

DELAWARE COURT OF CHANCERY REFUSES TO ALLOW PRIVATE EQUITY GROUP TO DENY ADVANCEMENT AND INDEMNIFICATION RIGHTS TO DIRECTORS OF ITS FAILED PORTFOLIO COMPANY

A recent decision by Vice Chancellor Strine of the Delaware Court of Chancery ruled that a private equity investment partnership was not entitled to deny advancement and indemnification rights to its sponsor personnel who served as directors of one of its failed portfolio companies. The basis of the decision was the Court's interpretation of ambiguities in the indemnification provisions of a partnership agreement, which the Court construed against the partnership and in favor of the individual indemnitees. *See Stockman v. Heartland Industrial Partners, L.P.*, Civ. A. Nos. 4227-VCS, 4427-VCS, 2009 WL 2096213 (Del. Ch. July 14, 2009). The decision offers a cautionary tale for all partnerships on the perils of vaguely drafted partnership agreements.

Background

Stockman concerned claims for advancement and indemnification by David Stockman, former White House Budget Director under Ronald Reagan, and Michael Stepp. Stockman was a cofounder of Heartland Industrial Partners, L.P. ("Heartland"), a private equity fund, and Stepp was a Senior Managing Director. Both were also officers and directors of Collins & Aikman Corporation ("C&A"), a maker of car parts in which Heartland held a majority stake. In 2005, C&A publicly disclosed that it had corrected "certain historical accounting errors" that had come to light after an internal management review. Two months later, C&A filed for bankruptcy; it was liquidated in 2007.

Civil lawsuits followed, naming Stockman and Stepp (among others) as defendants. In addition, a criminal action was brought against Stockman and Stepp in New York. In January 2009, however, that criminal action was dismissed at the request of the U.S. Attorney, who had concluded that further prosecution "would not be in the interests of justice."

After they were sued, Stockman and Stepp submitted claims to C&A's insurance carriers for advancement of their ongoing legal expenses, which were apparently paid until those policies were exhausted. They next looked to Heartland's carriers for advancement, but those insurance policies had been exhausted too. Stockman and Stepp then turned to Heartland directly to provide the funds necessary to pay for their defense of the ongoing civil proceedings and to indemnify them for the expenses they had incurred in connection with the dismissed criminal proceedings.

But Heartland refused to "open its purse strings."¹ In Heartland's view, advancement was not mandatory under the terms of the Partnership Agreement unless its General Partner gave written

¹ Heartland acted through an executive committee to which Stockman had delegated his powers and duties in light of the criminal proceedings against him. 2009 WL 2096213, at *2 n.4.

approval, which it refused to do unless certain conditions not set forth in the Partnership Agreement were met.² Heartland also took the position that, notwithstanding the dismissal of the criminal indictment, Stockman's and Stepp's requests for indemnification were premature. According to Heartland, because the dismissal of the criminal action was without prejudice, the U.S. Attorney's Office could bring the same charges against Stockman and Stepp if it so chose. In addition, Heartland contended that, if a court in one of the still-pending civil actions found that Stockman's and Stepp's conduct involved a state of mind inconsistent with the requirements set forth in the indemnification provision, then Stockman and Stepp would not be entitled to indemnification with regard to the criminal proceeding. As a result, Heartland argued, it could not make a determination about Stockman's and Stepp's eligibility for indemnification until all legal proceedings against them were resolved. Stockman and Stepp then filed suit.³

The Decision

The Court did not look kindly on Heartland's attempt to avoid its obligations. Delaware statutory law, the Court noted, grants limited partnerships wide freedom of contract to craft their own scheme for a partnership's indemnitees. However, because individuals who agree to join an organization after its formation must rely on the face of an existing operating agreement whose terms they did not negotiate, any ambiguities in such agreements should be resolved against the drafter. Thus, even though the Heartland Partnership Agreement was ambiguous in certain respects, those ambiguities were to be construed against Heartland and in favor of Stockman's and Stepp's reasonable expectations regarding their advancement and indemnification rights.⁴

For example, Heartland argued that the Partnership Agreement gave it complete discretion to refuse to advance the costs of defense. Even though the Agreement provided that an indemnitee's reasonable expenses "shall be advanced," it also provided that no advancements were to be made "without the prior written approval of the General Partner." The Court disagreed, contrasting that provision with others in the Partnership Agreement that expressly

² Stockman and Stepp alleged that they were asked to submit written certifications that they were entitled to advancement, including statements that they had at all times acted in accordance with the requirements for indemnification, and to provide adequate security in case repayment was ultimately required. In addition, Stockman alleged that Heartland required him to accept a cap on the total amount of legal fees for which he could receive advancement. Similarly, but less restrictively, Heartland requested that Stepp provide monthly litigation budgets as a condition of receiving advancements. 2009 WL 2096213, at *3.

³ Several motions and cross-motions were filed, with Heartland moving to dismiss the Stockman and Stepp complaints in their entirety, and Stockman and Stepp moving for partial summary judgment on their advancement claims. The result was that the advancement claims were subject to both motions for summary judgment and motions to dismiss. The indemnification claims, by contrast, were subject only to Heartland's motion to dismiss. 2009 WL 2096213, at *4.

⁴ The Court noted that, unlike Stepp, Stockman was presumably involved in drafting the Partnership Agreement, given his role as Heartland's cofounder. Nevertheless, the Court construed any ambiguities in the Partnership Agreement in favor of both Stepp and Stockman, suggesting in a footnote that the Agreement should not mean different things to two persons who are both indemnitees within the meaning of the Agreement's provisions. 2009 WL 2096213, at *5 n.21.

provided for the General Partner's exercise of discretion. "It would be very poor drafting indeed," the Court remarked, "for Heartland to leave out a contractually important, liability-limiting term like 'sole and absolute discretion,' or at least 'discretion,' if that is what it truly meant." 2009 WL 2096213, at *6. As the Court saw it, the approval provision permitted the General Partner to address administrative issues such as whether the indemnitee's expenses were reasonably incurred or whether the indemnitees supplied an adequate undertaking to repay. But it did not confer blanket discretion to deny a proper advancement request. The Court therefore granted Stockman and Stepp summary judgment on their advancement claims.

The Court's analysis of the indemnification dispute followed a similar, although not identical, path. Typically, the Court noted, analysis of indemnification rights of participants in a limited partnership begins with the language of the relevant partnership agreement. The drafters of Heartland's Partnership Agreement, however, used their contractual freedom to craft an approach that employed language drawn from the Delaware General Corporation Law (the "DGCL"), which creates mandatory indemnification rights in some circumstances and bars indemnification in others. In particular, the indemnification provision of the Partnership Agreement adopted the standard for good faith and lawful conduct set forth in the DGCL, but was silent about the effect of a disposition of the underlying proceeding in favor of the indemnitee, which is a key consideration when determining whether a corporate official is entitled to indemnification. Moreover, all of the parties made express appeals to the language of the DGCL in their arguments as to how the indemnification provision should be interpreted. Accordingly, any ambiguity in the Partnership Agreement over whether Heartland owed indemnification rights was to be resolved against it and in favor of the indemnitees seeking indemnification, consistent with analogous precedent in corporate cases.

Heartland claimed that the criminal proceedings had not been finally resolved because the U.S. Attorney could re-indict Stockman and Stepp before the expiration of the statute of limitations, which would not happen for at least five years. What was more, Heartland argued, if any of the civil proceedings still pending found that Stockman's and Stepp's conduct involved a state of mind inconsistent with that required by the Partnership Agreement's indemnification provision, the pair would not be entitled to indemnification. Stockman and Stepp were thus not entitled to any indemnification until they proved that (i) they did not breach their duties to the partnership, (ii) they did not knowingly violate applicable law, and (iii) they did not act with scienter. Thus, Heartland argued, Stockman and Stepp were required to plead that their conduct met this standard, which they failed to do.

The Court again rejected Heartland's position. Stockman and Stepp were not required to make allegations about their conduct in order to state a claim for indemnification. Nor were they required to prove that their conduct met the standard of the Partnership Agreement at a plenary trial on the merits, were the matter to proceed further. Indeed, the Court reasoned, "*turning an indemnification case into a hypothetical trial on the merits of a dismissed case is a bizarre notion to propose* and would be counterproductive to Delaware's policy goal of assuring indemnitees 'that their reasonable expenses will be borne by the corporation they have served if they are vindicated.'" 2009 WL 2096213, at *16 (emphasis added).

Implications

Partnerships organized under Delaware law are contractually free to craft an approach to advancements and indemnification for their members in any way they see fit. As the *Stockman* decision makes clear, however, where a partnership agreement contains indemnification provisions that track Delaware corporate law, however imperfectly, the partnership agreement may be interpreted in a manner consistent with the strong Delaware policy favoring indemnification. Indeed, even partnership agreements that may not have been purposefully modeled upon the indemnification provisions of the DGCL may be construed in a manner consistent with Delaware corporate law (and the public policy considerations that underlie it) unless the parties' intent is clearly to the contrary. Any ambiguities will be construed against the partnership and in favor of individual indemnitees' reasonable expectations as to their rights. Sponsors of Delaware partnerships should therefore carefully review their partnership agreements to ensure that any advancement and indemnification provisions they contain properly reflect the partnership's intent.

* * * * *

If you have any questions regarding the foregoing or would like additional information, please contact Gregory S. Bruch (202-303-1205, gbruch@willkie.com), Mary Eaton (212-728-8626, meaton@willkie.com), Roger Netzer (212-728-8249, rnetzer@willkie.com), Adrienne Atkinson (212-728-8253, aatkinson@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C. 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

August 10, 2009

Copyright © 2009 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.