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The Importance of Advancement in Corporate Formation and Litigation Strategy

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Litigation

Corporate

Advancement is a corollary to indemnification, permitting directors, officers and managers to get legal fees advanced for their defense of claims asserted against them in their corporate capacity. While indemnification requires a company to pay legal fees incurred by the director, officer or manager *after* he or she defeats a claim, advancement allows for payment *before* a decision is made regarding the claims. Most companies and those serving in managerial capacity do not think about the impact of advancement; however, it is a powerful tool that should be negotiated and discussed at the forefront.

Delaware, where most entities are incorporated, has a strong public policy in favor of advancement rights so as to attract the most capable people into corporate service.¹ Indeed, as the Delaware Supreme Court previously has explained, “[a]dvancement provides corporate officials with immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings.”² Furthermore, Delaware public policy is in favor of allowing advancement even in cases where claims against the director, officer, or manager is for breach of fiduciary duty.³

Since advancement rights are distinct from indemnification rights, a determination with respect to indemnification is not a prerequisite to advancement. In fact, Delaware courts have consistently rejected efforts to conflate advancement and indemnification rights.⁴

Advancement provisions are interpreted broadly, and “ambiguities in advancement provisions generally are construed against the corporation who drafted them.”⁵ This approach to construction “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.”⁶

Thus, companies that intend to restrict advancement rights must clearly do so.⁷ The linchpin of advancement is the fees on fees that can be awarded. As a matter of course, Delaware courts award a plaintiff his reasonable fees and expenses incurred in prosecuting an advancement action, absent an express exclusion in the governing documents.⁸

If you are intending to serve in a managerial capacity in a corporation or alternative entity, review bylaws or operating agreements carefully before accepting the position. Ensure that the company’s corporate documents include advancement and indemnification rights, and that the company has the financial means to provide for such rights. If the corporate documents do not include advancement and indemnification rights, negotiate for such rights.

If you are forming an entity, consider carefully the advancement and indemnification language in your governing documents. Failure to do so can result in you advancing legal expenses for the individual who has allegedly wronged the company.

Advancement and indemnification rights should also be part of your consideration in pursuing any action against an officer, director, or manager. Finally, be thoughtful in denying advancement rights – if the individual is successful in showing entitlement to

advancement, the company can then be on the hook for the individual's legal fees in defending the pending action, as well as fees incurred in enforcing advancement rights.

If you have any questions about corporate or alternative entity disputes and how to secure your advancement rights (either pre- or post-litigation), please do not hesitate to contact one of the members of Gould & Ratner's Litigation team.

1 See *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005); see also *Fasciana v. Elec. Data Sys. Corp.*, 829 A.2d 160, 170 (Del. Ch. 2003) (noting that, without advancement, "corporations would find it difficult to retain high-quality directors and officers, especially ones willing to make socially useful decisions that involve economic risk").

2 *Homestore*, 888 A.2d at 211.

3 *Delphi Easter Partners Ltd. P'ship v. Spectacular Partners, Inc.*, 1993 WL 328079, at *8 (Del. Ch. Aug. 6, 1993).

4 See, e.g., *Morgan v. Grace*, 2003 WL 22461916, at *2 (Del. Ch. Oct. 29, 2003) (finding that the determination as to indemnification could "only be made after the Superior Court action has been adjudicated" and "[i]n the meanwhile, 4000 Associates must advance expenses to the plaintiffs"); *Trascent Mgmt. Consulting, LLC v. Bouri*, 152 A.3d 108, 112 (Del. 2016) (rejecting limited liability company's argument that advancement claimant had "duty in an advancement proceeding to disprove [its] belated allegations" of fraudulent inducement); *Reddy v. Elec. Data Sys. Corp.*, 2002 WL 1358761, at *5 (Del. Ch. June 18, 2002) ("[I]t is highly problematic to make the advancement right of such officials dependent on the motivation ascribed to their conduct by the suing parties. To do so would be to largely vitiate the protections afforded by § 145 and contractual advancement rights."); See *DeLucca v. KKAT Mgmt., L.L.C.*, 2006 WL 224058, at *11 (Del. Ch. Jan. 23, 2006) ("[T]he right to advancement does not go away simply because the entity from which advancement is sought is alleging that the plaintiff has committed perfidious acts against it. Indeed, it is precisely in the circumstance when a business official is accused of serious wrongdoing that the right to advancement is critical.").

5 *Paolino v. Mace Sec. Int'l, Inc.*, 985 A.2d 392, 402 (Del. Ch. 2009).

6 *Stockman v. Heartland Indus. Partners, L.P.*, 2009 WL 2096213, at *5 (Del. Ch. July 14, 2009).

7 See *Sassano v. CIBC World Markets Corp.*, 948 A.2d 453, 463 (Del. Ch. 2008) ("If CIBC intended to restrict nominal officers' advancement rights, it could have easily done so by including clear language to that end.")

8 See *Morgan* 2003 WL 22461916, at *4 (holding "plaintiffs are entitled to an award of 'fees on fees' to the extent they were successful in their claim to enforce a contractual right to advancement"); *DeLucca*, 2006 WL 224058, at *15 (holding plaintiff is entitled to award of litigation expenses in bringing advancement action and only way out of the "fees on fees" award is if the controlling document excluded "fees on fees"); *Weil v. VEREIT Operating P'ship, L.P.*, 2018 WL 834428, at *15 (Del. Ch. Feb. 13, 2018) (awarding fees on fees to plaintiff who succeeded on advancement claims).

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