

Clients & Friends Memo

Delaware Court Leaves Ousted Executive on His Own for Legal Fees

September 21, 2015

In a September 11, 2015, decision, the Delaware Chancery Court denied a former officer and director advance reimbursement of legal fees in a dispute with his company, despite his insistence that multiple corporate documents and Delaware law entitled him to advancement. The opinion underscores the importance of careful drafting of indemnification and advancement agreements and also highlights the limits on the ability of officers or directors to receive indemnification or advancement for actions taken beyond the scope or span of their positions.

Background

The decision involves the messy break-up of American Apparel and its founder, former Chairman and CEO, and 42.3% shareholder, Dov Charney. In June 2014, the American Apparel board attempted to oust Charney from his managerial and executive roles. Though he refused to resign at the time, Charney was suspended, and all of his authority to act on behalf of the Company was revoked.

Charney tried to regain power by leading an effort for shareholders to call a special meeting to expand the board and elect new directors. The Company and Charney were able to come to a temporary standstill agreement, under which Charney would serve only as a consultant, and the Company agreed to evaluate his suitability as CEO. Charney resigned as director soon thereafter, and in December 2014, following the Company's investigation, was officially fired from his position as CEO.

In May 2015, American Apparel sued Charney for breaching the standstill agreement, claiming he inappropriately attempted to influence American Apparel stock purchases and director elections and disparaged the Company. Charney asked the Company to advance his legal fees in connection with the lawsuit and then sued when it denied his requests. All of Charney's lines of reasoning were rejected, and the Court granted summary judgment in favor of the Company.

Takeaways

The Court relied heavily on both key fundamentals of contract interpretation and principles of Delaware law in its decision.

1. Advancement and Indemnification Agreements Should Spell Out Whether They Cover Former Directors and Officers. Charney contended that he was entitled to advancement under the Company's certificate of incorporation, which provides that the Company must indemnify any person "to the full extent permitted" by Delaware law and that it must advance expenses to any "officer or director" entitled to indemnification. In denying the claim, the Court emphasized that there are important differences between advancement of expenses and indemnification. While these rights are "correlative," advancement rights must be provided for in "specific language." Here, Delaware law and the Company's certificate of incorporation as written explicitly provide indemnification for anyone who is "or was" a director or officer. In stark contrast, the certificate of incorporation provided for advancement only for "officers" and "directors" without any qualifiers for whether they were current or former. The Court interpreted this advancement provision narrowly, noting that the provision could have been explicit about including former executives, as it was with indemnification, and that Delaware courts have previously interpreted the terms "officers" and "directors," when used without qualifiers, to mean only current officers and directors. Charney was no longer an officer or director when the standstill proceeding was initiated in May 2015, and, thus, advancement was denied.
2. Advancement Is Not Available to Directors and Officers for Claims Arising from Actions Taken beyond the Scope of Their Positions. Charney claimed that he was also entitled to advancement under the indemnification agreement between him and the Company, but after careful examination of the multiple parts of the agreement and their intersection, the Court similarly rejected this argument. The indemnification agreement provides advancement for claims "related to the fact" that Charney is or was a director or officer of the Company. The Court explained that this expression is akin to "by reason of the fact" in relevant Delaware law, "which requires a nexus or causal connection between the claims in the underlying proceeding and one's official corporate capacity to obtain advancement," and that the standstill lawsuit was not brought by reason of the fact that Charney was an American Apparel director or officer. In fact, in another recent decision, *Lieberman v. Electrolytic Ozone, Inc.*, C.A. No. 10152-VCN (Del. Ch. Aug. 31, 2015), the Chancery Court denied advancement to company officers and directors for similar reasons, finding that the claims did not arise "by reason of the fact" that they held these positions. It was known to be rare for the Chancery Court to deny advancement, but these two cases, together, provide a strong warning that the tide may be turning.

The Court went on to explain that to do otherwise – to interpret “related to the fact” to be broader than “by reason of the fact” as Charney suggests – would violate Delaware law. For, while the law permits indemnification and advancement rights to be delineated outside of a company’s certificate of incorporation and bylaws, these additional agreements are still subject to Delaware statutes and cannot provide protection more broadly than permitted by the law. Similarly, the law provides that companies “shall have the power” to indemnify directors and officers so long as the action was taken “in good faith” and in the “best interests of the company.” These caveats may well present a problem for the two former Dole executives slapped with nearly \$150 million in damages for fraud in the Court’s late August decision in *In re Dole Food Co., Inc. Stockholder Litigation*.

Relatedly, in its May 2015 decision, *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, the Delaware Supreme Court acknowledged that it did not want to discourage directors from making possible value-maximizing but controversial decisions because of the potential for personal liability and, thus, allowed claims against independent directors protected by exculpatory provisions to be dismissed. However, this policy-based protection extends only so far – directors do not receive a free pass for everything they do as directors. When the work is done outside the scope of their explicit duties, and, particularly, in an attempt to regain power, this decision shows that personal liability can result.

3. Confirmation of Existing Rights Does Not Create New Rights. The Court also found that the standstill agreement itself did not provide Charney a right to advancement. As the Court explained, the standstill agreement simply stated that the Company would “abide” by the Company’s charter, bylaws and previous indemnification agreements, and, thus, it did not extend any rights in this regard. If a post-employment agreement is meant to expand indemnity or advancement rights beyond what the certificate of incorporation, bylaws or prior indemnification agreement provides, it must state so explicitly.
4. Indemnification for Actions Seeking to Enforce Indemnification Rights Is Required Only for Successful Actions. Charney also sought indemnification for this lawsuit, claiming that the indemnification agreement entitled him to indemnification for any action brought for advancement in connection with the indemnification agreement itself. The court rejected this argument, explaining that while Delaware law generally allows for recovery of legal costs associated with a successful action for advancement or indemnification, this is not the case for unsuccessful actions. The *Lieberman* Court made a similar point, refusing to enforce a provision that the company was required to provide indemnification in a lawsuit for advancement

even if the officers or directors lost, as long as they brought the lawsuit in good faith. These opinions, thus, caution directors or officers to provide careful thought before initiating an action for indemnification or advancement, because they risk not being reimbursed for either action if they are not successful in the action.

For a full copy of the opinion, click [here](#).

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