

KIRKLAND M&A UPDATE

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An Unexpected Intersection of Deal-Related Indemnification and D&O Advancement

A recent Delaware case highlights potentially unexpected results from the intersection of provisions in a private company purchase agreement relating to advancement of D&O legal expenses and indemnification of a buyer for seller breaches.

Purchase agreements in many private company transactions contain some form of two seemingly unrelated provisions: (1) an agreement by the sellers to indemnify the buyer for certain losses arising out of breaches of representations and warranties made by the sellers and (2) an agreement by the buyer to maintain or assume the rights of former directors and officers of the target contained in the target's organizational documents to indemnification and advancement of expenses for actions taken prior to closing.

A recent Delaware Chancery Court decision by VC Glasscock (*Hyatt*) shows how these two distinct provisions can intersect in an unexpected way, resulting in what may appear to be a somewhat circular outcome. The summary judgment comes as the latest court decision in the long-running litigation saga that followed the sale by Al Gore of Current TV to Al Jazeera. In this case, the court was asked to address whether former officers of the target, who also served as representatives of the sellers, were entitled to advancement of their litigation expenses (under the second type of provision above) in defending a claim for indemnification for breaches of representations made to the buyer about the target business (under the first type).

The buyer claimed that the litigation expenses were being incurred by the former officers in their capacity as sellers, not former directors and officers, and therefore the D&O advancement rights did not apply. In fact, the buyer argued, the agreement contained a separate section requiring the losing party to pay attorneys' fees of the prevailing party in any dispute over indemnification with respect to breaches of representations and warranties, showing the parties' intent to specifically address responsibility for litigation expenses in breach claims in that fashion.

The sellers argued that the "loser pays" attorney fee provision addressed ultimate responsibility for the litigation fees and did not undercut the right of the former officers to be advanced their legal expenses pending final resolution of the claims. In addition, sellers argued that the breaches asserted by the buyer challenged actions that they took as officers of the target company and therefore were fully within the scope of the advancement continuation provision (even though the payment of any resulting liability was in their capacity as sellers) because the LLC agreement of the target promised indemnification and advancement of expenses to directors and officers for liabilities they face "by reason of the fact" that they held those offices.

The court, noting a tendency of the courts to favor D&O indemnification and advancement, determined that while the sellers did not face economic liability in the breach claim in their capacity as former officers, the breach claims did require them to defend the actions that they had taken in that capacity (i.e., in exercising their "decision-making authority" in allegedly causing the target to breach certain clauses in contracts between the target and third parties). In determining whether the breach indemnification claim involved a former director or officer capacity, the court examined whether "a 'nexus or causal connection' exists between the underlying proceedings [i.e., the breach claim] and the defendant's 'official corporate capacity'".

The result leaves the buyer in what might be a surprising position — pursuing a contractual breach claim against the sellers but being required to fund the defense by the sellers of those very claims. While this outcome turned on the specific wording of purchase agreement and organizational documents in this case (the latter of which, the court noted, tracked the general Delaware corporate statute), a similar result could occur under many of the customary formulations of the two agreement provisions described above.

While the court was not asked to address the issue, it appears possible that the court's reasoning may be susceptible to extension to the question of actual indemnification for any economic losses that the sellers are forced to pay to the buyer in the event they ultimately lose the case on the breach indemnification claim (which, under the court's test, arguably occurred because of actions the sellers took as officers of the target).

Parties may wish to consider this potential circularity in crafting these provisions in private company transactions where the sellers, as is often the case, include the target's directors and officers. For example, the right to continued D&O indemnification and advancement could specifically exclude expenses incurred by former directors and officers in defending breach claims under the purchase agreement, or the designated representative of the sellers in defending breach claims could specifically exclude any party (usually former directors and officers, but sometimes

also shareholders) who may be entitled to advancement of expenses under the right to continued coverage. More broadly, the agreement could include an "anti-circularity" provision which states that where the buyer seeks indemnification from sellers for breaches of the purchase agreement, no seller may seek indemnification, advancement or contribution from the target (now owned by the buyer) under any statutory, organizational document or contractual theory.

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While parties are often alert to, and therefore explicitly address, potential contradictions between two agreement terms that may be read as addressing the same matter (e.g., should a particular claim be brought as a purchase price adjustment or indemnification claim?), this recent Delaware decision is an important reminder of how even apparently unrelated provisions of a purchase agreement can intersect to provide unexpected results.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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