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A Buyer's Guide To Carelessly Losing Indemnification Rights

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Law360, New York (June 26, 2017, 4:58 PM EDT) -- The recent Delaware case of Davis v. EMSI Holding Co. reminds us that basic Delaware law can defeat even the most well-crafted indemnification arrangements in a private company stock acquisition. The purchaser may have negotiated broad representations and covenants backed by strong indemnification provisions with aggressive baskets, caps, definition of damages, and all of the other bells and whistles that a purchaser looks for to protect its interests. The parties may have fully documented an agreed-upon allocation of risk. Yet, if the sellers or the sellers' representatives are directors and officers of the target company, all that planning and drafting may be for naught. Under Delaware law, preclosing directors and officers very well may be entitled to indemnification for claims made by the purchaser under the acquisition agreement, including advancement of costs for defending the purchaser's claims. In effect, a company owned by the purchaser may have to pay the seller's legal fees, and perhaps even pay their damages, if the sellers are found liable for a claim.

Delaware courts have consistently held that actions taken by corporate officers and directors prior to the closing of a transaction are indemnifiable post-closing. Where a buyer sues the sellers for breach of a stock purchase agreement or merger agreement and the breach arguably relates to actions taken by the sellers in their capacities as preclosing officers and directors of the target company, the sellers, in addition to whatever responses they might make to the complaint, can also make a claim against the target company recently purchased by the buyer for indemnification and advancement of expenses to defend the suit by the buyer. In many cases, Delaware courts have required the target companies, in fact, to advance expenses to the former directors and officers to defend a claim by the purchaser of breach of the acquisition agreement.

The Davis v. EMSI Holding Co. case illustrates this trap. In this case, the purchaser purchased the stock of EMSI Holding Co. After closing, the purchaser accused the sellers of engaging in a complex accounting fraud and sued them. Two of the sellers were officers and directors of EMSI prior to closing. In a separate action, these two sellers sued EMSI (and not the purchaser) for indemnification pursuant to EMSI's bylaws. EMSI's bylaws contained fairly typical Delaware law indemnification provisions that required the company to indemnify directors or officers for third-party claims where they are sued by reason of being or having been a director or officer. The bylaws also provided for mandatory advancement of expenses, subject to receipt of an undertaking for repayment.

The court went through a straightforward Delaware law analysis noting that Delaware law permits indemnification, and the EMSI charter would require indemnification, if the claims are "by reason of the fact" that the defendants were former directors or officers. The court then noted that in the underlying claims, the purchaser is claiming that the defendants misused their position as directors and officers to engage in a widespread fraud. While these allegations might be breaches of representations and warranties in the acquisition agreement, the claims required the former officers and directors to defend their actions as officers and directors and their alleged abuse of corporate powers. The court ruled that the defendant officer and director sellers were entitled to advancement of expenses for defending the claims.

What makes typical bylaw indemnification provisions even worse for the unwary buyer are some of the additional consequences beyond a right to advancement of expenses:

- Delaware awards "fees on fees" — that is the director and officer suing for advancement or indemnification is also entitled to the legal fees incurred in successfully suing for advancement or indemnification. As with any Delaware monetary judgment, there may also be pre-judgment and post-judgment interest.

- Courts have enforced advancement rights even where the acquisition agreement explicitly states that each party shall pay its own costs. (Davis v. EMSI Holding; Hyatt v. Al Jazeera).

- Courts have enforced these rights where the former officer or director is being sued in his or her capacity as sellers' representative (effectively making the target advance all of the sellers' defense costs since the sellers' representative is defending the claims on behalf of all sellers). (Hyatt v. Al Jazeera)

- Advancement is not the worst issue — Delaware law provides that even if a former officer or director loses a lawsuit by a third party (the purchaser in this case), they are still entitled to indemnification if the former officer or director acted in good faith and in a manner that he or she reasonably believed to either be in (or not opposed to) the best interests of the company. The purchaser can win its claim for breach of representations, warranties and covenants, yet has to prove bad faith to actually be able to collect damages without having to indemnify the defendants!

- While the majority of cases on this topic involve Delaware corporations, if a Delaware limited liability company operative documents provide for indemnification that mirrors that of a Delaware corporation, a Delaware court is likely to apply this precedent where the target company is a limited liability company. (Hyatt v. Al Jazeera)

These consequences are draconian — so much so that our experience is that many of these suits are settled promptly after the ruling on advancement. And not just a settlement of the indemnification claim. The purchaser also will generally settle the underlying acquisition claim. The parties almost never litigate the merits of the underlying claim.

The Delaware provisions on indemnification and advancement are well-known to practitioners. Section 145 of the Delaware General Corporation Law provides that a corporation must indemnify a director or officer who is successful on the merits or otherwise of an indemnifiable action or proceeding. Section 145 (a) provides that a corporation may indemnify a director or officer against expenses, judgments,

fines and amounts paid in settlement in any claim or suit where the director or officer is a defendant "by reason of the fact" that the person was or is a director or officer. In our experience, most corporations have made this indemnification mandatory. In addition, Section 145 (e) authorizes a corporation to advance expenses (upon receipt of an undertaking by the director to repay if, ultimately, found liable) of the director or officer defendant during the course of the proceedings. Again, in our experience most private corporations provide mandatory advancement of expenses subject to the Delaware law standards.

The courts' broad reading of indemnification rights keys off the phrase "by reason of the fact" in Section 145. The Delaware courts have consistently held that an action against a director or officer is brought "by reason of the fact," of their status as a director or officer if a "nexus or causal connection exists between the underlying proceedings and the defendant's official corporate capacity. This nexus or causal connection will be deemed to exist if corporate powers were used or necessary for the commission of the alleged misconduct." As a practical matter, many (if not most) indemnification claims will fall under this standard. In lawsuits seeking indemnification under purchase agreements, Delaware courts have held the following actions satisfy this "by reason of the fact" test:

- Allegations that the target was in breach of most-favored nations provisions in its contracts (Hyatt v. Al Jazeera);

- Allegations that the target misled the purchaser on ongoing business disputes (Hyatt v. Al Jazeera);

- Allegations that the officer's fraudulent misrepresentations induced the purchaser to grant the sellers a license in connection with the sale by the sellers of their business (Danenberg v. Fitracks Inc.); and

- Allegations that the sellers engaged in fraud, conversion, breach of fiduciary duty, misrepresentations, and deletion of computer files (Douglas v. Tractmanager Inc.).

And the courts are not sympathetic at all to the aggrieved purchaser. As the master in the Tractmanager case observed, "The advancement disputes that reach this court often begin to take on a quality reminiscent of the late Harold Ramis' comedic masterpiece, "Groundhog Day." Although the arguments change slightly, and companies occasionally seize upon novel arguments to advance their ultimate goal of avoiding their contractual obligations, the plot rarely shifts: a company that granted its directors and officers broad indemnification and advancement rights in bylaws or employment agreements seeks to avoid the consequences of that promise when a director or officer is accused of serious wrongdoing that allegedly injured the company."

The courts instead are driven by the dual policies underlying Section 145: "(a) allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and (b) 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." (VonFeldt v. Stifel Fin. Corp.) The Delaware courts are not about to abandon these long-standing policies just because a purchaser thinks they have a breach-of-contract claim.

So what is a buyer to do? We have seen very few purchasers take any protective steps. In a few

instances, purchasers state in the acquisition agreement that the target will not have to indemnify officers and directors for preclosing breaches (we see this usually as a carveout to the typical covenant requiring the target to maintain director and officer indemnification protections for the preclosing officers and directors). This is a necessary step, but does nothing to amend any underlying indemnification protections in the target's bylaws or in any employment or indemnification agreements. We have not seen a purchaser request changes to these core documents to deal with this issue. Any amendment to an employment or indemnification agreement would require the consent of the officer or director party to the agreement. In most instances, an amendment to the bylaw indemnifications provisions will also require the consent of the affected officers and directors. Section 145(f) of the Delaware General Corporation Law provides that amendments to the rights to indemnification or advancement are generally not retroactive.

To solve this problem, a purchaser must get individual enforceable releases from each of the preclosing officers and directors. Many stock purchase agreements, where the individual sellers all have to sign anyway, do contain releases by the sellers. Ironically enough, these releases almost always include an explicit provision that the seller directors and officers are not releasing any indemnification rights! The release in the stock purchase agreement should also release all indemnification rights to the extent the underlying claims are related to or arising from a breach of the stock purchase agreement.

Merger agreements are a bit different. The individual sellers do not sign the merger agreement. Until the Cigna v. Audax case, many practitioners were comfortable putting a release in a letter of transmittal. It is not clear whether a release in a letter of transmittal is enforceable after Cigna v. Audax, and as with the stock purchase agreement releases, most releases in letters of transmittal included explicit provisions preserving director and officer indemnification rights. With the Cigna case, the purchaser under a merger agreement needs to be blunt — it needs a release from each director and officer releasing all claims for preclosing indemnification (whether pursuant to the acquisition agreement, the charter or bylaws, or an employment or indemnification agreement) to the extent the underlying claim is related to or arising from a breach of the acquisition agreement.

As deal lawyers in private acquisitions, we often focus on the deal and maximizing the contractual protections for our client in the documents. The Davis v. EMSI Holding case reminds us we need to start with basic corporate law, and make sure the deal documents and the underlying law work together to maximize our client's position.

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