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Limiting Obligation To Advance Legal Fees

Law360, New York (March 23, 2009) -- Government investigations and shareholder litigation frequently last several years, leaving companies with an expensive obligation to pay legal fees for officers and directors who are targets, defendants or even mere witnesses. This obligation often arises from written employment agreements or a company's articles of incorporation.

One issue with such payments is whether the company must pay the fees as they are incurred (advancement) or only at the conclusion of the dispute or investigation (indemnification). Under Delaware law, these two rights have consistently been held to be legally distinct: a right to indemnification does not mean a right to advancement.

A decision by the Delaware Court of Chancery that was recently affirmed by the Supreme Court of Delaware, however, suggests that courts will impose advancement obligations with more frequency unless companies take specific steps to protect themselves.[1]

Sodano v. American Stock Exchange LLC — Finding a Right to Advancement Even Where Parties Do Not Explicitly Create One

Put simply, indemnification is the right to have all expenses and losses paid. This right is usually subject to a requirement that the officer or director have acted in good faith and in a manner he believed to be in the best interest of the corporation, and, in a criminal case, had no reasonable cause to believe his or her actions were unlawful.

Because of this requirement, disputes over indemnification generally cannot be resolved until the litigation or government investigation has been completed.

In contrast, advancement is the right to have fees and expenses paid as they are incurred and usually is not subject to any requirement other than the submission of an undertaking to repay the amounts if the party is ultimately determined not to be entitled to indemnification.

Delaware courts have "maintained for a generation that the terms advancement and indemnification are not synonymous. Because rights to indemnification and advancement differ in important ways, [the] courts have refused to recognize claims for advancement not granted in specific language clearly suggesting such rights." Majkowski v. American Imaging Mgmt. Servs., 913 A.2d 572, 589 (Del. Ch. Ct. 2006).

In Sodano v. American Stock Exchange LLC, C.A. No. 3418-VCS, 2008 WL 2738583 (Del. Ch. Ct. July 15, 2008), aff'd, American Stock Exchange LLC v. Financial Industry Regulatory Authority (Del. Sup. Ct. Mar. 17, 2009), the Delaware courts took an important step away from this long-standing distinction and created a pratfall for those corporations who have not specifically delineated their advancement and indemnification obligations.

In Sodano, the former chairman of the American Stock Exchange (“Amex”) sued Amex and the Financial Industry Regulatory Authority (“FINRA”) seeking advancement of his legal fees in a long-running Securities and Exchange Commission (“SEC”) investigation into regulatory failures at Amex.

During the SEC investigation, Sodano had incurred in excess of $4 million in legal fees. FINRA is formerly the National Association of Securities Dealers (“NASD”), and it acquired Amex in 1998.

Sodano was an officer and director at FINRA until 1999, when FINRA asked him to serve as Amex’s Chairman and CEO. He maintained his officer status with FINRA in name only and worked full-time for Amex. When it decided to sell Amex, FINRA negotiated a separation agreement with Sodano that was finalized in late 2004.

Sodano’s separation agreement included a section titled “Indemnification/D&O Insurance.” It read: “[NASD] will indemnify you for any liability (including but not limited to, all reasonable legal fees and out-of-pocket expenses) you incur ... to the fullest extent permitted by law and NASD’s organizational documents.” The agreement did not mention advancement rights, but did include a release of all rights.

FINRA’s certificate of incorporation included a section, Article Fifth, that provided for advancement and indemnification for directors (called “governors”) in separate subsections. Indeed, there was no dispute in the case that if Sodano still worked at FINRA, he would have had an advancement right.

FINRA’s position at trial, however, was that the language in the separation agreement that it would “indemnify” him provided only for indemnification and not advancement.

Sodano argued that the reference in the agreement indemnification section to “the fullest extent permitted by ... [FINRA’s] organizational documents,” was sufficient to create an advancement obligation because the organizational documents provided for advancement.

The Chancery Court concluded that the reference to “organizational documents” in the agreement meant that FINRA had an advancement obligation to Sodano because FINRA’s certificate of incorporation “uses ‘indemnification’ both broadly to encompass both advancement and ultimate indemnification and narrowly to cover ultimate indemnification only.” 2008 WL 2738583 at *11.

The court noted that there were two “broad uses” of the word “indemnification” in the certificate. First, the title of the article about indemnification and advancement was “Indemnification; Governor Liability.” Id. Second, the certificate included the phrase “indemnification provided by this Article Fifth” in reference to both advancement and indemnification. Id.

The court drew this conclusion even though the certificate conferred indemnification and advancement rights in separate subsections and imposed different requirements on individuals seeking them. The certificate also included language that clearly separated the rights.

For example, one section limited FINRA's "obligation, if any, to indemnify or advance expenses." Another set out a procedure to be used "if a claim for indemnification or advancement of expenses under this Article Fifth is not paid in full."

Nonetheless, the court ignored FINRA's efforts to separate these rights and instead held that the mere reference in Sodano's separation agreement to the certificate — even without mentioning advancement rights — was sufficient to impose on FINRA the obligation to advance Sodano's fees.

In short, the holding in Sodano frees Delaware courts to overlook the substance of a company's articles of incorporation that separate the two rights. Instead, any imprecise language will be interpreted against the company and in favor of advancement rights for the individual.

How to Protect Your Company After Sodano

Although Sodano's holding is somewhat surprising given Delaware's strict separation of indemnification and advancement rights, it is also a helpful roadmap for companies seeking to maintain control over their advancement and indemnification obligations. Here are five suggestions for those companies:

First, companies should conduct a close review of their articles of incorporation and other organizational documents. If any headings or other language use the word "indemnification" to refer to both indemnification and advancement, they should be changed to “indemnification and advancement.”

It may make for a tedious-sounding final product — with repeated references to “indemnify and advance” — but it will protect against the result in Sodano.

Second, it may also be helpful to include explicit language mandating that the articles should be read to treat these two rights separately. The Sodano decision did not reach this issue but making such a statement removes any ambiguity as to whether the company understands the difference between the two rights and intends to treat them differently.

Third, companies should consider including language that limits the company’s indemnification and advancement obligations where the individual is able to recover such payments from another entity. This makes good business sense, as it conserves corporate assets when there is another potential indemnitor. In Sodano, FINRA’s certificate had a section that read:

"[FINRA’s] obligation, if any, to indemnify or advance expenses to any person who is or was serving at its request as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust enterprise or nonprofit entity shall be reduced by any amount such person may collect as indemnification or advancement form such other corporation, partnership, joint venture, trust, enterprise or nonprofit entity."

Mr. Sodano’s legal expenses had been advanced by Amex (without dispute) throughout the SEC investigation. In fact, Amex conceded that it had an advancement obligation to Mr. Sodano under its own articles of incorporation and that it had the ability to pay the fees.

The court rejected Amex’s argument that the language in FINRA’s certificate made the two entities co-indemnitors, each obligated to advance one-half of Sodano’s fees.

Rather, it concluded that “the best interpretation” of the section “is that [FINRA] is secondarily liable to Sodano for the advancement of his expenses” and that Sodano had an affirmative “duty .. to seek advancement from the Amex and to reduce [FINRA’s] obligation by the amount Sodano may actually collect from the Amex.” 2008 WL 2738583, *14.

The court explained that this reading made sense because FINRA had made the rational business decisions to operate Amex as a separate subsidiary and to make the subsidiary primarily liable for obligations that arose as a result of actions at the subsidiary level.

Where the employee is essentially seconded to a subsidiary, the parent company acts “solely as a back-stop insurer” if the subsidiary cannot pay. Id. at *15.

The SEC investigation arose out of Sodano’s actions on behalf of Amex, not on behalf of FINRA; thus, Amex was primarily obligated to advance Sodano’s fees and FINRA had to pay only if Amex could not.

Companies with subsidiaries should consider adopting a similar provision in their articles of incorporation. Although financial consolidation may mean that there is no practical difference between a payment by a parent and a payment by a subsidiary, if the subsidiary is later spun off or sold, such a change would protect the parent company.

Fourth, the Sodano case teaches that when a company negotiates the departure of an officer, director or employee who is part of a government investigation or lawsuit, it should carefully consider advancement and indemnification obligations and ensure that the written agreement addresses the issue.

Inside and outside counsel need to be cognizant of the difference between these concepts and negotiate them explicitly, knowing that the Delaware courts are increasingly likely to interpret ambiguous language in favor of the individual seeking advancement.

Finally, companies should consider eliminating mandatory advancement obligations to former officers and directors. Delaware companies have significant flexibility to change their bylaws in this regard.

In Schoon v. Troy Co., 948 A.2d 1157 (Del. Ch. Ct. 2008), the Delaware Chancery Court held that a former director was not entitled to advancement where the company had amended its bylaws to exclude advancement rights for former directors. The director in that case had not been sued when he left the company.

This decision allows companies to limit advancement for wrongdoing that may have already occurred but has not been made part of litigation or a government investigation.

(To encourage current directors to permit such a bylaw change, the company may need to agree separately to provide them indemnification and advancement even after they leave the company.)

The Schoon holding is particularly relevant when a company conducts an internal investigation and discovers wrongdoing. If the company terminates an officer or director for that wrongdoing before the individual has incurred legal fees, this type of bylaw change may protect the company from having to pay fees for an individual it believes contributed to the wrongdoing.

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Baker Botts represented the Financial Industry Regulatory Authority in this litigation. The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] Companies should not feel pressured by the government to refuse to pay such attorney fees as part of a cooperation agreement with the government during an investigation. In a recent Second Circuit case, United States v. Stein, No. 07-3042-cr, 2008 WL 3982104 (2d Cir. Aug. 28, 2008), the court upheld the dismissal of criminal charges against

several partners and employees of the accounting firm KPMG. The court held that these defendants had been denied their Sixth Amendment right to counsel based on the government's pressure on the company not to pay the fees as part of the company's cooperation agreement.
