

Covering Your Tail: Court Approves Advancement of Legal Fees to Directors and Officers under §363

Written by:

Robert J. Dehney
Morris, Nichols, Arsht & Tunnell LLP
Wilmington, Del.
rdehney@mnat.com

Curtis S. Miller
Morris, Nichols, Arsht & Tunnell LLP
Wilmington, Del.
cmiller@mnat.com

In a bench ruling on June 30, 2006, the U.S. Bankruptcy Court for the District of Delaware in *In re RNI Wind Down Corp.*, Case No. 06-10110 (Bankr. D. Del. Filed Feb. 7, 2006), approved the debtors' advancement of legal fees and expenses to current and former officers, directors and employees who were the target of an investigation undertaken by the Official Committee of Equity Securities-Holders (EC). This appears to be a case of first impression where a court authorized, over objection, a debtor's advancement of legal fees and expenses pursuant to 11 U.S.C. §363 to directors and officers during the pendency of a case.¹



Robert J. Dehney

Case History

Riverstone Networks Inc., and its affiliated debtors filed voluntary bankruptcy petitions on Feb. 7, 2006, following an investigation by the Securities and Exchange Commission (SEC), earnings restatement and de-listing from

About the Authors

Robert Dehney is a bankruptcy partner and the Practice Group leader and Curtis Miller is an associate of the Business Reorganization and Restructuring Group at Morris, Nichols, Arsht & Tunnell, LLP in Wilmington, Del.

trading on NASDAQ. As a result of these problems and competitive pressures, the debtors, among other things, experienced a decline in market share and experienced the loss of available cash by approximately \$4-5 million per month.

The debtors' objective in filing for bankruptcy was to effect a sale of all of their assets pursuant to §363 and to file a plan that provided for full payment of all allowed claims and a distribution to equity security-holders. Following an auction conducted on March 20 and 21, 2006, Lucent Technologies Inc. submitted

debtors' corporate charter, bylaws, indemnification agreements and applicable state law.

Advancement and Indemnification to the Directors and Officers



Curtis S. Miller

A director's or officer's right of advancement is separate and distinct from his or her right to indemnification. Advancement, as opposed to indemnification, provides "corporate officials with immediate inter-

im relief from the personal out-of-pocket financial burden of paying the significant ongoing expenses inevitably involved with investigations and legal proceedings." *Homestore Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005).

Feature

what the debtors determined to be the highest and best bid. On March 23, the sale to Lucent was approved by the court, generating sufficient proceeds to pay all creditors in full, plus interest, and to provide a distribution to equity security-holders.

The Equity Committee's Investigation

On May 28, 2006, the court entered an order authorizing the EC to undertake an investigation into, *inter alia*, any and all causes of action that may be asserted against current and former directors and officers of the debtors. The professional fees and expenses the EC incurred as part of this investigation were funded by the debtors' estates pursuant to the standard fee application process. Based on this authorization, the EC served discovery requests on certain of the debtors' directors and officers and initiated depositions. As a result, certain of the directors and officers incurred legal defense costs and sought advancement and indemnification from the debtors to cover these expenses pursuant to the

Indemnification, by contrast, "cannot be established...until after the defense to legal proceedings has been "successful on the merits or otherwise." *Id.* (inner quotation omitted). Stated another way, a right of advancement is not dependent upon a finding that a party has been successful on the merits of an action or otherwise entitled to indemnification.

The Delaware Supreme Court has described the importance of advancement for inducing highly qualified individuals to serve as corporate managers:

No Delaware corporation is required to provide for advancement of expenses. Nevertheless, most Delaware corporations do adopt advancement provisions as an inducement, which promotes the same salutary public policy that is served by indemnification: attracting the most capable people into corporate service. Although advancement provides an individual benefit to corporate officials, it is actually "a desirable underwriting of risk by the corporation in anticipation of greater corporate-wide rewards"

¹ In a recent decision in *In re Delphi Corp.*, Bankr. C.A. No. 05-44481 (Bankr. S.D.N.Y. filed Oct. 8 and 14, 2005), the court, in a bench ruling, denied a bid by former Delphi executives and employees for an order compelling the debtors to comply with their advancement obligations under corporate bylaws. The former executives and employees argued that a first-day order that provided the debtors with discretion to advance expenses to former executives and employees (subject to a \$5 million cap), pursuant to which the debtors decided not to advance, or to cease advancing, legal expenses to certain former executives and employees, violated their constitutional rights under the Fifth, and potentially Sixth, Amendments. See Motion of Creditors/Interested Parties John Blahnik, Paul Free, Milan Belans, Laura Marion, Peter Janak, and Cathy Rozanski to Modify Oct. 13, 2005, Order, and to Compel Delphi Corporation to Advance Legal Fees and Costs (D.I. 5354 in Bankr. C.A. No. 05-44481); Transcript of Nov. 30, 2006, Hearing at 46:3-48:9. The Delphi court, however, allowed the former executives and employees to obtain advancement under certain of the debtors' directors' and officers' insurance policies subject to an initial \$5 million cap. The court conditioned any further access to the proceeds of these policies upon subsequent application and court approval. Transcript of Nov. 30, 2006, Hearing at 84:23-86:10. Additionally, in an unpublished decision in *In re GB Holdings Inc.*, Case No. 05-42736, 2006 WL 4457350 (Bankr. D. N.J. Sept. 21, 2006), the court granted the debtor's motion to authorize payment and advancement of legal fees and expenses to its current and former directors pursuant to a directors' and officers' insurance policy over the objection of the official committee of unsecured creditors. In *GB*, the debtor sought to advance the fees on numerous grounds, including (as in *RNI*) §363 of the Code. The *GB* court did not, however, grant the motion on the basis of §363, instead authorizing advancement on alternative grounds.

for its shareholders. The broader salient benefits that the public policy behind §145 seeks to accomplish for Delaware corporations will only be achieved if the promissory terms of advancement contracts are enforced by courts even when corporate officials...are accused of serious misconduct.

Homestore, 888 A.2d at 218. A party entitled to advancement, however, may be required to return any advances if he or she is subsequently found not to be entitled to indemnification. *See* 8 Del. C. §145(e).

According to the debtors' certificate of incorporation and indemnification agreements with certain of the directors and officers (which are similar to those seen in many corporate charters and indemnification agreements), the debtors had an obligation to provide advancement and indemnification to the directors and officers. The debtors' certificate of incorporation provided the following mandatory right to advancement:

[T]he corporation shall advance payment of expenses incurred by an Indemnitee in advance of the final disposition of any matter

only upon receipt of an undertaking by or on behalf of the Indemnitee to repay all amounts so advanced in the event that it shall ultimately be determined that the Indemnitee is not entitled to be indemnified by the corporation as authorized in this Article. Such undertaking may be accepted without reference to the financial ability of the Indemnitee to make such repayment.

Articles of Incorporation at Art. IX. The indemnification agreements executed by the debtors with certain of the directors and officers contained a similar right of advancement.

The Debtors' Motion for Advancement

Pursuant to their obligations, the debtors sought approval of the provision of advancement and indemnification under §363 of the Bankruptcy Code as a reasonable exercise of their business judgment.² Two parties filed substantive

² The debtors contended that advancement was a transaction within the ordinary course of their business as they had previously advanced such costs and expenses in connection with internal investigations, external investigations by the SEC, and actual litigation, see Motion at ¶ 19, yet filed the Motion out of an abundance of caution in the event the Court were to conclude that advancement was an act outside of the ordinary course of business.

objections to the motion, the unsecured creditors' committee and the EC, with the EC raising the most meaningful objection.³ The EC argued that the court should deny the motion because the claims were covered by director and officer insurance, were merely contingent, unliquidated and disputed claims, subject to subordination, and potentially subject to setoff (the "EC Objection"). In support of its arguments, the EC Objection focused exclusively on case law regarding indemnification, relying heavily on precedent providing that claims for indemnification are pre-petition unsecured claims because, regardless of whether they were incurred pre- or post-petition, such claims do not arise from a transaction with the debtor-in-possession (DIP) and, therefore, cannot satisfy the §503 test for an administrative expense.⁴ The EC did not cite to any cases denying advancement of legal expenses under §363 nor cases denying administrative expense priority for advancement.

In response to these arguments, certain of the directors and officers filed

³ Several other parties filed responses to the Motion, including former directors and officers of the debtors who sought advancement to the same extent authorized for the current directors and officers of the debtors.

continued on page 79

Covering Your Tail: Court Approves Advancement of D&O Legal Fees

from page 27

a reply noting that the EC Objection blurred the distinct and separate objectives of indemnification and advancement (the “Reply”). The directors and officers contended that they were not seeking a final adjudication of their indemnification rights or the amount of their claims, but simply an order confirming the debtors’ authority to comply with their obligations to advance fees and expenses to those directors and officers who were the subject of the EC’s investigation. The Reply also noted that the issue presented for the court was not whether advancement would be paid (as a result of the fact that all creditors were being paid in full and because the directors’ and officers’ claims for advancement were such “claims”), but when advancement would occur.

The Reply also noted the inequity of denying the directors and officers advancement when the costs they were incurring were the result of an investigation being undertaken by the EC, whose fees and expenses for such investigation were being paid by the debtors’ estates. Finally, the directors and officers, in response to the EC’s argument that advancement should be denied because it may be subject to valid defenses and setoff, cited precedent providing that any potential defenses to indemnification or right to setoff are

irrelevant to a corporation’s obligation to fulfill its voluntary promise to provide advancement to its employees.⁵

The Court’s Ruling Approving Advancement under §363 of the Bankruptcy Code

The court overruled the objections to the Motion and approved advancement under §363 as a reasonable exercise of the debtors’ business judgment. The court reached this conclusion after hearing testimony from the debtors’ interim president and general counsel regarding, *inter alia*, the debtors’ history of performing their obligation to provide advancement to directors, officers and certain employees during SEC investigations, internal investigations and lawsuits, and the business justification for providing such advancement.⁶ The court capped advancement at \$500,000, which was the deductible for the debtors’ director and officer insurance policies, and conditioned any further advancement upon reapplication to the court.

The ruling in *RNI* is a watershed case for directors and officers of bankrupt

corporations that are faced with the prospect of, or currently embroiled in, actions or investigations questioning their actions leading up to and in bankruptcy. The basis on which the *RNI* court approved advancement, §363, removed the request from the procedure that indemnified individuals have historically followed: relying solely on the filing of a claim for reimbursement of these expenses. Admittedly, the ruling in *RNI* can be viewed as simply an aberration due to exceptional facts (in that the estates had sufficient assets to pay all creditors in full and make distribution to equity security-holders); however, if directors and officers of other bankrupt companies are successful in following the strategy taken by the directors and officers in *RNI*, it relieves them of the burden of waiting in line with other creditors for payment of their advancement claims while they continue to incur significant legal fees and expenses.⁷

This ruling is equally important in its recognition of the statutory objective of advancement in bankruptcy, which is “a desirable underwriting of risk by the corporation in anticipation of greater corporate-wide rewards’ for its shareholders.” *Homestore*, 888 A.2d at 218. The acknowledgment of this important policy protects the legitimate expectations of qualified individuals that choose to serve as corporate managers in reliance on statutory rights such as §145 of the Delaware General Corporation Law and, in turn, provides important benefits to corporate stakeholders.⁸ ■

⁴ See, e.g., *In re Pinnacle Brands Inc.*, 259 B.R. 46, 50 (Bankr. D. Del. 2001) (“In the instant case, the contract of indemnification was executed pre-petition. Consequently, [the indemnitee’s] contractual indemnification claim is a pre-petition claim”); *In re Mid-Am. Waste Sys. Inc.*, 228 B.R. 816, 821-22 (Bankr. D. Del. 1999) (“An indemnification claim by an officer or director based on that officer’s or director’s pre-petition services is not a claim on account of ‘services rendered after the commencement of a case’ that is entitled to administrative expense priority”); but see *In re Baldwin-United Corp.*, 43 B.R. 443, 461-62 (S.D. Ohio 1984) (holding that advancement claims for directors and officers serving post-petition may be entitled to administrative expense priority but remanding the issue to the bankruptcy court for additional findings on the question of whether their current services were sufficiently valuable to the debtors to justify awarding administrative priority to their legal fees).

⁵ See, e.g., *Kuang v. Cole Nat’l Corp.*, 884 A.2d 500, 509-10 (Del. 2005) (stating that “the narrow scope of an advancement proceeding prohibits an ultimate determination of indemnification and liability owed by a corporate official for sums already advanced”); *Radiancy v. Azar*, 2006 WL 224059, at *1 (Del. Ch. 2006) (“[T]his opinion emphasizes the unambiguous fact that corporations that voluntarily extend to their officers and directors the right to indemnification and advancement under 8 Del. C. §145 have a duty to fulfill their obligations under such provisions with good faith and dispatch. It is no answer to an advancement action, as either a legal or logical matter, to say that the corporation now believes the fiduciary to have been unfaithful. Indeed, it is in those very cases that the right to advancement attaches most strongly.”); see also *Ridder v. Cityfed Fin. Corp.*, 47 F.3d 85, 87 (3d Cir. 1995) (“Under Delaware law, appellants’ right to receive the costs of defense in advance does not depend upon the merits of the claims asserted against them, and is separate and distinct from any right of indemnification.”) (citations omitted).

⁶ In addition to finding that the debtors acted reasonably in deciding to abide by their advancement obligations, the court noted that it was “far from convinced that the advancement of legal expenses to officers and directors under certificate of incorporation and bylaws is outside the ordinary course of business.” For many debtors, advancement has been an ordinary practice as they are financially distressed and their corporate managers are often the target of unhappy constituents’ lawsuits.

⁷ This, of course, assumes that an indemnified individual is a current manager of the company and has the ability to cause the company to comply with its advancement obligations.

⁸ *Id.* at 211 (“Advancement is an especially important corollary to indemnification as an inducement for attracting capable individuals into corporate service.”).