Advancement rights: Are you covered?

Two recent Delaware decisions emphasize the need to review these rights and to monitor developments in this area.

BY DOUG RAYMOND

SERVING AS A DIRECTOR of a company, particularly a public company, can be no picnic. Earnings disappointments, activist stockholders, government regulation, and difficult succession issues can keep directors awake at night. They should not also have to worry about having to defend their board actions with their own personal funds. Corporations should be able to assure their directors that litigation costs will be paid by the company, subject to well-known exceptions (such as where the director is found to have violated his or her fiduciary duties).

Despite the importance of advancement and indemnification rights, Delaware law is far from certain as to the scope and limitations of these rights. Recent Delaware Chancery Court decisions, which come on the heels of Delaware corporation law amendments related to expense advancement, should trigger a careful re-examination of advancement and indemnification rights. In particular, boards and companies should know that:

• A company's bylaws may impose reasonable restrictions on expense advancements.

• The full scope of advancements and indemnification rights should, but does not necessarily have to, be contained in one document.

• Courts expect a director to be aware of the scope and restrictions of these protections as described in a company's charter and bylaws.

• A director may be entitled to these protections for defending against a company's counterclaim even if the original suit had been brought by the director against the company.

Advancement rights returned to the spotlight in 2008 with a controversial decision by the Delaware Chancery Court (*Schoon v. Troy*), which enforced a bylaw amendment that retroactively eliminated expense advancements to former directors. These directors, therefore, were on the hook for funding their own legal defenses. In the wake of *Schoon*, companies amended bylaws and entered into indemnification agreements with their directors to strengthen the advancement and indemnification rights and to prevent changes that would reduce these rights to the detriment of a former director. In response to *Schoon*, the Delaware legislature amended the corporation law to prohibit elimination of advancement rights after the occurrence of the action giving rise to the litigation, unless a specific provision explicitly authorized elimination. Following this amendment, many of the questions resulting from *Schoon* were resolved and the pressure to review these rights subsided.

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Then, the Delaware Chancery Court issued two other opinions about expense advancement and indemnification rights: *Xu Hong Bin v. Heckmann Corp.* and *Paolino v. Mace Security International, Inc.* In *Xu Hong*, the court analyzed whether a bylaw provision that allowed a company to impose restrictions on the advancement of legal fees was consistent with the company's charter, which included an advancement provision, but not the restriction. In *Paolino*, a former CEO filed a demand for arbitration for wrongful discharge and breach of his employment agreement against his former company. In response, the company filed counterclaims asserting, among other things, breach of his fiduciary duties. The former CEO sought expense advancement to defend against the company's counterclaims.

As decided, *Xu Hong* makes clear that a Delaware corporation's bylaws may impose restrictions on advancements, even if not in the charter. The court noted that the bylaws had been adopted simultaneously with the charter and the court assumed that the drafters did not intend for the two documents to conflict. Additionally, both the bylaws and charter were in effect when the director began his service on the board and, accordingly, the director should have been on notice of the bylaw limitations. The court also noted that there is no requirement that conditions on advancements be included in the same document granting the advancement rights. Indeed, if such a requirement did exist, many indemnification agreements between companies and directors might not be enforceable. In *Paolino*, the court held that the director was entitled to advancement for defending against the company's counterclaims, which were not initiated by him but did include claims related to his fiduciary duties and, thus, were related to his service as a director. Because it was not practical to distinguish between expenses incurred by the director in his affirmative claims and defending against the counterclaims, the court ordered that all of the director's reasonable expenses must be advanced.

The decisions in *Xu Hong* and *Paolino* emphasize the need to thoughtfully review expense advancement and

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flows received *after* the next five years. If you doubt this, take any publicly traded company and compare the dividends received over the next five years to the price and you will find that most of the value is in the terminal value, even for low-growth utilities;

2) this terminal value is very sensitive to the future growth of a company, with small changes producing large swings in value; and,

3) all CEOs are replaced at some point, and it's likely to be in this future period where the dominant CEO leaves. So what we have is a situation where the growth and value of the company are highly dependent on an executive who is likely to be replaced. Hence, increased risk.

Next, consider *informational risk.* The CEO-dominated board is less likely to get the information it needs to perform its duties. Problems can be hidden until revealed by a disaster. It is even more likely that the problems will be hidden if the firm is doing well. It is tough to challenge success and to critically assess the factors contributing to it.

Then we have what we might call *lifecycle risk.* Some firms are CEO-centric because of the stage in their life cycle. We've already mentioned founder firms, but mature firms with well-tenured CEOs can also fall into this stage. In this latter case, risk increases because the CEO resists change that is needed to transform the firm.

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Expropriation risk can also occur in CEO-centric firms. This occurs where a CEO with a weak board appropriates wealth from minority shareholders. (This is more likely in countries with weak legal protection of investors.)

Finally, consider *perception risk.* If the public thinks a firm is heavily dependent on the CEO, that perception will impact the valuation — even if the public perception is mistaken.

The solutions to the risks of CEO centricity vary with the type of dominance. For dependency risk, the most obvious solution is careful succession planning. Indeed, effective leaders and effective boards will have developed sound contingency plans to mitigate the loss of their CEOs. Subordinates should be prepared to take over the reins on short notice, and the board should be thoroughly familiar with the strengths and weaknesses of these individuals. Still, replacing the creative and entrepreneurial talents of a Steve Jobs is a formidable task.

Improved governance is also a natural remedy for informational risk. The chairman of the board (or lead director) must pursue an independent assessment of the strengths and weaknesses of the firm and see that adequate attention is given to potential problems and opportunities, particularly if things seem to be going well. One must be particularly careful to assess all the possible opportunities and not just choose the obvious, or continue with past strategies without challenging the reason for their success.

Perception risk is best handled with a strong public relations campaign. Microsoft could have been viewed as dependent on its chairman, Bill Gates, but his transition out of that position was orchestrated over a two-year period and carefully presented to the public. The result was minimal disruption in the stock price upon his departure.

In summary, the dominant CEO creates special risks. Like many types of risks, the key is not to eliminate them but to understand them — embracing the benefits, mitigating the dangers, and ensuring that shareholder value is continually enhanced. ■

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indemnification rights and to monitor developments in this area. As noted by the court in *Xu Hong*, directors are bound by any limitations on advancement and indemnification existing at the time they begin service on the board. *Xu Hong* also illustrates the importance of having consistent and well-integrated corporate documents that may affect advancement and indemnification rights. Directors who rely solely on the charter may be surprised to learn that they may be responsible for their own legal defense in the future.

If there are any questions, directors should consider indemnification agreements, which can provide clarity. Indemnification agreements can include detailed provisions defining the types of conduct for which advancement and indemnification are available, the method for determining whether a director is eligible for advancement and indemnification, the priority of payments, and the remedies available to directors for nonpayment. Additionally, indemnification agreements generally authorize indemnification to the fullest extent permitted by law as such law may be amended to increase any permitted indemnification. A well-drafted, specifically tailored indemnification agreement can benefit both a company and its directors and may prevent future litigation. ■

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