FINDING (AND FUNDING) THE COST OF FREEDOM: INDEMNIFICATION AND ADVANCEMENT FOR ALTERNATIVE BUSINESS ENTITIES

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Delaware business entities often grant indemnification and/or advancement rights to attract qualified persons to serve in positions of authority and to protect them from exposure to out of pocket expenses for legal fees relating to their service to the business. Significant ink has been spilled by both commentators and the Delaware judiciary about the proper balance to strike between principles of "freedom of contract" in the context of alternative business entities (such as limited liability companies and limited partnerships) and fiduciary or other public policy principles that are generally applicable to corporations.[1] In opinions that generally receive less attention, however, Delaware courts have repeatedly stressed that contractarian principles alone govern indemnification and advancement provisions for alternative business entities. Using examples drawn from Delaware case law and the authors' practice, this article will highlight some of the differences between indemnification and advancement rights under the Delaware General Corporation Law (the "DGCL") and the statutory authority governing Delaware's alternative entities. Contractual freedom often comes at a cost.

I. INDEMNIFICATION AND ADVANCEMENT UNDER DELAWARE LAW

Indemnification generally refers to the payment by the business entity of fees and expenses (and, in certain instances, liabilities) incurred by an individual serving as director, officer, manager, managing partner, partner, employee or member of the business for litigation or other proceedings.[2] Indemnification is generally not available until the conclusion of the proceedings giving rise to the indemnification right.[3] Advancement refers to the payment of potential indemnification in advance of the conclusion of the proceedings giving rise to the indemnification right, such as out of pocket defense costs as they are incurred by the potential indemnitee. In essence, indemnification is akin to an insurer's coverage obligations, whereas advancement is akin to an insurer's duty to defend.

In order to encourage able people to serve in leadership positions in a business enterprise and encourage potentially profitable business risk taking, Delaware law permits and sometimes requires those businesses to indemnify or advance certain expenses to such persons. "Delaware has a strong public policy in favor of assuring key corporate personnel that

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1. *See* Auriga Capital Corp. v. Gatz Properties LLC, 40 A.3d 839 (Del. Ch. 2012), *aff'd sub. nom.* 59 A.3d 1206 (Del. 2012) (affirming but criticizing the then Chancellor's "dictum" regarding default fiduciary duties); Feely v. NHAOGC, LLC, 62 A.2d 649, 661-63 (Del. Ch. 2012). *See also* Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnership and Limited Liability Companies*, 46 Am. Bus. L. J. 221 (2009); Ann E. Conaway & Peter I. Tsoflias, *Challenging Traditional Thought: No Default Fiduciary Duties in Delaware Limited Liability Companies After Auriga*, 13 J. Bus. & Sec. L. 1 (2011).

2. *See* In re Delta Holdings, Inc., C.A. No. 18064-VCC, 2004 WL 1752857, at *4 (Del. Ch. July 26, 2004).

3. Paolino v. Mace Sec. Int'l, Inc., C.A. No. 4462-VCL, 2009 WL 4652894, at *4 (Del. Ch. Dec. 14, 2009).

the corporation will bear the risks resulting from performance of their duties on the grounds that such a policy best encourages responsible persons to occupy positions of business trust …."[4] Beyond that, its larger purpose is "to encourage capable [persons] to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve."[5] Delaware law also permits indemnification and advancement for alternative business entities and similar policy concerns are in play.[6]

Without the benefit of advancement rights, an officer or director may not have the financial ability to mount a vigorous defense on the merits.[7] The defense of a white-collar criminal prosecution relating to alleged accounting fraud (and related civil actions), for example, could cost millions of dollars to defend.[8] While the terms of an advancement or indemnification agreement may be appealing to company decision makers on a "clear day,"[9] business enterprises often have different views of those obligations after a former officer or director has been accused of serious wrongdoing. After accusations are made or troubling facts come to light, advancing fees and expenses of an individual who is alleged to have engaged in such malfeasance becomes unpalatable to the business, its governing body, its investors and even government authorities.[10] In addition, in high profile matters, the amount of the advancement obligations can grow to staggering sums.[11] As a result, these provisions have been the subject of considerable litigation in Delaware courts.

II. STATUTORY AUTHORITY FOR INDEMNIFICATION AND ADVANCEMENT

Title 8, Section 145 of the Delaware General Corporation Law permits indemnification of directors, officers, employees and agents of a Delaware corporation for certain expenses in defending a proceeding, and for settlements,

4. DeLucca v. KKAT Mgmt., L.L.C., C.A. No. 1394-VCN, 2006 WL 224058, at *7 (Del. Ch. Jan. 23, 2006) (citing Perconti v. Thornton Oil Corp., C.A. No. 18630-NC, 2002 WL 982419, at *3 (Del. Ch. May 3, 2002)); VonFeldt v. Stifel Fin. Corp., 714 A.2d 79, 84 (Del. 1998).

5. In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 66 (Del. 2006) (citing Stifel Fin. Corp. v. Cochran, 809 A.2d 555, 561 (Del. 2002)). *See also* Homestore, Inc. v. Tafeen, 888 A.2d 204, 218 (Del. 2005) (explaining that advancement provisions promote the public policy of attracting capable people into corporate service).

6. *See, e.g.*, *DeLucca*, 2006 WL 224058, at *7 ("Delaware has a strong public policy in favor of assuring key corporate personnel that the corporation will bear the risks resulting from performance of their duties on the grounds that such a policy best encourages responsible persons to occupy positions of business trust, so Delaware courts have read indemnification contracts to provide coverage when that is reasonable.").

7. Homestore, Inc. v. Tafeen, 886 A.2d 502, 505 (Del. 2005). *See generally* U.S. v. Stein, 495 F. Supp.2d 390 (S.D.N.Y 2007).

8. Homestore, Inc. v. Tafeen, 2005 WL 656221 (Del. Ch. Feb. 24, 2005) (Jenkins, S.M.) (ordering the payment of nearly $4 million of advancements).

9. *See* William D. Johnston, *Flexibility Under Delaware Law in Drafting Advancement Provisions on a "Clear Day," and Potential Surprises for Those Who Do Not Take Advantage of that Flexibility*, 13:1 Del. L. Rev. 21, 24 (2011).

10. From 2003 through 2006, guidance from United States Department of Justice (*i.e.*, the so-called "Thompson Memo") was widely viewed as hostile to the payment of certain advancement and indemnification obligations. *See generally Stein*, 495 F. Supp.2d at 390.

11. *See* Andrew M. Johnston, Amy L. Simmerman & Jeffery M. Gorris, *Recent Delaware Law Developments in Advancement and Indemnification: An Analytical Guide*, 6:1 NYU J. L. & Bus. 81, 83 (2009) (noting high profile cases with indemnification obligations as high as $119 million).

judgments, penalties and fines.[12] Delaware corporations may indemnify such a person "who was or is a party or is threatened to be made a party" to any action brought by a third party "by reason of the fact that the person is or was a director, officer, employee or agent of the corporation."[13] Section 145 requires indemnification when "a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding … or in defense of any claim, issue or matter therein."[14] Section 145 also permits, but does not require, advancement of fees and expenses.[15] Subject to certain public policy limitations reflected in Section 145, a corporation can elect to provide broader rights in its certificate of incorporation, bylaws, or other contractual agreements.[16]

Delaware limited liability companies ("LLCs") are governed by the Delaware Limited Liability Company Act (the "LLC Act").[17] Section 18-108 of the LLC Act gives contracting parties great discretion in establishing the scope of indemnification and advancement rights for an LLC.[18] The LLC Act provides:

> Subject to such standards and restrictions, if any, as are set forth in its limited liability company agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever.[19]

The LLC Act specifically provides that "it is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."[20] Consistent with this policy, Delaware courts have "made clear that § 108 defers completely to the contracting parties to create and delimit rights and obligations with respect to indemnification and advancement."[21] The "point of § 108 is that the parties to these agreements have complete freedom of contract — they are free to contract for advancement because neither the statute nor any principle of law or equity prohibits it."[22]

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12. 8 *Del. C.* § 145.

13. *Id.* § 145(a) & (b); VonFeldt v. Stifel Fin. Corp., C.A. No. 15688-VCC, 1999 WL 413393, at *2 (Del. Ch. June 11, 1999).

14. *Id.* § 145(c).

15. *Id.* § 145(e).

16. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 65-66.

17. 6 *Del. C.* §§ 18-101 *et seq.*

18. *See* Delphi Easter P'rs Ltd. P'ship v. Spectacular P'rs, Inc., C.A. No. 12-1409-VCA, 1993 WL 328079, at *2 (Del. Ch. Aug. 6, 1993) (interpreting Limited Partnership Act). *See also* Branin v. Stein Rowe Inv. Council, LLC, 2014 WL 2961084, at *9 (Del. Ch. June 30, 2014) ("Limited liability companies are tersely and expansively authorized by statute to provide indemnification.")

19. 6 *Del. C.* § 18-108.

20. *Id.* § 18-1101(b).

21. Majkowski v. Am. Imaging Mgmt. Servs., LLC, 913 A.2d 572, 591 (Del. Ch. 2006) (internal quotations omitted); *Delphi*, 1993 WL 328079, at *2.

22. *Majkowski*, 913 A.2d at 591.

Delaware limited partnerships ("LPs") are governed by the Delaware Revised Uniform Limited Partnership Act ("DRULPA").[23] Section 17-108 of the DRULPA allows a limited partnership to "indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever."[24] A limited partnership is a creature of both statute and contract, and, like the LLC Act, the DRULPA "embodies the policy of freedom of contract and maximum flexibility."[25] The Delaware Supreme Court has recognized that parties to a Delaware limited partnership have the discretion to create a limited partnership "in an environment of private ordering" and operate the partnership according to the provisions in the partnership agreement.[26] The DRULPA is therefore "broadly empowering and deferential to the contracting parties' wishes regarding indemnification and advancement."[27]

III. DIFFERENCES BETWEEN ADVANCEMENT AND INDEMNIFICATION UNDER THE DGCL AND THE ALTERNATIVE ENTITIES ACTS

Alternative business entities such as LLCs and LPs have proliferated in the past two decades. Indeed, the formation of LLCs and LPs recently outpaced the formation of Delaware corporations.[28]

While the DGCL provides a default structure of indemnification and advancement for Delaware corporations, the LLC Act and the LLP Act simply permit the members or partners to provide for such rights contractually. As the law applicable to these newer forms of business organization has developed, practitioners have sometimes attempted to apply the well-developed body of corporate law to such entities.[29] It is crucial, however, to recognize the differences in the fundamental nature of these business forms and critically evaluate those concepts in light of the contractual provisions that the members or partners chose to govern their business relationship. The body of law developed in the corporate context may not apply to the specific contractual provisions negotiated (or simply chosen) by the participants in an alternative business form. Delaware Courts have repeatedly stressed that alternative entities are creatures of contract and the contractual terms selected by the parties must be given primacy.[30]

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23. *See* 6 *Del. C.* §§ 17-101 *et seq.*

24. *See also Delphi*, 1993 WL 328079, at *2 (interpreting Section 17-108 of the DRULPA and noting that "Section 17-108 defers completely to the contracting parties to create and delimit rights and obligations with respect to indemnification and advancement of expenses. The statute itself creates no rights to indemnification.").

25. 6 *Del. C.* §17-1101(c); Gotham P'rs, L.P. v. Hallwood Realty P'rs, L.P., 817 A.2d 160, 170 (Del. 2002) (citing Elf Atochem N. Am., Inc. v. Jafari, 727 A.2d 286, 290, 291 n.27 (Del. 1999)).

26. Twin Bridges Ltd. P'ship v. Draper, C.A. No. 2351-VCP, 2007 WL 2744609, at *8 (Del. Ch. Sept. 14, 2007.) (citing *Gotham P'rs*, 817 A.2d at 170).

27. Active Asset Recovery, Inc. v. Real Estate Asset Recovery Servs., Inc., C.A. No. 14-15478-VCS, 1999 WL 743479, at *16 (Del. Ch. Sept. 10, 1999) (citing *Delphi*, 1993 WL 328079, at *1-2)).

28. *See* Rodney D. Chrisman, *LLCs Are the New King of the Hill: A Empirical Study of the Number of New LLCs, Corporations, or LLPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 Fordham J. Corp. & Fin. L. 460 (2010).

29. *See, e.g.*, *DeLucca*, 2006 WL 224058, at *2 (rejecting attempt to "superimpose" the "typical 'corporate capacity' analysis" on the terms of an LLC indemnification provision "despite its absence from the contractual text.").

30. *See, e.g.*, Fillip v. Centerstone Linen Services, LLC, C.A. No. 8712–ML, 2013 WL 6671663, at *5 (Del. Ch. Dec. 3, 2013); Senior Tour Players 207 Mgmt. Co. LLC v. Golftown 207 Holding Co. LLC, C.A. No. 20116-VCL, 2004 WL 550743, at *3 (Del. Ch. Mar. 10, 2004).

A. Fullest Extent Provisions

Many corporations include stock language in their charters or bylaws that includes mandatory indemnification and advancement "to the fullest extent permitted by Delaware law." In the corporate context, it is well established that the "fullest extent" provisions encompass both indemnification and advancement under the default provisions of the DGCL and include the broadest possible right available.[31] For example, such provisions require the indemnification of expenses incurred in successfully prosecuting an indemnification suit (*i.e.*, "fees on fees")[32] or fees incurred in successfully defending counterclaims brought by the corporation even when the indemnitee initiates the action.[33] Delaware Courts have also provided substantial guidance regarding the meaning of the terms employed in Section 145 of the DGCL including "by reason of the fact," "in defending," "successful on the merits or otherwise," and "final disposition" under fullest extent provisions.

It is less clear, however, what the "fullest extent" terminology could mean for LLCs and LPs where the statute is simply broadly enabling and default terms are absent.[34] Indeed, two prominent members of the Delaware judiciary have recently noted that "when investors try to evaluate [alternative entity] contract terms, the expansive contractual freedom authorized by the alternative entity statutes hampers rather than helps. Precisely because the statutes lack mandatory terms and permit great flexibility, a profusion of provisions abounds."[35]

In *Stockman v. Heartland Indus. Partners, L.P.*,[36] the Court of Chancery interpreted a limited partnership agreement that had an indemnification provision that began "[t]o the fullest extent permitted by law, the Partnership agrees to indemnify and save harmless each of the Indemnitees from and against *any and all claims*, liabilities damages, losses, costs and expenses … *of any nature whatsoever*, known or unknown, liquidated or unliquidated…."[37] The Court viewed this provision as "an expansive grant of mandatory indemnification rights."[38] The Court noted that "to the fullest extent

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31. *See* Zaman v. Amedeo Holdings, Inc., C.A. No. 3115-VCS, 2008 WL 2168397, at *16 (Del. Ch. May 23, 2008) (interpreting "fullest extent" bylaw provision to encompass mandatory indemnification under Section 145(c)); Cochran v. Stifel Fin. Corp., C.A. No. 173-350-VCS, 2000 WL 1847676, at *8 (Del. Ch. Dec. 13, 2000) (interpreting "fullest extent" contract provision to encompass mandatory indemnification under Section 145(c)), *aff'd in pertinent part*, 809 A.2d 555 (Del. 2002); Dunlap v. Sunbeam Corp., 1999 WL 1261339, at *5 (Del. Ch. July 9, 1999) (holding that advancements were required under mandatory provision so long as mandatory indemnification under Section 145(c) remained a possibility).

32. *Stifel*, 809 A.2d at 561.

33. *Paolino*, 2009 WL 4652894, at *6.

34. *See* Stockman v. Heartland Indus. Partners, L.P., C.A. Nos. 4227, 4427-VCS, 2009 WL 2096213, at *8 (Del. Ch. July 14, 2009) (noting that the DRULPA provides "wider freedom of contract" permitting limited partnerships to "craft their own scheme for a partnerships indemnitees than is available to corporations under Section 145 of the DGCL, which creates mandatory indemnification rights for corporate indemnitees in some circumstances and also bars indemnification in others.").

35. Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* Elgar Handbook on Alternative Entities (Mark Lowenstein & Robert Hillman eds., forthcoming 2014).

36. *Stockman*, 2009 WL 2096213, at *12.

37. *Id.*

38. *Id.*

permitted by law" language is "common in both corporate bylaws and in alternative entity operating agreements, and is 'an expression of the intent for the promise of indemnity to reach as far as public policy will allow.'"[39] In *Stockman*, the limited partnership was required to provide indemnification for former officers of a portfolio company in connection with civil and criminal proceedings involving allegedly fraudulent financial reporting. Under such an expansive indemnification provision, however, one could conceive of mandatory indemnification for conduct that is less related to the business affairs of the entity – such as sexual harassment charges against a manager at a holiday party or even battery charges against an employee who channels "Terry Tate — Office Linebacker" when another employee forgets to refill the coffee pot. A contractual commitment to indemnify someone from "any and all claims … of any nature whatsoever" reflects both poor drafting and bad business decision-making.

Drafters of indemnification agreements for alternative entities must exercise caution because, as expansive as indemnification rights may be under the DGCL, the DGCL provides an outer limit for those rights in the statutory requirements that, among other things, the claims arise "by reason of the fact" that the indemnitee was an "director, officer, employee or agent of the corporation," whereas by contrast, the LLC Act and LP Act do not circumscribe the scope of the indemnification and advancement rights in any way.[40] Moreover, unless the indemnitee was an active participant in drafting the indemnification provision itself, any ambiguities are likely to be construed against the company and in favor of indemnification.[41] Thus, a "fullest extent" indemnification provision for an LLC or LP could result in expansive, unanticipated, and expensive indemnification and advancement obligations for the business.

B. Who Is Covered By The Indemnification Provision?

Corporate indemnification and advancement provisions often apply to directors and officers and avoid extending mandatory advancement and indemnification rights to agents and employees. Such rights do not extend to investors (stockholders). The LLC Act and LP Act, however, do not limit who may receive indemnification.[42] Instead, they permit the entities to offer indemnification to members, managers, partners, and "other persons from and against any and all claims and demands whatsoever." Thus, passive investors without any role in managing the business affairs of the entity may be provided with indemnification and/or advancement rights.

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39. *Id.* (citations omitted).

40. *Branin*, 2014 WL 2961084, at *8 n.54 (noting that "Defendants argue that to the 'full extent permitted' by Delaware law means to the full extent permitted by the [LLC Act]. The implication of Defendants' assertion is that the full extent of the law permitted by Delaware's [LLC Act] is limited and would prevent a company from creating an indemnification or advancement scheme which mirrors that permitted under Delaware's corporate law in a manner which reproduces the results of *Kidsco* or *Salaman*. Defendants' approach fails because it does not account for the broad powers granted to drafters of operating agreements.") (internal citations omitted).

41. *Stockman*, 2009 WL 2096213, at *5 ("When an agreement like the Partnership Agreement makes promises to parties who did not participate in negotiating the agreement, Delaware courts apply the general principle of *contra proferentum*, which holds that ambiguous terms should be construed against their drafter. The *contra proferentum* approach protects the reasonable expectations of people who join a partnership or other entity after it was formed and must rely on the face of the operating agreement to understand their rights and obligations when making the decision to join."); SI Mgmt. L.P. v. Wininger, 707 A.2d 37, 42-44 (Del. 1998) (holding that ambiguities in a limited partnership agreement should be construed against the general partner unless all participants engaged in individualized negotiations); Harrah's Entm't, Inc. v. JCC Holding Co., 802 A.2d 294, 309-10 (Del. Ch. 2002).

42. *Branin*, 2014 WL 2961084, at *4 (noting that "[n]o criteria are established by statute to govern the indemnification that limited liability companies may offer.").

Indemnification and advancement rights often are limited to expenses incurred in a business capacity. The scope of what is permitted, however, can be very different in a corporate case under Section 145 than under contractual provisions applicable to an alternative entity. Section 145 of the DGCL permits corporations to "indemnify any person who was or is a party or is threatened to be made a party … *by reason of the fact* that the person is or was a director, officer, employee, or agent of the corporation." (emphasis added). Corporate charters, bylaws and indemnification agreements often track the language of Section 145 to ensure broad indemnification and advancement rights. The Delaware Supreme Court has held 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 a corporate officer, without regard to one's motivation for engaging in that conduct."[43] The requisite causal "'connection is established if the corporate powers were used or necessary for the commission of the alleged misconduct.'"[44] In *Perconti v. Thornton Oil Corp.*, for example, the Court of Chancery found that a corporate officer was entitled to indemnification after an unsuccessful criminal prosecution for, among other things, "investing beyond his authority and directing that corporate funds be applied for his personal benefit."[45] Even though that indemnitee was alleged to have engaged in criminal conduct for personal benefit, he was, nevertheless, prosecuted by "reason of fact" that he was an officer because his "use of corporate powers entrusted to him was critical to, and instrumental in, the carrying out of the scheme in which he participated and because of which the [i]ndictment issued."[46] On the other hand, the Court has held that the requisite causal connection does not exist when the proceeding "does not involve the exercise of judgment, discretion or decision-making authority on behalf of the corporation" such as the breach of personal contractual obligations under an employment agreement (*e.g.*, taking too much vacation time or submitting fraudulent travel expenses) without any connection to official duties to the company.[47]

In the alternative entity context, however, there is minimal statutory "patina."[48] The Court must simply determine whether indemnification or advancement is available under the relevant contractual provisions. An LLC or LP agreement may provide for indemnification and advancement for 'any and all claims and demands whatsoever.' Thus, the indemnifiable expenses need not be incurred in the potential indemnitee's business capacity or even in connection with the business that is providing the indemnification.

In *Giannini v. Arthur Dogswell LLC*, after the company asserted claims against Giannini alleging breaches of a non-compete agreement and Giannini's fiduciary duties to the Company, Giannini demanded advancement for his defense costs.[49] The LLC agreement provided for indemnification "to the fullest extent permitted by law" for any "threatened, pending or completed claim, action, suit or proceeding … arising out of, related to or in connection with" the terms of

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43. *Homestore*, 888 A.2d at 214.

44. Danenberg v. Fitracks, Inc., C.A. No. 6454-VCL, 2012 WL 11220, at *5 (Del. Ch. Jan. 3, 2012) (citation omitted).

45. *Perconti*, 2002 WL 982419, at *7.

46. *Id.*

47. *Paolino*, 2009 WL 4652894, at *11-15 (internal citations omitted).

48. *See* Reinhard & Kreinberg v. Dow Chem. Co., C.A. No. 3003-CC, 2008 WL 868108, at *2 (Del. Ch. Mar. 28, 2008) (noting that "'indemnification is a right conferred by contract, under statutory auspice.' Although Courts use the tools of contractual interpretation when construing bylaw provisions relating to indemnification and advancement, they simultaneously apply the patina of Section 145's policy.").

49. Giannini v. Arthur Dogswell, LLC, et al., C.A. No. 8942-VCP, transcript at 4 (Del. Ch. Jan. 15, 2014).

the LLC agreement.[50] In granting summary judgment in favor of the indemnitee, the Court reasoned that the language in the LLC agreement "appears to have been used to capture the broadest possible universe."[51] The Court rejected the proffered defense that the claims were personal rather than official in nature, noting that "while the distinction between personal and fiduciary obligations may have some significance in determining advancement in the corporate context, it is not an inherently relevant distinction in the LLC context" because "in the LLC environment, an entity or individual's right to advancement and indemnification is governed by the terms of the parties' agreement and not by Section 145 of the DGCL."[52] The Court refused to apply by analogy the distinction between personal and fiduciary obligations under the DGCL, highlighting that the "LLC agreement allows for advancement and indemnification for claims 'arising out of, related to or in connection with' the company's business or affairs" and that coverage is broader than what is provided for under Section 145 of the DGCL.[53]

In *DeLucca v. KKAT Management, LLC*, the potential indemnitee (DeLucca) was incurring fees to defend herself against claims by her former employer (Katonah) and its controller (Kohlberg).[54] DeLucca had served as the managing member of Katonah, which managed certain investment funds (the "Funds").[55] DeLucca and Kohlberg also invested their own money in the Funds through the KKAT Companies.[56] DeLucca claimed a right to advancement under the Operating Agreements of the KKAT Companies.[57]

The indemnitors (the KKAT Companies), however, were not the beneficiaries of the relief sought in the claims brought by Katonah and Kohlberg against the indemnitee DeLucca. Accordingly, the KKAT Companies contended that "it [was] absurd to think that they [were] bound to advance funds to DeLucca."[58] The Court noted that "[a]t first blush … [t]he mind does initially recoil at the notion that the KKAT Companies could have an obligation to advance funds for DeLucca to defend herself against claims by her former employer, Katonah, and its controlling stockholder, Kohlberg, when those claims do not seek monetary damages on behalf of the Katonah Funds or the KKAT Companies. But after deeper consideration, that immediate reaction is mistaken."[59]

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50. *Id.* at 8.

51. *Id.* at 20.

52. *Id.* at 19-20.

53. *Id.* at 21. Robust advancement provisions may also disincentivize indemnitors with potentially valid, but monetarily insignificant claims, from vigorously pursuing litigation against a former member or partner. When the indemnification obligation is greater than the value of a claim, thereby rendering the claim economically unreasonable, a plaintiff may choose to forego such a claim, even if it is otherwise strategically advantageous. These situations often arise in the business divorce context, as in *Giannini*, when the damages at issue may be *de minimus*, but the former business associates are vying for control.

54. *DeLucca*, 2006 WL 224058, at *1.

55. *Id.* at *3.

56. *Id.* at *1, 3.

57. *Id.* at *7-8.

58. *Id.* at *2, 11.

59. *Id.* at *12.

In granting the requested advancement, the "basic task of the court" was "the same as in a corporate advancement case," and the Court's role was to determine:

> 1) whether [the potential indemnitee] is within the class of persons who are generally covered by the Operating Agreement's advancement provisions; 2) whether she has suffered losses of the kind that are generally eligible for advancement; and 3) whether those losses were incurred in connection with a legal proceeding for which advancement is due her under the Operating Agreements.[60]

The Operating Agreement included "capacious and generous"[61] language that provided for indemnification and advancement for any loss in "connection with or arising out of or related to" the KKAT Companies' operating agreements, "the operation or affairs of a KKAT Company or [a] Fund, or the operations, or affairs of Kohlberg [and his Affiliates] if the loss was attributable to a KKAT Company or [a] Fund."[62] The Court found that DeLucca was an affiliate of Kohlberg and that her fees and expenses incurred in defending the action brought by Kohlberg and Katonah arose out of or "related to" the "operations and affairs" of the funds and that KKAT Companies.[63] Thus, the KKAT Companies — investors in the funds that were being managed by the entity that was suing the indemnitee for its own benefit — were obligated to fund DeLucca's defense of claims asserted by the entity managing the funds in which they had invested for claims that did not seek relief on behalf of those investors.

In *Connecticut General Life Insurance Company v. Pinkas, et al.*, the indemnitee was a limited partner of the general partner (itself a limited partnership) of a limited partnership investment fund (the "Fund").[64] Limited partners of the Fund asserted claims against the Fund's general partner (the management company) and its general partner (the GP). The GP then caused the management company to assert counterclaims and a third party claim against a limited partner of the management company alleging that he usurped a corporate opportunity of the management company. Although indemnification was available from the management company, mandatory advancement was only available from the Fund. The indemnitee therefore sought advancement from the Fund. The Fund's limited partnership agreement provided for the advancement to that entity's General Partner, and to the general and limited partners, agents, and employees of the General Partner, of "attorneys' fees and expenses which arise out of or in any way relate to the Partnership … or which arise by reason of any of them being the General Partner, or a partner, employee, or Partner."[65] In discussing the breadth of the term "relate to" in the indemnification provision in the Fund's Operating Agreement at oral argument, the Court noted:

> I'm not sure I know how to draft anything more encompassing [than] 'relate to.' … I'm still struggling with the notion of 'relating to' is so broadly drafted that it would almost be the functional equivalent of if it touches upon, it relates to and — and, therefore, there's a sufficient nexus to what was going on with [the partnership] for the indemnification provision if it otherwise applies to kick in.[66]

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60. *Id.* at *7.

61. *Id.* at*2.

62. *Id.* at *1, 7.

63. *Id.* at *9-11.

64. 2010 WL 4925832, at *1 (Del. Ch. Nov. 18, 2010).

65. *Id.*

66. Connecticut Gen. Life Ins. Co. v. Pinkas, et al., C.A. No. 5724-VCN, transcript at 14-15 (Del. Ch. Nov. 1, 2010).

The Court found that the limited partner/indemnitee had established an entitlement to advancement under the Fund's limited partnership agreement, and noted that while the "it may be attenuated, the nexus between these claims and [the limited partnership] is sufficient to satisfy the very broad 'in any way relate to' language of the advancement provision."[67] Thus, although the indemnitee may have ultimately been entitled to indemnification from the management company in which he was a limited partner, the Court ordered the Fund to advance the indemnitee's defense costs.

Delaware courts have repeatedly urged practitioners to exercise caution in drafting broad advancement and indemnification provisions under the DGCL.[68] The lack of default standards and flexibility afforded to drafters of alternative entity provisions warrants even greater caution. A broadly drafted indemnification provision may require an LLC or LP to fund claims brought against another entity, including claims seeking a personal benefit

C. Nature Of The Claims Giving Rise To The Indemnification Or Advancement.

The DGCL limits the availability of indemnification and advancement to certain types of claims and conduct. Mandatory indemnification under Section 145(c) and advancement under Section 145(e) are limited to expenses incurred "in defense of" or "in defending" a proceeding. In addition, indemnification is only available if the indemnitee "acted in good faith and in a manner the person 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 the person's conduct was unlawful." These statutory limitations preclude an indemnitee from having the corporation fund offensive claims against it[69] or to pay indemnification for intentional malfeasance or knowingly unlawful conduct.[70]

The LLC and LP Acts, however, do not include those statutory limitations.[71] Thus, an LLC or LP Agreement may provide for indemnification or advancement for persons who are involved in a proceeding or investigation in any way – including as a plaintiff – and regardless of whether the indemnitee is found to have been acting in bad faith or with criminal intent. For example, a broadly drafted indemnification provision in an LLC Agreement may provide: "Indemnity of Members, Employees and Other Agents. The Company shall, to the maximum extent permitted under the Limited Liability Company Act, indemnify and make advances for expenses to Members." Such a provision raises substantial issues because "the LLC Act permits parties to an operating agreement to provide indemnification and advancement rights for

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67. *Connecticut Gen.*, 2010 WL 4925832, at *1.

68. *See, e.g.*, *DeLucca*, 2006 WL 224058, at *2 ("this is yet another case in which defendants in an advancement case seek to escape the consequences of their own contractual freedom. Regretting the broad grant of mandatory advancement they forged on a clear day, they seek to have the judiciary ignore the plain language of their contracts and generate an after-the-fact judicial contract that reflects their current preference. But it is not the job of a court to relieve sophisticated parties of the burdens of contracts they wish they had drafted differently but in fact did not. Rather, it is the court's job to enforce the clear terms of contracts.").

69. *See, e.g.,* Citadel Holding Corp. v. Roven, 603 A.2d 818, 824 (Del. 1992); *Paolino*, 2009 WL 4652894, at *6; *Zaman*, 2008 WL 2168397, at *16; Baker v. Impact Holding, Inc., C.A. No. 5144-VCP, 2010 WL 2979050, at *3 (Del. Ch. July 30, 2010).

70. *See* Hermelin v. K-V Pharma. Co., 54 A.3d 1093, 1094 (Del. Ch. 2012).

71. *Fillip*, 2014 WL 1821299, at *6("[U]nlike Section 145(e), the LLC Act does not preclude a company from providing advancement rights beyond fees and expenses incurred 'in defending' a covered proceeding. Section 18–108 permits a limited liability company to 'indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever.'").

'any and all claims and demands whatsoever.'"[72] Such a provision would entitle members (and potentially "other agents" and "employees") to receive both advancement and indemnification for fees and expenses regardless of the capacity in which they incurred those fees, regardless of whether they were incurred as a plaintiff or a defendant, they were seeking benefit themselves or the company, or they were acting with criminal intent.

Indeed, in *Salovaara v. SSP Advisors*, the Court granted indemnification to an indemnitee for his fees and expenses incurred *as a plaintiff* in connection with actions to obtain a "*personal* recovery" under a limited partnership agreement that was not limited to defensive indemnification.[73] More recently, in *Fillip v. Centerstone Linen Services, LLC*,[74] the Court highlighted that "LLC Act gives contracting parties complete discretion in establishing the scope of indemnification and advancement rights"[75] and noted that unlike the DGCL, limited liability company operating agreements can provide indemnification "without regard to whether those costs are incurred 'in defense of' a covered proceeding or claim."[76]

In the absence of statutory limits on advancement and indemnification rights, drafters of alternative entity agreements must be cautious to include clearly defined limits on the scope of advancement and indemnification rights so that the business does not find itself in the position of funding actions against it or indemnifying intentional misconduct.

D. Mandatory Indemnification

Section 145(c) provides for mandatory indemnification when a present or former director or officer has been "successful on the merits or otherwise in defense of" a proceeding. The language of Section 145 been held to be broad enough to entitle a former officer partial indemnification if he successfully defends himself against one count of a criminal indictment but is convicted on another count.[77] Contractual provisions governing LLCs and LPs, however, may not provide for any mandatory indemnification at all (*e.g.*, the company's decision making body can grant or deny indemnification in its discretion) or provide for mandatory indemnification under an even broader standard.

In *Branin v. Stein Rowe Investment Council, LLC*,[78] the indemnitee sought indemnification for fees and expenses of over $3 million in litigation that spanned over 10 years.[79] The LLC agreement provided for indemnification "for any loss, damage or claim by reason of any act or omission performed or omitted by such Person in good faith on behalf of the Company and, as applicable, in a manner reasonably believed to be within the scope of the authority conferred on it

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72. *Fillip*, 2013 WL 6671663, at *4.

73. Salovaara v. SSP Advisors, L.P., C.A. Nos. 20288-NC, 16579-NC, 2003 WL 23190391, at *1 (Del. Ch. Dec. 22, 2003).

74. *Fillip*, 2014 WL 1821299.

75. *Id.* at *6.

76. *Id.*

77. *See* Fasciana v. Elec. Sys Data Corp., 829 A.2d 160, 185 (Del. Ch. 2003) (citing *Cochran*, 2000 WL 1847676, at *4 n.10, *aff'd in part, rev'd in part*, 809 A.2d 555 (Del. 2002)).

78. *Branin*, 2014 WL 2961084.

79. *Id.* at *1.

by this Agreement."[80] The Court noted that the indemnitee's rights did not depend upon being "successful on the merits or otherwise in defense of any action."[81] Instead the agreement simply required that the potential indemnitee have acted "in good faith" and in a manner that the indemnitee reasonably believed was "within the scope of his authority."[82] The Court noted that further proceedings were necessary to resolve the factual questions under this standard.[83] Thus, under the indemnification provision litigated in *Branin*, an indemnitee could be unsuccessful in defending the claims brought against him but still entitled to indemnification if he could demonstrate that he acted in good faith and in a manner he reasonably believed to be within the scope of his authority.[84] When advancement and indemnification rights are not carefully circumscribed even losers can be winners.

Leaving an indemnification decision entirely within the company's discretion may seem like a sensible approach. It can, however, have serious consequences when there has been a change in control or when the company does not have independent decision-makers to authorize the indemnification. In the event of a change in control under a discretionary structure, an indemnitee may find themselves completely vindicated in underlying litigation but strapped with a hefty bill for legal fees that the company's new decision-makers are unwilling to pay. If the company lacks independent decision-makers to authorize the indemnification, granting the indemnification may invite a lawsuit on the grounds of self-dealing.[85] Careful drafting with experienced counsel enables a more insightful, and often more economically efficient, approach.

IV. CONCLUSION

Practitioners may find it convenient to apply well-developed principles of DGCL to issues involving alternative business entitles, but the contractarian nature of alternative entities must be given primacy. Time and again, Delaware Courts have warned business people that they "must exercise the contractual freedom afforded to them under Delaware law to delimit the circumstances in which they are obliged to advance funds to, or ultimately indemnify, employees and other officials. There is no requirement that advancement provisions be written broadly or in a mandatory fashion. But when an advancement provision is, by its plain terms, expansively written and mandatory, it will be enforced as written."[86] Advancement and indemnification provisions in documents governing contractual alternative entities should be given particularly close scrutiny because even the limits of the DGCL do not apply to contractarian alternative entities. Far too often, participants in alternative entities do not carefully consider the importance and application of the indemnification and advancement provisions in their governing documents until it is too late.

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80. *Id.* at *2

81. *Id.* at *5.

82. *Id.*

83. *Id.* at *10.

84. *See id.*

85. *See, e.g.*, Havens v. Attar, C.A. No. 15134-VCC, 1997 WL 55957, at *13-14 (Del. Ch. Jan. 30, 1997) (holding that plaintiffs were reasonably likely to rebut the presumptions of the business judgment rule in challenging a *quid pro quo* advancement decision).

86. *DeLucca*, 2006 WL 224058, at *13; *Branin*, 2014 WL 2961084, at *14 n.43.