Covering Their Tails—Again: Court Rejects Objection to Officer Advancement Claim under 11 U.S.C. §502(e)(1)(B)[1]

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In an article published in the June 2007 issue of the *ABI Journal*,[3] we discussed a June 20, 2006, bench ruling from 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), approving the debtors' advancement of defense costs to current and former officers and directors under §363 of the Bankruptcy Code. In a recent follow-up decision, *In re RNI Wind Down Corp.*, 369 B.R. 174 (Bankr. D. Del. 2007), the Delaware Bankruptcy Court overruled an objection to a former officer's claim for advancement and, in the process, departed with precedent from the Second Circuit that precluded current and former managers from recovering advancement under §502(e)(1)(B) of the Code. This article discusses the latest *RNI* decision, which provides management with the ability, in certain circumstances, to enforce their rights to obtain advancement during the pendency of a bankruptcy case.

The SEC Investigation[4]


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Prior to the debtors' bankruptcy filing on Feb. 7, 2006, the SEC began an investigation of the debtors related to the debtors' accounting practices. As a result of this investigation and an internal investigation conducted by the debtors, the debtors restated their financial statements for 2002 and the first three quarters of fiscal year 2003. On or about Oct. 28, 2005, an attorney for the SEC sent the debtors a "Wells" letter informing them that she was recommending that the SEC bring a civil injunction action against them for potential violations of the Securities Exchange Act of 1934. Shortly after the bankruptcy filing, the debtors reached a settlement with the SEC related to these charges.

Notwithstanding this settlement, the SEC instituted a civil action against certain of the debtors' former employees related to the debtors' restatement of financial statements (SEC action). As part of this action, the SEC sought, *inter alia*, civil penalties from the former employees.[5]

One of these employees, a former officer of the debtors (claimant), sought indemnification and the advancement of his defense costs incurred as a result of the SEC investigation pursuant to the debtors' corporate charter. These documents required the debtors to provide advancement and indemnification to its officers and directors to the fullest extent authorized under Delaware law.[6] On July 20, 2004, the debtors agreed to advance attorneys fees and costs to the claimant for the SEC's investigation and related proceedings and, in accordance with the debtors' corporate charter and §145 of the Delaware General Corporation Law (DGCL), the claimant agreed to repay any amounts advanced if a court subsequently determined that he was not entitled to indemnification of legal fees and expenses.[7]

The Debtors' Motion for Advancement and the Claimant's Claim

On June 1, 2006, the claimant filed a claim seeking, *inter alia*, enforcement of his right to advancement and the reimbursement of defense costs related to the SEC action (claim). On June 12, 2006, the debtors filed a motion seeking an order pursuant to 11 U.S.C. §363 authorizing the advancement of defense costs to certain officers and directors.[8] The Delaware Bankruptcy Court approved the debtors' advancement of defense costs to certain of the debtors' current and former officers and directors, including the claimant on July 17, 2006 (advancement order).[9] The advancement order did not, however, resolve the objections raised to the claim, pursuant to which the Equity Committee sought, *inter alia*, to disallow the claim under §502(e)(1)(B) of the Code (objection).[10]

By the objection, the plan administrator sought to disallow the claim on the ground that it was a contingent claim for reimbursement of a debt for which the debtors were co-liable under §502(e)(1)(B).[11] The plan administrator argued that (1) a claim for advancement is a claim for reimbursement under applicable law, (2) the claim for advancement was "contingent" because the amount of advancement was unknown and because the claimant may be required to repay any amounts advanced if he was subsequently found not to be entitled to indemnification and (3) the claimant was co-liable with the debtors because his defense costs were incurred in defending the SEC action, an action in which the debtors were potentially liable.

The Delaware Bankruptcy Court's Opinion and Order Overruling the Objection

In its opinion dated June 9, 2007, the Delaware Bankruptcy Court agreed with the plan administrator that advancement is a claim for reimbursement, but rejected his

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1 This article regarding developments in the law does not constitute legal advice and may not address all the issues surrounding a particular individual's or business's circumstances. Those seeking legal advice should always engage qualified legal counsel to ensure that the appropriate course of action is taken.

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3 *See* Dehney, Robert J. and Miller, Curtis, "Covering Your Tail: Court Approves Advancement of Legal Fees to Directors and Officers under §363," *ABI Journal*, Vol. XXVI, No. 5, p. 26 (June 2007) (hereafter, the "363 Article").

4 As we included a discussion of the case history in the June 2007 article, we will not repeat that background here.

5 *RNI*, 369 B.R. at 180.

6 *Id.*

7 *Id.* at 180-81. Section 145(a) of the DGCL authorizes indemnification of a director, officer, employee or agent of the corporation if the indemnified person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful."

8 This motion did not include a request to provide advancement to the claimant or other former officers and directors; however, the Delaware Bankruptcy Court's advancement order (as defined below), which approved advancement to certain current and former officers and directors under §363 of the Bankruptcy Code, approved advancement for the claimant.

9 *See* 363 Article.

10 The objection was initially made by the official committee of equity security holders but, as the objection was litigated post-confirmation, it was prosecuted by the plan administrator.

11 *Id.* at 178. If disallowance was denied, the plan administrator sought as alternative relief an order estimating the claim at $600,000 to $700,000.

arguments that the advancement was contingent and that the claimant was co-liable with the debtors for his defense costs.[12]

1. Section 502(e)(1)(B) of the Bankruptcy Code. Section 502(e)(1)(B) of the Code provides, in pertinent part, that "the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor...to the extent that...(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution[.]"[13] To disallow a claim pursuant to §502(e)(1)(B), an objecting party must prove three elements: (1) the claim is contingent, (2) for reimbursement or contribution of a debt, (3) for which the debtor and the claimant are co-liable.[14]

2. Advancement Is a Claim for Reimbursement. The claimant argued that the court should overrule the objection because a claim for advancement is not a claim for "reimbursement" under §502(e).[15] The Delaware Bankruptcy Court rejected this argument, finding that, although advancement is distinct from indemnification, this distinction was insufficient to distinguish case law providing that indemnification is a form of reimbursement. The Delaware Bankruptcy Court held that, similar to indemnification, a request for advancement of defense costs is a request for "reimbursement of legal fees."[16] Accordingly, the first prong of §502(e)(1)(B) was satisfied.

3. Advancement Is Not Contingent. Although the Delaware Bankruptcy Court concluded that a claim for advancement satisfies the first prong of the §502(e)(1)(B) test, it rejected the plan administrator's argument that the claimant's request for advancement was contingent because (a) the amount of the claim was unknown, and (b) it was impossible to know if the claimant would ultimately be required to repay the advancement. Under §502 (e)(1)(B), a claim is contingent if "it has not yet accrued and...is dependent upon some future event that may not happen."[17] This contingency is evaluated at the time of allowance or disallowance of the claim.[18]

In rejecting the plan administrator's first argument, the Delaware Bankruptcy Court noted that a claim is not contingent simply because the full amount of the claim is undeterminable at the time of allowance or disallowance. The Delaware Bankruptcy Court also noted that the plan administrator was confusing an unliquidated claim with a contingent one, and the mere fact that the claimant was continuing to accrue defense costs did not render the claim contingent.[19]

The Delaware Bankruptcy Court also rejected the plan administrator's argument that the potential that the claimant may be required to repay the defense costs if he were subsequently found not to be entitled to indemnification made the claim contingent. In reaching this conclusion, the Delaware Bankruptcy Court distinguished cases where courts found that claims for indemnification were contingent under §502(e)(1)(B) because a right to indemnification must await a future decision as to the underlying liability of the entity requesting indemnification.[20]

In particular, the Delaware Bankruptcy Court noted that the decisions *In re Wedtech Corp.*, 85 B.R. 285 (Bankr. S.D.N.Y. 1988) (*Wedtech I*), and *In re Provincetown-Boston Airlines Inc.*, 72 B.R. 307 (Bankr. M.D. Fla. 1987), both of which held that claims for indemnification are contingent under §502(e)(1), were inapplicable to the claim because neither of those decisions addressed requests for advancement.

In *Wedtech I*, a former officer and director and former director filed claims for indemnification of attorneys' fees and expenses related to various civil lawsuits brought against them for embezzlement and fraud.[21] These officers and directors did not request advancement in their claims. The *Wedtech I* court held that the claims for indemnification were contingent because the underlying liability (for which indemnity would be provided) had not been established as of the time of allowance or disallowance of the claims.[22]

In *Provincetown-Boston Airlines*, the claimant, a lead underwriter for a stock offering of the debtor, filed a claim for indemnification or contribution pursuant to the terms of the underwriting agreement with the debtor.[23] The claimant was a joint defendant with the debtor in a securities class action where the plaintiffs alleged that the debtor and the claimant were jointly and severally liable for violations of securities laws.[24] As in *Wedtech I*, the claimant did not include a request for advancement in its claim. The *Provincetown-Boston Airlines* court held, similar to *Wedtech I*, that because the claimant's right to indemnification would only accrue if it was subsequently found liable in the class action lawsuit, its claim was dependent on a future event, and thus contingent.[25]

In contrast to both *Wedtech I* and *Provincetown-Boston Airlines*, the Delaware Bankruptcy Court noted that the claimant's right to advancement was already established; according to the debtors' corporate charter, he had the ability to force the debtors to pay his litigation expenses as they were incurred.[26] The Delaware Bankruptcy Court emphasized that "[a]dvancement [as opposed to indemnification] provides corporate officials *with immediate interim relief* from the personal out of pocket financial burden of paying the significant ongoing expenses inevitably involved with investigations and legal proceedings."[27] Because the claimant's right to advancement was not dependent upon any future event, the Delaware Bankruptcy Court concluded that advancement was "anything but contingent."[28]

The Delaware Bankruptcy Court further concluded that the fact that the debtors held a contingent claim against the claimant for return of these defense costs if he was subsequently found not to be entitled to indemnification was "insufficient, as a matter of law, to render [the claimant's] claim for pre-indemnification advancement of litigation related expenses as contingent."[29] The debtors' contingent claim did not alter the claimant's present enforceable right to recover his ongoing defense costs and, therefore, did not subject the claim to disallowance under §502(e)(1)(B).

4. *The Claimant Was Not Co-Liable with the Debtor for his Defense Costs.* The Delaware Bankruptcy Court also concluded that the plan administrator failed

12 *Id.* at 181-92.

13 11 U.S.C. §502(e)(1)(B).

14 *RNI*, 369 B.R. at 181 (*citing In re Pinnacle Brands Inc.*, 259 B.R. 46, 55 (Bankr. D. Del. 2001)).

15 *See* Andrew Feldman's post-trial brief and response to plan administrator's post-trial brief in connection with claim of Andrew Feldman for indemnity at pp. 9-10.

16 *RNI*, 369 B.R. at 182.

17 *In re GCO Servs. LLC*, 324 B.R. 459, 466 (Bankr. S.D.N.Y. 2005) (inner quotation omitted); *Highland Holdings & Zito I LP v. Century/ML Cable Venture*, No. 06 Civ. 181, 2007 WL 2405689, at *5 (S.D.N.Y. Aug. 24, 2007).

18 11 U.S.C. §502(e)(1)(B); *GCO*, 324 B.R. at 467 (*citing In re Baldwin-United Corp.*, 55 B.R. 885, 894-95 (Bankr. S.D. Ohio 1985)); *Highland Holdings*, 2007 WL 2405689, at *5.

19 *RNI*, 369 B.R. at 183-84.

20 *Id.* at 184-85. The right to indemnification "allows corporate officials to defend themselves in legal proceedings 'secure in the knowledge that, *if vindicated*, the corporation will bear the expense of litigation.'" *Homestore Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005) (emphasis added) (*quoting VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998)).

21 85 B.R. at 287-88.

22 *Id.* at 289.

23 72 B.R. at 307.

24 *Id.* at 310.

25 *Id.*

26 *RNI*, 369 B.R. at 186-87.

27 *Homestore*, 888 A.2d at 211 (emphasis added).

28 *RNI*, 369 B.R. at 187.

29 *Id.* at 187.

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to establish the third prong of the §502(e)(1)(B) test requiring that the claim be one in which the claimant and the debtor are co-liable.[30] The plan administrator, relying on two cases from the Southern District of New York, *In re Wedtech Corp.*, 87 B.R. 279 (Bankr. S.D.N.Y. 1988) (*Wedtech II*), and *In re Drexel Burnham Lambert Group*, 146 B.R. 98 (Bankr. S.D.N.Y. 1992), argued that even though the claim sought advancement for defense costs, something that the SEC would not seek to recover from the debtors, the claim satisfied the co-liability prong because there was a potential for co-liability in the SEC's underlying enforcement action.[31] In reaching its decision, the Delaware Bankruptcy Court departed from the reasoning of the Southern District of New York.

In *Wedtech II*, the claimant, the debtor's former accounting firm, filed a claim for reimbursement for liability it incurred in lawsuits brought against it related to the services it provided to the debtor. In ruling that the claimant could not avoid the disallowance of these claims, the *Wedtech II* court broadly defined §502(e)'s use of the word "reimbursement," stating that reimbursement "encompasses whatever claims a co-debtor has, which entitle him to be made whole for monies he has expended on account of a debt for which he and the debtor are both liable."[32] This expansive reading of "reimbursement," if adopted by the Delaware Bankruptcy Court, arguably would have led to the disallowance of the request for advancement because the underlying action for which the claimant sought defense costs presented potential co-liability between the debtors and claimant.

In *Drexel Burnham*, the court addressed the question of whether a claim for indemnification of costs, attorneys' fees and expenses filed by a former underwriter of the debtor should be disallowed under §502(e)(1)(B).[33] The claimants argued in *Drexel Burnham*, as did the claimant in *RNI*, that its claim for indemnification of defense costs should not be disallowed under §502(e)(1)(B) because these were not claims for which they were co-liable with the debtor; the plaintiffs in the underlying action were not seeking to recover the claimants' defense costs as part of their action. The *Drexel Burnham* court rejected this argument, relying on the expansive reading of "reimbursement" in *Wedtech II*. The *Drexel Burnham* court stated that the fact that the claimant was not co-liable with the debtor with respect to defense costs was irrelevant, as "[t]he interdependence between [the claimant's] defense costs and the underlying action for indemnification places all of [the claimant's] claims under the umbrella of §502(e)(1)(B)."[34]

Acknowledging that *Wedtech II* and *Drexel Burnham* supported the disallowance of the claim, the Delaware Bankruptcy Court declined to follow their broad interpretation of "reimbursement," concluding that these holdings ignored the distinction between damages and defense costs and incorrectly collapsed reimbursement and co-liability in their analyses.[35] The Delaware Bankruptcy Court noted that this departure from *Drexel* and *Wedtech II* was not only consistent with the express text of §502(e), which only requires the disallowance of debts for which co-liability exists, but also adhered to the "central purpose" of §502(e)(1)(B), to prevent the double payment by the estate.[36]

The Import of RNI

For the second time in just over a year, the Delaware Bankruptcy Court has safeguarded officers' and directors' advancement rights in bankruptcy. As mentioned in our prior article, a corporation's decision to provide advancement is used as an inducement "to attract the most capable people into corporate service."[37] This inducement arguably becomes even more important in attracting and retaining well-qualified individuals to serve as managers of an insolvent or nearly-insolvent company, as these entities are "most in need of effective and proactive leadership."[38] The *RNI* decision appears to be a judicial recognition of these policies.

It remains to be seen, however, whether the *RNI* decision will encourage the filing of additional officer and director claims in upcoming bankruptcies and whether creditor constituencies, who are likely to argue that the effect of the *RNI* decision is to put the interests of officers and directors before other similarly-situated unsecured creditors potentially leading to the significant depletion of already limited assets,[39] will object to such claims on other grounds. ■

30 *Id., citing Provincetown-Boston Airlines*, 72 B.R. at 309.

31 Plan administrator's post-trial brief in connection with claim of Andrew Feldman for indemnity at p. 13 n. 7. The debtors were not defendants in the SEC action. Nevertheless, the plan administrator argued that there was still a potential for co-liability because the "SEC could not have described its claims against the claimant without describing the conduct of the debtors." *Id.* at p. 11.

32 *Wedtech II*, 87 B.R. at 287-88.

33 *Drexel*, 148 B.R. at 986.

34 *Id.* at 989 (*quoting Sorensen v. Drexel Burnham Lambert Group Inc.* (*In re The Drexel Burnham Lambert Group Inc.*), 146 B.R. 92, 97 (S.D.N.Y. 1992)) (alterations in original).

35 *RNI*, 369 B.R. at 190.

36 *Id.* at 190.

37 *Homestore*, 888 A.2d at 218.

38 *N. Am. Catholic Edu. Programming v. Gheewalla*, 930 A.2d 92, 100-101 (Del. 2007).

39 For example, in *RNI*, as of the time of the Delaware Bankruptcy Court's decision, the claimant had expended approximately $1 million in defense costs in defending the SEC action.