each person who was or is involved in any action, suit or proceeding, whether civil, criminal, administrative or investigative (the "Proceeding"), by reason of the fact that such person is or was a director or officer of the corporation, or is or was serving at the request of the corporation as an officer or director of another corporation, shall be indemnified and held harmless by the corporation to the fullest extent permitted by law. The corporation shall pay all expenses (including attorney's fees) incurred by such director or officer in defending any such Proceeding as they are incurred in advance of its final disposition.

Under Kentucky and Delaware law, the only

prerequisite to receipt of the advancement 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. As held in *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 212 (Del. 2005) and *Reddy v. Electronic Data Sys. Corp.*, 2002 WL 1358761, *4 (Del. Ch. 2002), absent a provision in the governing document or agreement to the contrary, the officer or director need not establish he or she has the means to actually repay the company.

Enforcement of Advancement Rights

Frequently, officers, directors and managers, both current and former, find themselves at odds with current leadership or shareholders of a company. In those cases, the company frequently seeks to avoid enforcing the advancement rights it elected to provide.

When a dispute arises, the enforcement of the advancement right is pursued through a legal action. Kentucky's statutes are silent as to nature of that legal action. In

Delaware, the statute provides for the dispute to be resolved in a summary proceeding to avoid delay of the advancement.

The logic of this supports the policy behind advancement rights—absent a summary proceeding, the officer or director could not receive the benefit of her advancement rights for years while the parties litigated numerous factual and legal issues in an advancement proceeding. As the Delaware Supreme Court explained in *Homestore, Inc. v. Tafeen*, 886 A.2d 502, 505 (Del. 2005), "to be of any value to the executive or director, advancement must be made promptly, otherwise its benefit is forever lost because the failure to advance fees affects the counsel the director may choose and litigation strategy that the executive or director will be able to afford."

Because of the summary nature of the proceeding, the scope of it is narrow—as explained in *Tafeen v. Homestore, Inc.*, 2004 WL 556733, *4 (Del. Ch. 2004), the court should not inquire into the conduct-related allegations or make any determinations as to the state of mind of the officer or director. Rather, the court in *Holley v. Nipro Diagnostics, Inc.*, 2014 WL 7336411, *8 (Del. Ch. 2014) explained courts should be "focused on determining 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.

The Meaning of "By Reason Of"

Almost uniformly, indemnification and advancement provisions utilize the phrase "by reason of" in affording those rights to officers and directors. Several courts have considered what "by reason of" means in terms of actions for indemnification or advancement of expenses. As Amy L. Goodman & Bart Schwartz explained in, *Corporate Governance: Law and Practice*, §5.03 (2007), "[c]ourts have shown some latitude in interpreting this language such that if there is a nexus or causal connection between any of the underlying proceedings...and one's official corporate capacity, those proceedings are 'by reason of the fact' that one was" an officer or director.

Stated another way by the court in *Homestore*, 888 A.2d at 214, an officer or director is a party to a proceeding "by reason of" her status as an officer or director "if there is a nexus or causal connection between any of the underlying proceedings...and one's official corporate capacity." Under this test as described in *Paolino v. Mace Security International, Inc.*, 985 A.2d 392, 406 (Del. Ch. 2009), "the requisite connection is established if the corporate powers were used or necessary for the commission of the alleged misconduct." The question to resolve according to *Weil v. VEREIT Operating Partnership, L.P.*, 2018 WL 834428, *6 (Del. Ch. 2018) is "[w]hether an individual has been sued in an official capacity for purposes of advancement normally turns on the pleadings in the underlying litigation."

For instance, in *Reddy v. Electronic Data Systems Corporation*, Reddy sought advancement of expenses related to two proceedings against him that arose from his service for Electronic Data Systems (EDS). 2002 WL 1358761 (Del. Ch. 2004). In determining whether Reddy was entitled to advancement of fees and expenses in defending those actions, the court declined to apply "pleading formalism," i.e., to look only to formal words of the pleadings. *Id.* at *6. Instead, the court looked at the substance of the allegations against Reddy, which "could be seen as fiduciary allegations, involving as they do the charge that a senior managerial employee failed to live up to his duties of loyalty and care to the corporation." *Id.*

The court also placed emphasis on the fact that the alleged acts of misconduct were "in the course of performing his day-to-day managerial duties." *Id.* Therefore, if the alleged misconduct of the officer or director could not have been accomplished without some use of his or her official powers, then the officer or director has likely been sued "by reason of" his or her status as an officer or director.

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The Meaning of "At The Request Of"

Frequently, parent companies may request individuals serve as officers, directors or manager of a subsidiary. This fact can be critical, particularly if the subsidiary's governing documents or agreements do not provide for advancement rights, but the parent company's documents do so provide. Delaware courts focus on the extent to which corporate formalities are observed between the parent and subsidiary to determine whether the officer or director of the subsidiary is serving at the request of the parent.

For instance, in *VonFeldt v. Stifel Financial Corp.*, VonFeldt was a director of Stifel Nicolaus Corporation (SNC), a wholly-owned subsidiary of Stifel Financial. 714 A.2d 79, 80 (Del. 1998). VonFeldt was a party to four separate lawsuits relating to his conduct as an officer, director or employee of SNC, and he brought an enforcement action for indemnification and advancement rights against Stifel Financial. *Id.* SNC's by-laws did not include indemnification or advancement provisions, but Stifel Financial's did. *Id.* at 81. VonFeldt alleged that he served SNC at the request of Stifel Financial and presented two theories for this.

First, he alleged there was sufficient evidence showing Stifel Financial exerted control over its subsidiary's operations and the functions and duties VonFeldt performed for SNC. *Id.* at 83. Second, VonFeldt also advanced the theory that because Stifel Financial owned 100 percent of SNC's stock, Stifel Financial was the only entity with authority to select SNC's directors. *Id.* Thus, VonFeldt reasoned that he was serving at the request of Stifel Financial who had voted all of its stock for his election.

At trial, the chancery court ruled against VonFeldt on both theories. It concluded the evidence of Stifel Financial's control was in conflict and sided with Stifel Financial. *Id.* While not successful on this claim, the chancery court's consideration of it and the Supreme Court's review of it indicate in certain circumstances, such proof could be sufficient to prove a parent corporation requested the officer or director to serve. As to VonFeldt's second argument, the Supreme Court overturned the chancery court. Specifically, the court held that "[t]he vote of a 100 percent stockholder is a public expression of support" for the board of directors candidate and "must amount to a 'request' in the eyes of the law." *Id.* at 85.

Thus, an attorney considering whether advancement rights are available to her client should familiarize herself with the governing documents for parent companies and the facts surrounding how the client came to serve as an officer or director of the subsidiary. As the court in *VonFeldt* noted, "[o]ther cases will have to be decided on their own facts concerning what constitutes one corporation's request to serve another corporation." *Id.*

The Meaning of "Reasonably Incurred"

Some governing documents or agreements providing for advancement rights will define what expenses are covered. The only guidance provided by KRS 271B.8-530 is that the expenses be reasonably incurred by the officer or director. Generally, courts con-

sidering whether the fees and expenses are reasonable conduct a similar analysis to the lodestar method used in awarding attorneys' fees and expenses. As a result, courts like that in *Danenberg v. Fitracks, Inc.*, 58 A.3d 991, 998 (Del. Ch. 2012) inquire as to whether the number of hours expended appear reasonable and whether the hourly rate appears within market norms. An attorney pursuing advancement rights should be prepared with proof concerning the reasonableness of her fees and expenses, by expert proof or affidavits or testimony from similarly practicing attorneys.

The Meaning of "In Defending"

Frequently, organizational documents or agreements that provide for advancement rights do so for expenses incurred "in defending" a legal action or proceeding. That raises the question of what exactly constitutes defending a proceeding. As many litigators know, often counterclaims are asserted for defensive purposes in addition to offensive purposes. Even Delaware courts have struggled with whether all counterclaims are within the scope of "in defending." Currently, Delaware law holds all compulsory counterclaims are within the scope of "in defending." Permissive counterclaims, however, appear to fall outside the scope.

In *Citadel Holding Corp. v. Roven*, the Delaware Supreme Court addressed whether a director's affirmative defenses and counterclaims were covered by the indemnification provisions. 603 A.2d 818, 824 (Del. 1992). The court concluded all affirmative defenses fall within the scope of "in defending."

Turning then to counterclaims, the court noted that certain counterclaims are permissive, while others are compulsory under the Federal Rules of Civil Procedure if they arise from the same transaction as the original complaint. *Id.* After reflecting on the types of counterclaims, the court then held "any counterclaims asserted by [the director] are necessarily part of the same dispute and were advanced to defeat, or offset" the claims against the director, the court concluded they were brought in order to defend the director. *Id.* However, the court was not clear if its holding applied to all counterclaims or only compulsory ones.

As a result, Delaware Chancery courts have reached opposing conclusions. For instance, in *Reinhard & Kreinberg v. The Dow Chemical Company*, the Delaware Chancery court adopted a bright-line rule that "the law requires advancement of legal fees incurred with respect only to compulsory counterclaims." 2008 WL 868108, *1 (Del. Ch. 2008) (emphasis original). If a counterclaim does not arise out of the same transaction or occurrence as the original complaint, then it is not asserted in defense of the officer or director. *Id.*

However, in *Zaman v. Amedeo Holdings, Inc.*, the Delaware Chancery court noted that adopting a bright-line rule was problematic, particularly because there are 16 states that do not have compulsory counterclaims in their civil rules. 2008 WL2168397, *34-36 (Del. Ch. 2008). In *Zaman*, a director sought advancement for legal expenses related to several actions—some pending in federal court and subject to the Federal Rules of Civil

Procedure and some pending in New York state court and subject to that state's rules of civil procedure. *Id.* Under New York rules, all counterclaims are permissive, and the defendants to the advancement proceeding argued they were not obligated to advance litigation expenses related to those counterclaims. *Id.*

The court reasoned that the decision to assert a counterclaim, whether it be a permissive or compulsory counterclaim, is made with the goal of "negating the viability of the claim against the corporate official." *Id.* at 35. Further, the court feared that if a claim was only subject to advancement if brought in a forum recognizing compulsory counterclaims in its civil rules would encourage forum shopping. Thus, the *Zaman* court held that a counterclaim is subject to advancement if it satisfies the compulsory counterclaim requirements under federal rules and "when the counterclaim directly relates to a claim against a corporate official such that success on the counterclaim would operate to defeat the affirmative claims against the corporate official." *Id.*

As a result, it is clear that a compulsory counterclaim will almost always fall within the scope of an advancement right provision. Permissive counterclaims could potentially fall within the scope, if the attorney establishes the counterclaim was brought to offset or defeat the claims against the officer, director of manager.

Addressing Covered and Non-Covered Claims

As the counterclaim example demonstrates,

frequently litigation can include claims that fall outside the scope of the advancement rights. Additionally, counsel for one officer or director can often find herself providing legal services to other individuals in the same litigation. Thus, a question arises on how to deal with advancement expenses when the officer or director's counsel is providing legal services for claims or parties that are not subject to an advancement claim. Should a court in an advancement proceeding allocate fees and expenses between non-covered claims or non-covered parties?

There are no Kentucky cases addressing allocation in indemnification or advancement settings. However, in other settings, Kentucky law does not require allocation when claims are inextricably intertwined. In *Young v. Vista Homes, Inc.*, 243 S.W.3d 352, 368 (Ky. 2007), homeowners brought various claims against a construction company and others related to the septic tanks installed for their homes. *Id.* at 357. The cases proceeded to trial, with the homeowners succeeding on some, but not all of their claims. *Id.* at 358. The homeowners were successful on a statutory claim that permitted an award of attorneys' fees, and the trial court allocated attorneys' fees for the statutory code violation claim only. *Id.* at 368. The Supreme Court reversed and remanded, holding that "where all of plaintiff's claims arise from the same nucleus of operative facts and each claim was 'inextricably interwoven' with the other claims, apportionment of fees is unnecessary." *Id.* (citations omitted).

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Delaware courts have adopted a method of addressing the presence of non-covered claims or parties, which acknowledges the “inextricably interwoven” reasoning Kentucky courts have adopted in other settings. The court in *White v. Curo Texas Holdings, LLC*, 2017 WL 1369332, *10 (Del. Ch. 2017) (internal citations omitted) articulated the following test when covered and non-covered claims are present:

To determine whether expenses incurred defending both covered and non-covered proceedings are subject to advancement, the operative test is: Would the disputed expenses have been incurred in defense of the covered proceeding even if there was no non-covered proceeding? If the answer is yes, then the disputed expenses are advanceable. If the fee requests relate to both advanceable claims and non-advanceable claims, i.e., the work is useful for both types of claims, that work is entirely advanceable if it would have been done independently of the existence of the non-advanceable claims. Any doubts should be resolved in favor of advancement.

In *Danenberg v. Fitracks, Inc.*, Danenberg served as CEO of Fitracks and negotiated a deal for Aetrex to acquire Fitracks. 2012 WL 11220, *1 (Del. Ch. Dec. 14, 2011). The merger included an agreement that Danenberg and other shareholders could form a new company that would receive licensing benefits from Aetrex/Fitracks. *Id.* Following the merger, Danenberg no longer was an officer, but continued as an employee of Aetrex/Fitracks. *Id.* at *5. Danenberg formed a new company, Just4Fit, Inc., which entered into a license agreement with Aetrex/Fitracks. *Id.* at *2. Subsequently, Aetrex/Fitracks terminated the licensing agreement and Just4Fit sued for breach. *Id.* Aetrex/Fitracks counterclaimed, asserting claims against Danenberg personally for alleged

misrepresentations before and after the merger in both his capacity as an officer and as an employee. *Id.* at *2-*3.

Danenberg filed an action seeking advancement of litigation fees and expenses from Aetrex/Fitracks. *Id.* at *4. Aetrex/Fitracks argued it had no obligation to advance expenses on three bases: 1) that it was only making claims against Danenberg for a time period when he was an employee of Aetrex/Fitracks, for which the bylaws did not provide advancement rights; 2) that it had no obligation to advance expenses for the entirety of the underlying action, but only for the claims asserted against Danenberg, i.e., not for Just4Fit's claims against Aetrex; and, 3) that the presence of third parties benefitting from Danenberg's counsel's work required allocation. *Id.* at *5-*6.

The court rejected each of Aetrex/Fitracks' arguments. First, the court held that despite Aetrex/Fitracks' representations as to what conduct of Danenberg formed the basis of the claims, the substance of the claims and arguments made in the underlying action indicated Danenberg's conduct both as an officer and as an employee formed the basis of the claims. *Id.* at *6. Moreover, the court determined that it was not “possible at the advancement stage to parse finely between Danenberg's pre- and post-merger conduct,” i.e., between his conduct as an officer versus an employee. *Id.* The court reasoned that for advancement purposes, there was enough overlap in the claims asserted against Danenberg for his officer and employee actions as to make parsing the matter not feasible for an advancement determination. *Id.*

Second, the court determined that Aetrex/Fitracks was obligated to advance Danenberg 100 percent of his expenses and fees related to the underlying action. *Id.* at *6. The court again reasoned that all claims were premised on pre- and post-merger

actions, making an allocation impossible at the advancement stage without getting into the merits of the case. *Id.* Finally, as to the argument that an allocation must be made between fees and expenses incurred for Danenberg's benefit versus the benefit of third parties represented by his attorneys, the court held that “[i]f a particular defense or litigation activity benefits multiple third-party defendants, but Danenberg would have raised or undertaken it himself if he were the sole third-party defendant, then Fitracks must advance 100 percent of the related fees and expenses.” *Id.* at *7.

Delaware courts have looked to the attorneys representing the officer or directors to initially draw the line between covered and non-covered claims. The Court of Chancery of Delaware explained *Weil v. VEREIT Operating Partnership, L.P.*, 2018 WL 834428, *7 as follows:

Determining whether work would have been incurred in the absence of the non-covered proceeding frequently requires a degree of judgment. The attorneys who coordinated the defense of the various actions are the most competent to opine as to what would have been required for the defense of the covered proceeding, even if the non-covered aspects did not exist. Absent clear abuse, counsel's good faith certification is sufficient to support an award of advancements.

Implications for the Company

If a company chooses to provide advancement rights to its officers and directors, that choice is likely to impact litigation decisions for the company. Any company considering legal action against an officer or director should consider whether any of the claims asserted would be subject to advancement. If so, the company 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.

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 should carefully consider whether to challenge an officer or director's request for advancement. As the cases discussed above indicate, advancement proceedings are not dependent on the outcome of the underlying suit or the alleged misconduct of the officer or director. Courts tend to resolve disputes in favor of advancement benefitting 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, as occurred in *Fasciana v. Electronic Data Systems Corp.*, 829 A.2d 178, 182-183 (Del. Ch. 2003). 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 the court in *Heffernan v. Pacific Dunlop GNB Corp.*, 965 F.2d 369, 370 (7th Cir. 1992) 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. Consequently, 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.

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