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Case No. 2362-VCL

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

RICHARD W. SCHOON and WILLIAM J. BOHNEN,	)	
	)	
Plaintiffs,	)	
	)	
v.	)	C.A. No. 2362-VCL
	)	
TROY CORPORATION, a Delaware corporation,	)	
	)	
Defendant.	)	

PLAINTIFFS' SUPPLEMENTAL MEMORANDUM ADDRESSING
LEVY V. HLI OPERATING CO., INC.

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INTRODUCTION

During the hearing on the parties' cross motions for summary judgment in this advancement action, the Court requested supplemental briefing on the impact of *Levy v. HLI Operating Co.*, 924 A.2d 210 (Del. Ch. 2007), a decision issued by this Court after Plaintiffs submitted their final brief. As discussed below, *Levy* was an indemnification case, not an advancement case. Accordingly, the contribution and allocation principles that *Levy* established for determining the final allocations of liability among co-indemnitors do not and should not apply in the advancement context.

Regardless, even if *Levy*'s contribution and allocation rules were applied in the advancement context, they would not change the result in this case. Bohnen and Schoon do not have multiple sources of mandatory advancements. Their only source of mandatory advancements is Troy.[1] Plaintiffs therefore respectfully request that the Court order Troy to advance all of the fees and expenses that Bohnen and Schoon have incurred to date defending against the Breach of Fiduciary Duty Claims, regardless of whether incurred in the Section 220 Action or the Plenary Action. Plaintiffs also request that the Court declare that Bohnen and Schoon have a right to on-going advancements for their defense of the Breach of Fiduciary Duty Claims.

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[1] Defined terms not defined herein are used as in Plaintiffs' opening brief in support of their motion for summary judgment and in Plaintiffs' combined reply brief in support of their motion and answering brief in opposition to Troy's cross motion for summary judgment. Citations to these briefs are in the form "POB __" and "PRB __" respectively. Citations to the Defendants' corresponding briefs are in the form "DOB __" and "DRB __" respectively. Citations in the form "Ex. __" are to the Supplemental Transmittal Affidavit of Matthew F. Davis, Esq., filed contemporaneously herewith. Plaintiffs will continue Troy's practice of citing only to the Charter or the Bylaws, which "contain corresponding, nearly identically-worded provisions." DOB 16 n.5.

BACKGROUND

I. THE *LEVY* DECISION.

Levy was a quite complex indemnification case in which six former outside directors of HLI Operating Company, Inc. (respectively, the "Six Directors" and "Old Hayes") sought to obtain indemnification for amounts paid to settle various federal securities lawsuits (the "Federal Securities Actions"). During discovery, it became apparent that four of the Six Directors possessed and had received mandatory indemnification for their settlement contributions from another source. The *Levy* decision held that those four directors could not obtain indemnification from Old Hayes under those circumstances, although the party who had indemnified them could assert a right of contribution against Old Hayes.

A. The Factual and Procedural Background for *Levy*.

Old Hayes declared bankruptcy on December 15, 2001, shortly after the filing of the Federal Securities Actions. 924 A.2d at 214. Old Hayes emerged from bankruptcy on May 12, 2003, as a reorganized entity ("New Hayes"). *Id.* Prior to the bankruptcy, an investor group led by Joseph Littlejohn Levy Fund II, L.P. (the "JLL Fund") held approximately 34% of Old Hayes' common stock and had the right to appoint four members of the Old Hayes board. Four of the Six Directors were representatives of the JLL Fund (the "JLL Representatives").

In 2005, the parties to the Federal Securities Actions settled those proceedings. The Six Directors agreed to contribute $7.2 million to the settlement. *Id.* Each of the Six Directors, at the time he became a director of Old Hayes, had entered into an indemnification agreement with Old Hayes which provided, among other things, for

mandatory indemnification of amounts paid in settlement. *Id.* Each of the Six Directors also enjoyed mandatory indemnification rights under the Old Hayes bylaws. *Id.*

The Six Directors sued Old Hayes to obtain indemnification for their contributions to the $7.2 million settlement (the "Enforcement Action"). *Id.* at 216.[2] Discovery revealed that the JLL Representatives also possessed mandatory indemnification rights under the JLL Fund's limited partnership agreement. *Id.* Discovery further revealed that the JLL Representatives had not paid their share of the $7.2 million settlement out of their own pockets. Instead, the JLL Fund had contributed $1.2 million to the settlement on behalf of each JLL Representative for a total of $4.8 million. The two remaining directors who were not JLL Representatives had paid the remaining $2.4 million. *Id.* at 217.

Old Hayes had been providing advancements to the Six Directors for the fees and expenses they were incurring in the Enforcement Action (the "Enforcement Expenses") until it discovered the facts regarding the JLL Representatives' other indemnification rights and the JLL Fund's contributions to the settlement. *Id.* At that point, Old Hayes stopped advancing Enforcement Expenses, filed counterclaims against the JLL Representatives, and moved for summary judgment seeking (i) a determination that Old Hayes had no indemnification obligation for the $4.8 million paid by the JLL Fund and (ii) recovery of Enforcement Expenses previously advanced to the JLL Representatives on the grounds that they had no right to indemnification. Old Hayes also filed third party

[2] The Six Directors originally filed suit against both Old Hayes and New Hayes. The Court dismissed the claims against New Hayes in an earlier decision. *Levy v. Hayes Lemmerz Int'l, Inc.*, C.A. No. 1395, 2006 WL 985361 (Del. Ch. Apr. 5, 2006).

claims against the JLL Fund, to which the JLL Fund responded with a third-party counterclaim for contribution and indemnification. *Id.* at 217-18.

B. <u>The Allocation Rule.</u>

In ruling on Old Hayes' motion for summary judgment, the Court first addressed the argument that the JLL Representatives had no contractual right to indemnification for "amounts paid in settlement" because they did not actually pay the amounts out of their own pockets. *Id.* at 217. Old Hayes contended that while the JLL Fund could bring a claim for contribution under *Chamison v. HealthTrust, Inc.*, 735 A.2d 912 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000), the JLL Representatives could not assert an indemnification claim because they had not "paid" any "amounts" themselves.

The Court began by clarifying the meanings of three key terms: contribution, indemnification, and subrogation.

- "An equitable right of contribution arises when one of several obligors liable on a common debt discharges all, or greater than its share, of the joint obligation for the benefit of all the obligors." 924 A.2d at 220. Contribution seeks to shift the excess portion of the loss to the parties who should have born it. *Id.* By analogy to insurance law, contribution exists only between or among co-indemnitors who pay or are liable for indemnification. Contribution does not arise between or among indemnitees and their sources of indemnification. *Id.*

- A right to indemnification seeks to put "the entire burden of a loss upon the party ultimately liable, or responsible for it." *Id.* at 221. Whereas contribution seeks to shift the excess portion of a loss, indemnification seeks to shift the entire loss. *Id.* Indemnification and contribution are therefore mutually exclusive. *Id.* Indemnification may exist (i) where the party seeking indemnification was secondarily liable and another party was primarily liable, or (ii) by statute or contract. *Id.*

- Subrogation is the right of a party who has paid an obligation to stand in the shoes of the party whose obligation was paid and "demand full payment from another party primarily responsibly for the loss." 924 A.2d at 220. Subrogation differs from indemnification in that indemnification is a direct right from one party to another party. *Id.* Under subrogation,

> by contrast, the party who initially paid the obligation succeeds to the rights of the party on whose behalf the obligation was paid. *Id.*

Based on these definitions, and following *Chamison*, the *Levy* Court held that where one party has fulfilled an indemnification obligation to a director, that party can assert a right of contribution against any other party against whom the director also had mandatory indemnification rights. *Id.* at 222 (citing *Chamison*, 735 A.2d at 926). Absent an agreed-upon hierarchy of responsibility among indemnitors, each indemnitor is "equally liable for any indemnifiable amounts," and thus the default allocation among indemnitors is *pro rata* based on the number of indemnifying parties (the "Allocation Rule"). *Id.* Put simply, the Allocation Rule holds that absent prior agreement, indemnification obligations will be allocated *pro rata* among multiple parties who granted mandatory indemnification rights.[3]

C. <u>The Contribution Rule.</u>

The *Levy* Court next held that to enforce a right of contribution in the indemnification context, "the co-indemnitor, not the indemnitee, is the appropriate party to bring suit." *Id.* (the "Contribution Rule"). The Court observed that Sections 145(a), (b) and (c) of the General Corporation Law ("GCL") empower a corporation to indemnify only those amounts "actually ... incurred by the person." *Id.* Once an indemnitee has been fully reimbursed for indemnifiable liabilities, "the indemnitee lacks

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[3] The Court did not hold that the allocation was based on the number of indemnification rights. If each indemnification right had been viewed as analogous to a separate and independent contract, such as a separate insurance policy, the Court could have allocated the losses based on the number of indemnification rights. In that case, the allocation would have been 2/3 to Old Hayes, which provided the JLL Representatives with two sources of mandatory indemnification (one under its bylaws and one under the indemnification agreement), and 1/3 to the JLL Fund, which only granted the JLL Representatives one source of indemnification (under its partnership agreement).

standing to assert an indemnification claim against the other indemnitor in the indemnitee's own right." *Id.* at 223.

Although *Chamison* held that an indemnitor can bring a claim in the name of the indemnitee on the basis of subrogation, the *Levy* Court disagreed and held that the party seeking contribution for indemnification must sue in its own right. *Id.* The *Levy* Court noted that principles of contribution do not give rise to a subrogation claim, and that "allowing a Section 145 indemnitor to proceed in the name of its indemnitee does not vindicate any cognizable public policy." *Id.* The Court also noted that permitting the suit to be conducted in the name of the indemnitee would give rise to "murky pleadings wherein the true facts surrounding payment of the indemnitee's liabilities are obscured unnecessarily until discovery." *Id.*

Applying these principles to the facts before it, the Court held that the JLL Representatives did not have a right to indemnification from Old Hayes because they had been indemnified by the JLL Fund. *Id.* at 224. The Allocation Rule and the Contribution Rule, however, gave the JLL Fund a right to seek contribution from Old Hayes for the amounts it paid, subject to fact-intensive defenses that Old Hayes would be able to assert at trial regarding issues such as whether the settlement payment was unreasonable or also benefitted individuals to whom Old Hayes owed no contractual right of indemnification. *Id.*

D. <u>The No Success Provision and the Pro Rata Repayment Rule.</u>

Having held that the JLL Representatives were not entitled to indemnification, the Court next considered Old Hayes' application to recover the Enforcement Expenses advanced to the JLL Representatives during the course of the proceeding. Section 4 of each of the Six Directors' indemnification agreements provided that an indemnitee would

be entitled to recover expenses incurred enforcing an indemnification right (or retain those expenses if advanced) "regardless of whether [the party] is ultimately determined to be entitled to [i]ndemnification." *Id.* at 225 (the "No Success Provision") (citation omitted). The *Levy* Court held that the No Success Provision was invalid as a matter of Delaware law.

In reaching this conclusion, the *Levy* Court relied on *Stifel Financial Corp. v. Cochran*, 809 A.2d 555 (Del. 2002), and *Fasciana v. Electronic Data Systems Corp.*, 829 A.2d 178 (Del. Ch. 2003). In *Cochran*, the Delaware Supreme Court held that "indemnification for expenses incurred in successfully prosecuting an indemnification suit are permissible under [section] 145(a), and therefore 'authorized by law.'" 809 A.2d at 561. The Supreme Court then concluded that a mandatory indemnification provision required indemnification for fees on fees incurred successfully prosecuting an indemnification action. *Id.* In *Fasciana*, Vice Chancellor Strine extended *Cochran* to suits for advancements, but held that fees-for-fees only could be recovered in proportion to success. 829 A.2d at 184.

The *Levy* Court noted that both *Cochran* and *Fasciana* involved provisions which required indemnification to the fullest extent authorized by Delaware law. 924 A.2d at 225. The *Levy* Court therefore concluded that under Section 145 and as a matter of Delaware public policy, "[a] party must succeed (at least to some extent) on its underlying indemnification action to have a legally cognizable claim for monies expended in forcing its indemnitor to make it whole." *Id.* at 225-26. The Court held that a provision "which mandates indemnification for fees on fees in unsuccessful litigation is invalid." *Id.*

Based on this conclusion, the *Levy* Court held that the four JLL Representatives were not entitled to fees on fees for the Enforcement Action. They therefore had to repay the Enforcement Expenses that Old Hayes had advanced to them for the Enforcement Action. In the Court's words, "Old Hayes is entitled to recover the pro rata portion of fees and expenses it advanced on behalf of the JLL Representatives (4/6ths) because the JLL Representatives achieved no success on their underlying indemnification claims." *Id.* at 225 (the "Pro Rata Repayment Rule"). The Court noted that on at least one other occasion, the Court of Chancery had held co-indemnitees who retained joint counsel responsible for their pro rata share of advanced fees and litigation costs. "This bright-line rule comports with general notions of equity and prevents the court from having to engage in a time-consuming supplemental hearing to precisely allocate expenses amongst the individuals by examining attorneys' time sheets." *Id.* at n. 62 (citing *Valeant Pharm. Int'l v. Jerney*, 921 A.2d 732, 753-54 (Del. Ch. 2007)).

II. THE ROLE OF STEEL AND THE TERMS OF ITS CHARTER AND BYLAWS.

To date, Steel has paid Schoon and Bohnen's legal fees, subject to being reimbursed by Schoon and Bohnen for any amounts recovered from Troy. *See* Ex. HHH at 2. Steel has made these payments voluntarily. Although Schoon and Bohnen have a right to mandatory indemnification from Steel, they do not have any right to mandatory advancements from Steel. *See* Ex. III (Steel's certificate of incorporation); Cummings Aff., Ex. A (Steel's operative bylaws).[4]

[4] James Cummings, Esq. has served as Steel's secretary and general outside counsel since its formation. As explained in Mr. Cummings' affidavit, filed contemporaneously herewith, Steel has never formally adopted bylaws. The operative bylaws of Steel instead were previously the operative bylaws of its predecessor corporation, Steel Sales Corporation ("Steel Sales"). Steel

Article NINTH of Steel's certificate of incorporation provides that "[t]he Corporation shall to the fullest extent permitted by Section 145 of the Delaware General Corporation Law, as amended from time to time, indemnify all persons whom it may indemnify pursuant thereto." Ex. III. Bohnen has a right to mandatory indemnification under this provision as a former director and officer of Steel. Schoon has a right to mandatory indemnification under this provision as an agent of Steel, in which capacity he is a "person whom [Steel] may indemnify" under Section 145(a) and (b) of the GCL.

Article V of Steel's bylaws also provides mandatory indemnification to Steel officers and directors. It does not contain any language regarding advancements, much less mandatory advancements:

> Each director or officer of the company whether or not then in office, shall be held harmless and indemnified by the company against all claims and liabilities and all expenses reasonably incurred or imposed upon him in connection with or resulting from any action, suit or proceeding, or the settlement or compromise thereof, and against all expenses reasonably incurred by him in connection with or resulting from the preparation for defense of any action, suit or proceeding which may be threatened, through which he is or may be made a party by reason of any action taken or omitted to be taken by him as a director or officer of the company, in good faith, if such person (a) exercised and used the same degree of care and skill that a prudent man would have exercised or used under he same circumstances in the conduct of his own affairs, or (b) took or omitted to take such action in reliance upon advice of counsel or upon statements made or information furnished by officers or employees of the company which he had reasonably grounds to believe.

Cummings Aff., Ex. A. Bohnen has a right to mandatory indemnification under this provision as a former director and officer of Steel. Schoon has no rights under this provision because he has never served as an officer or director of Steel.

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was formed to acquire all of the assets Steel Sales, which no longer exists. Since its formation, Steel has operated using the Steel Sales bylaws.

ANALYSIS

This is an advancement case. *Levy* was an indemnification case. "Delaware law has traditionally recognized that indemnification and advancement are two distinct and different legal rights, with the latter being a narrower and more provisional subset of the former." *Majkowski v. Am. Imaging Mgmt. Servs.*, 913 A.2d 572, 586 (Del. Ch. 2006). Different public policies and rules of interpretation come into play in the different contexts. The policies and rationales that animated *Levy* do not apply in the advancement context, and the rules articulated in *Levy* should not apply to this case.

Assuming for the sake of argument that the rules established in *Levy* were applied in the advancement context, they would not change the result here because Bohnen and Schoon do not have multiple sources of mandatory advancement rights. Their only source of mandatory advancements is from Troy. There is accordingly no basis for allocation or contribution. Bohnen and Schoon also are not invoking a No Success Provision. Finally, the Pro Rata Repayment Rule is irrelevant to the initial receipt of advancements, which is governed by other well-established precedents.

I. SCHOON AND BOHNEN SHOULD HAVE NO OBLIGATION TO ALLOCATE ADVANCEMENTS.

Under the *Levy* Court's Allocation Rule, in the absence of an agreement on allocation of indemnified amounts, multiple parties who each owe mandatory indemnification to an individual must allocate the indemnified amounts among themselves *pro rata*. The Allocation Rule should not apply to Schoon and Bohnen's right to advancements from Troy. First, Schoon and Bohnen do not have multiple rights to mandatory advancements – they only have a right to mandatory advancements from

Troy. Second, the Allocation Rule was created in the indemnification context; it should not apply in the quite different context of advancements.

A. **The Allocation Rule Cannot Apply Where There Is Only One Mandatory Contract Right.**

The fundamental premise of the Allocation Rule is the existence of multiple sources of mandatory indemnification. *Levy*, 924 A.2d at 222; *Chamison*, 735 A.2d at 926. The rule cannot apply to Schoon and Bohnen's advancement claim, because Troy is the only source of mandatory advancement rights. No other party, including Steel, owes mandatory advancements to Schoon or Bohnen. The Allocation Rule is therefore inapplicable.

The fact that Steel *voluntarily* paid Schoon and Bohnen's expenses to date confirms that the Allocation Rule does not apply. As the *Levy* Court explained, the Allocation Rule is premised on the right of contribution, which "arises when one of several obligors liable on a common debt discharges all, or greater than its share, of the joint obligation for the benefit of all the obligors." 924 A.2d at 220. Steel did not pay Schoon and Bohnen's expenses as an obligor, but rather as a volunteer.

To the extent Steel has any right of recovery against Troy, it would be under principles of subrogation, by which Steel could invoke the advancement right that Schoon and Bohnen hold. 924 A.2d at 220. As the *Levy* Court explained, subrogation is the right of a party who has paid an obligation to stand in the shoes of the party whose obligation was paid and "demand full payment from another party primarily responsible for the loss." *Id.* Because subrogation seeks to shift the full amount of the loss, there would be no need for allocation, and the Allocation Rule is again inapplicable.

Because there is only one mandatory contract right at issue in this case, there is no basis to apply the Allocation Rule. There is no other contractual obligor with whom expenses could be allocated.

B. The Allocation Rule Should Not Apply In The Advancement Context.

The *Levy* Court articulated the Allocation Rule to govern an indemnification dispute in which the Court was finally determining the relative responsibilities of indemnifying parties with respect to a fixed loss. Advancements, however, are different. An advancement is not a fixed loss, but rather an interim loan of money. *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 210 (Del. 2005). A ruling on advancement rights therefore does not establish a fixed loss, but rather an on-going obligation. Nor is it clear that an advancement will ever give rise to fixed loss, since the advancements may be repaid. And because advancement rights must be adjudicated promptly to have value, they should not be bogged down with allocation issues that may never need to be addressed. The Allocation Rule therefore should not apply to advancements.

"Although the right to indemnification and advancement are correlative, they are separate and distinct legal actions." *Id.* at 212. "Advancement is an especially important corollary to indemnification" because it "provides corporate offices with immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings." *Id.* at 211. "[T]he ultimate right to keep payments characterized as an 'advancement' depends upon whether the former corporate official is entitled to indemnification." *Id.* at 211-12. "A grant of advancement rights is essentially a decision to advance credit to the company's officers and directors because the officer or director must repay all sums advanced to him if it is later determined that he is not entitled to be indemnified."

Majkowski, 913 A.2d at 587; *see Homestore*, 888 A.2d at 212-13 ("advances must be repaid if it is ultimately determined that the corporate official is not entitled to be indemnified").

Because of the nature of advancement rights, an advancement ruling does not establish a fixed loss. "Advancement ... is a right whereby a potential indemnitee has the ability to force the company to pay his litigation expenses as they are incurred regardless of whether he will ultimately be entitled to indemnification." *Majkowski*, 913 A.2d at 586. As in this case, an advancement action typically will involve a request for certain past due amounts, but it more broadly will seek a determination that advancements must be paid going forward. *See, e.g., Homestore*, 888 A.2d at 213 (noting that an advancement proceeding usually involves "determining the issue of entitlement"). The Allocation Rule envisions the apportionment of a fixed amount. *See Levy*, 924 A.2d at 222. A fixed amount will not be available for allocation in an advancement case, which inherently will be about future payments. This renders the Allocation Rule inapplicable.

The fact that advancements are subject to repayment also renders the Allocation Rule inapplicable. Each of the three legal doctrines discussed in *Levy* – contribution, indemnification, and subrogation – involve the shifting in whole or in part of an actual liability. *See* 924 A.2d at 220-21. The party seeking contribution has paid more than its fair share of the liability. The party seeking indemnification or subrogation wants to shift the full amount of the liability. In each situation, there is a liability.

Not so in the advancement context. "[T]he decision to extend advancement rights should ultimately give rise to no net liability on the corporation's part. The corporation maintains the right to be repaid all sums advanced, if the individual is ultimately shown

not to be entitled to indemnification." *Advanced Mining Sys. v. Fricke*, 623 A.2d 82, 84 (Del. Ch. 1992). Because advancements are subject to repayment, it is impossible to know until the underlying action is complete and an indemnification determination made whether the party making the advancements has paid more than its fair share or has any liability to shift. If the party who received advancements is not entitled to indemnification, then the advancements must be repaid and the party making the advancements has no basis for contribution, indemnification or subrogation. It is only if the party who received the advancements retains them, and potentially obtains indemnification for additional amounts, that the Allocation Rule can come into play.

The absence of a fixed amount to allocate, or indeed any liability at all, renders the Allocation Rule inapplicable in the advancement context. Equally important, the Allocation Rule should not apply to advancements because of the expedited nature of an advancement action. "The statutory authorization for the advancement of litigation costs reflects a policy determination by the legislature that courts should be receptive to and accord expedited treatment to claims for advancement of expenses by directors and officers." William E. Knepper & Dan A. Bailey, 2 *Liability of Corporate Officers & Directors*, § 22.14 at 22.42-22.43 (7th ed. 2007). "[T]he right to advancement has little if any substantive value to the applicant unless it is declared and enforced while the underlying substantive action is pending. Indeed, it is of increasingly diminished value (except, perhaps for interest calculations) as the constituent action proceeds to final disposition." Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate & Commercial Practice in the Delaware Court of Chancery* § 8-2[h] at 8-34 (2007); *see Morgan v. Grace*, C.A. No. 20430, 2003 WL 22461916, at *1 (Del. Ch. Oct. 29, 2003) ("The value

of the right to advancement is that it is granted or denied while the underlying action is pending."); *Lipson v. Supercuts, Inc.*, C.A. No. 15074, 1996 WL 560191, at *2 (Del. Ch. Sept. 10, 1996) ("if advance indemnification is to have any utility or meaning, a claimant's entitlement to it must be decided relatively promptly").

Injecting allocation issues into an advancement proceeding will only bog down what should be a prompt, efficient, rifle shot action. Advancement proceedings typically are resolved by motions for summary judgment. With the introduction of allocation issues, summary judgment no longer will be available. Defendants instead will engage in discovery regarding potential alternative sources of advancement and possible allocation claims. Moreover, if allocation among multiple sources were ordered, it would make the on-going receipt of advancements cumbersome and unwieldy. The party with advancement rights would have to tender bills to multiple sources and await payment from multiple sources, all the while engaging in and suffering through ***with each of the multiple sources*** the unpleasant and often petty disputes over invoices that inevitably accompany advancements. The burden of seeking and obtaining advancements would become significant.

Nor is such a multi-faceted proceeding and complicated post-adjudication procedure necessary or equitable. Entities do not grant broad and mandatory advancement rights with the expectation that the interim cost of providing advancements will be shared with other parties. A corporation that grants an advancement right does so expecting to advance the cost itself. Accordingly, no prejudice will befall a single entity that is required to advance all of a party's expenses. That entity is merely being asked to fulfill the contractual obligation that it agreed to undertake in the first place, and it is

entirely possible that the entity may recover all of the advancements plus interest. The Allocation Rule should not apply in the advancement context.

II. STEEL SHOULD NOT HAVE TO SUE IN ITS OWN NAME.

In *Levy*, this Court applied the Contribution Rule to hold that a party seeking contribution after paying more than its fair share of an indemnification obligation must sue in its own name rather than having the indemnified directors bring suit. *Levy,* 924 A.2d. 223. The Contribution Rule should not apply in the advancement context. The parties with the advancement rights – here, Schoon and Bohnen – are the proper plaintiffs. Steel should not have to bring suit on their behalf or intervene in the action as an additional plaintiff.

As with the Allocation Rule, fundamental distinctions between indemnification and advancement render the Contribution Rule unsuitable for an advancement proceeding. The rationale underlying the Contribution Rule is that the real party in interest in an over-payment scenario is the indemnifying party that paid more than its fair share of a loss. *Id.* at 220. For the reasons discussed in Part I, *supra*, there will not be such a party in an advancement case because (i) there has not been a determination of a specific amount at issue, (ii) the advancement right is an on-going right, and (iii) the party receiving advancements may be forced to repay them, unwrapping the entire transaction and leaving no loss to bear. The Contribution Rule therefore does not fit the advancement context.

Moreover, the Contribution Rule rests at least in part on the premise that the party with the legal right being enforced is the real party in interest and should be the named plaintiff in the lawsuit. In an advancement case, the individual with the advancement right is the real party in interest, even if another entity has stepped up in the interim to

fund litigation expenses. This Court has held squarely that when one party voluntarily pays fees and expenses on behalf of an individual, the fact of payment does not undercut the individual's right to advancements. *DeLucca v. KKAT Mgmt., L.L.C.*, C.A. No. 1384, 2006 WL 224058, at *9 (Del. Ch. Jan. 23, 2006). Vice Chancellor Strine explicitly rejected the argument, made by Troy here, that a party has not incurred expenses subject to advancement if another party has paid the expenses on the party's behalf. *Id.* "[That] argument," he wrote, "is not one consistent with the policy underlying Delaware law." *Id.* "[T]o embrace [such an] argument would provide a perverse incentive. If a person owed advancement rights could find an affluent aunt, best friend, or other third party to front her defense costs, she would thereby forfeit her right to seek recompense from the party that should have been advancing those costs on the grounds that she was not 'out of pocket' herself even though she was obligated to repay her benefactor. That would be inequitable and reward the refusal to honor promises of advancement." *Id.* The Delaware Superior Court has rejected the same argument in the analogous insurance law context addressing payment of defense costs. *See Sun-Times Media Group, Inc. v. Royal & SunAlliance Ins. Co. of Canada*, C.A. No. 06C-11108RRC, 2007 WL 1811265, at *11 (Del. Super. Ct. June 20, 2007) ("The fact that International has paid some or all of the costs does not relieve the Third Layer Insurers from their duty under the policy to advance defense costs.").

Given that payment by another party of expenses subject to advancement does not affect the underlying advancement right, there is no basis for the application of the Contribution Rule. Under *DeLucca*, the party with advancement rights remains entitled to advancements and is the real party in interest. Schoon and Bohnen are thus the real

parties in interest in this case. They are the individuals to whom Troy granted advancement rights, and they are the individuals who will benefit going forward from a determination that they are entitled to advancements for defending the Breach of Fiduciary Duty Claims. The fact that Steel voluntarily paid amounts on Schoon and Bohnen's behalf does not alter their status as the holders of advancement rights and the real parties in interest.

The Contribution Rule also should not apply because assuming Steel were to sue, Steel's action would not proceed under a theory of contribution but rather under a theory of subrogation. As discussed in Part I.A, Steel has no contractual obligation to make advancements, and therefore does not have a contribution right. Any right of action by Steel against Troy instead would be grounded in principles of subrogation, in which Steel would be stepping into the shoes of Schoon and Bohnen and asserting their rights. *Chamison* held that such a suit can be brought by and in the names of the individuals whose rights are being asserted. 735 A.2d at 918.

This Court noted in *Levy* that in the indemnification context, having the indemnitor sue for contribution in its own name would simplify the proceeding and allow the Court to analyze the actual right at issue – contribution. The same is not true in an advancement case, where the only possible doctrine would be subrogation. Requiring Steel to sue in its own name would unnecessarily complicate this dispute because the parties would have to brief subrogation issues in addition to advancement issues, and the Court would have to analyze the subrogation issues and Steel's relationship to the case. Ultimately, however, the outcome would turn on Schoon and Bohnen's advancement rights, which Steel would be asserting as subrogee. If the analysis ultimately turns on

Bohnen and Schoon's advancement rights, the simplest way to proceed is for those individuals to sue in their own names and for the Court to analyze their rights. The Contribution Rule should not apply to advancements.

Regardless, the issue is moot in this case because Schoon and Bohnen have agreed to reimburse Steel for the amounts that Steel has paid to date to counsel on their behalf to the extent that they receive advancements from Troy. Schoon and Bohnen therefore always have been and remain the real parties in interest.

III. SCHOON AND BOHNEN ARE ENTITLED TO ALL OF THEIR FEES FOR THIS ENFORCMENT ACTION.

The *Levy* decision invalidated the No Success Provision, which purported to award the Six Directors their Enforcement Expenses regardless of whether or not they were successful in their Enforcement Action. 924 A.2d. at 225. Schoon and Bohnen seek to invoke a different type of provision, found in Troy's Charter and Bylaws, which grants them the right to all of their Enforcement Expenses if they are successful "in whole or in part" in this action (the "Partial Success Provision"). The Partial Success Provision is valid under Delaware law and should be enforced.

The *Levy* Court held that the No Success Provision was invalid under Delaware law because in *Cochran*, the Delaware Supreme Court wrote that "indemnification for expenses incurred in *successfully* prosecuting an indemnification suit are permissible under [section] 145(a), and therefore 'authorized by law.'" 809 A.2d at 561 (emphasis added). In *Cochran,* the party seeking indemnification was successful. The Delaware Supreme Court had no reason to comment on whether indemnification would have been permissible if the suit were unsuccessful.

Under the plain language of Section 145(a) and (b), however, indemnification is clearly **not** limited to situations in which a covered person has been "successful." If Section 145(a) and (b) were so limited, then they would be wholly duplicative of Section 145(c), which provides directors and officers with mandatory statutory indemnification when they have been "successful on the merits or otherwise."

Section 145(a) explicitly permits a corporation to indemnify a covered person for "judgments, fines, and amounts paid in settlement." Indemnification for "judgments" and "fines" only could be required if the covered person was not successful on the merits of the relevant part of the litigation. Section 145(a) thus does not require "success" for indemnification to be permissible. Section 145(a) instead requires that the person have "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" (the "*Scienter* Test"). 8 *Del. C.* § 145(a). The statute goes on to provide that "[t]he termination of any action, suit or proceeding by judgment, order, settlement, **conviction**, or upon plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person" did not meet the *Scienter* Test. *Id.* The fact that indemnification could exist even in the face of a conviction demonstrates beyond any doubt that success is not a prerequisite for indemnification under Section 145(a).

The same is true under Section 145(b), except because that section addresses actions by or in the right of the corporation, indemnification is limited to "expenses (including attorneys' fees) actually and reasonably incurred." 8 *Del. C.* § 145(b). Once again, success is not required. Indemnification instead depends on meeting the *Scienter*

Test and, with respect to matters on which the person shall have been adjudged to be liable, "to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper."

Indemnification for actions in which the covered person did not achieve success on the merits is thus permissible under Sections 145(a) and (b). A corporation could choose to indemnify a covered person for an unsuccessful suit to enforce indemnification or advancement rights, as long as the covered person met the *Scienter* Test. A corporation also could choose to indemnify a covered person for a partially successful suit to enforce indemnification or advancement rights, as long as the covered person met the *Scienter* Test. A corporation should be able to provide in its charter or bylaws, or by agreement, for mandatory indemnification in such a situation, just as a corporation can provide for mandatory indemnification in other situations (and typically all situations).

Cochran did not involve a Partial Success Provision or a No Success Provision. *Fasciana*, in which this Court construed *Cochran* and other authorities to permit Enforcement Expenses only in proportion to success, also did not involve a Partial Success Provision or a No Success Provision. *Levy* invalidated a No Success Provision but did not address a Partial Success Provision. The validity of the Partial Success Provision is therefore an open issue.

Schoon and Bohnen believe they will be successful on the merits on all of their claims in this action, in which case the Court need not address the Partial Success

Provision. If the Court disagrees and denies Schoon and Bohnen some aspect of the relief they request, then Plaintiffs respectfully submit that the Partial Success Provision is valid. So long as Schoon and Bohnen achieve some success in their advancement action, they should be entitled to all of their enforcement expenses because Troy has chosen to provide mandatory indemnification in that context. To the extent *Fasciana* and *Levy* could be read to invalidate the Partial Success Provision, Plaintiffs respectfully submit that those decisions were wrongly decided. Because the Partial Success Provision simply makes indemnification mandatory in a situation where Troy could grant it permissively, the provision is valid and should be enforced.

IV. THE PRO RATA REPAYMENT RULE DOES NOT APPLY TO THE INITIAL RECEIPT OF ADVANCEMENTS.

The *Levy* Court held that because the JLL Representatives were not entitled to indemnification, they were obligated to repay all of the Enforcement Expenses advanced to them in the Enforcement Action. Applying the Pro Rata Repayment Rule, the Court held that because four of the six plaintiffs were not eligible for advancements, Old Hayes was entitled to recover 4/6 of the amount it had advanced. In an effort to limit Schoon and Bohnen's advancement rights, Troy seeks to invoke the Pro Rata Repayment Rule and apply it to the initial receipt of advancements by a covered person. For example, Troy has determined unilaterally that it will pay at most only 40% (and at times only 20%) of the advancements sought because Troy claims that only two (and in some cases Troy claims only one) out of the five defendants Troy chose to name have advancement rights. *See, e.g.*, Exs. M, O, and P to Affidavit of Kyle Wagner Compton (Transaction I.D. No. 12695516). Troy's approach is contrary to established Delaware law, which

provides that the initial receipt of advancements is **not** limited by a formulaic *pro rata* allocation.

The Pro Rata Repayment Rule makes sense when an individual is being required to reimburse a corporation for advancements previously received after a determination that he or she was not entitled to indemnification. The Pro Rata Repayment Rule is simply a further application of the general principles that govern in an indemnification case, which seeks to allocate a definite loss among responsible parties. Parties who are entitled to indemnification receive it, with the burden allocated among the parties obligated to pay it. Parties who are not entitled to indemnification must repay amounts they received, such as advancements.[5]

The Pro Rata Repayment Rule does not apply to the up-front receipt of advancements, which is controlled by other well-established precedent. Where advancement is mandatory, a corporation is generally obligated to advance **all** requested fees – not some percentage amount – unless the corporation demonstrates that the fees are

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[5] Although the Pro Rata Repayment Rule is one logical approach for indemnification cases, Delaware courts also have used other methods. *See, e.g., May v. Bigmar*, 838 A.2d 285, 290 (Del. Ch. 2003) (in indemnification case, adopting plaintiff's methodology of "assum[ing] that time and expenses are included unless otherwise specifically excluded" but applying 30% discount for matters upon which she lost), *aff'd,* 854 A.2d 1158 (Del. 2004); *Scharf v. Edgcomb Corp.*, C.A. No. 15224, 2004 WL 718923, at *6 (Del. Ch. March. 24, 2004) (in indemnification case, noting that "[a]llocation of attorney time and effort is best done by the attorney involved in the matter, whose good faith and reasonableness can be tested by cross-examination."), *rev'd on other grounds,* 864 A.2d 909 (Del. 2004). Even where the Court decides that reimbursement should be pro rata, the Court will ensure that the reimbursement is equitable under the circumstances. For example, in *Valeant Pharmaceuticals International v. Jerney*, the decision cited in *Levy* as the source of the Pro Rata Repayment Rule, this Court had to determine whether one director (Jerney), who had lost on the merits, was obligated to reimburse the company for all attorney fees that had been advanced, when the main culprit (Panic) had settled shortly before trial. 921 A.2d 732 (Del. Ch. 2007). The Court held that because "Jerney was a willing participant in the scheme, and his defense rested importantly on the successful defense" of Panic, and "their defense was, by and large, jointly conducted," the court found it proper to divide the litigation costs *pro rata* for the purposes of reimbursement. *Id.* at 755. Absent these factors, the Court could well have reached a different conclusion. *Id.*

unreasonable. *See, e.g., Citadel Holding Corp. v. Roven*, 603 A.2d 818, 826 (Del. 1992) ("Citadel is required to advance to Roven the costs of all reasonable expenses Roven incurs in defending the federal action."); *Dunlap v. Sunbeam Corp.*, C.A. No. 17048, 1999 WL 1261339, at *6 (Del. Ch. July 9, 1999) ("Having had the chance to review the fee schedules, I find no evidence that the legal fees are unreasonable in the number of hours or the cost per hour.... In litigation of this nature, legal fees are bound to be high ... [and] Defendant has made no specific showing of why this was unreasonably excessive."); *see also Kaung v. Cole Nat'l Corp.*, C.A. No. 163-N, 2004 WL 1921249 (Del. Ch. Aug. 27, 2004), *rev'd on other grounds,* 884 A.2d 500 (Del. 2005) (denying advancements that were unreasonable).

Under established Delaware law, when some portions of litigation are entitled to advancement but others are not, Delaware courts have expressly rejected the type of formulaic analysis Troy now seeks to apply. "[D]espite the administrative appeal of a formulaic analysis, the better approach is to rely, at least in the absence of a showing of abuse, upon the good faith allocation" of fees by the attorneys for the party entitled to advancement. *Weaver v. ZeniMax Media, Inc.*, C.A. No. 20439, 2004 WL 243163, at *5 (Del. Ch. Jan. 30, 2004); *see Fasciana v. Elec. Data Sys. Corp.*, 829 A.2d 160, 177 (Del. Ch. 2003) (holding that good faith allocation of litigation expenses by counsel was "adequate protection" at advancement stage so as to "reserve any ultimate fight about the precise amounts until a later indemnification proceeding").

The Delaware Supreme Court has admonished that it is "not appropriate" to subject requests for advancement to the "detailed analysis" required for indemnification. *Kaung v. Cole Nat'l Corp.*, 884 A.2d 500 (Del. 2005) ("The detailed analysis required of

such claims is both premature and inconsistent with the purpose of a summary proceeding."). "Indeed, the concept of advancement is based on the expectation that the final review of the reasonableness of fees will occur at the indemnification stage, after the final disposition of the litigation." *Westar Energy, Inc. v. Lake*, 502 F. Supp. 2d 1191, 1198 (D. Kan. 2007) (requiring corporation to advance fees despite deferring ruling on particular aspects of reasonableness). At the advancement stage, the question is "overall reasonableness," not nit-picking over nickels and dimes. *Id.* at 1195. Determining specific allocations with particularity is to be done after the conclusion of the merits litigation. Troy's hyper-analysis of bills and imposition of an arbitrary 2/5 rule thus frustrates the policies underlying mandatory advancement. *See Homestore*, 888 A.2d at 218.[6] Troy, in effect, wants to conduct indemnification litigation in an advancement proceeding. It would "turn this summary proceeding into a three ring circus." *Kaung*, 2004 WL 1921249, at *5.

The Pro Rata Repayment Rule therefore does not and should not apply to the receipt of advancements. If it did, it would create peculiar incentives. The most obvious result would be for individuals with advancement rights to hire separate counsel from those without advancement rights. Rather than a single counsel being able to represent similarly situated parties and economize on litigation costs overall, defendants with advancement rights would need to retain separate counsel to avoid suffering a *pro rata* haircut. Such an approach is contrary to existing case law, which encourages parties with

[6] In *Homestore*, the corporation fought paying advancements and adamantly denied the reasonableness of the former officer's fees. Seeing "no reasonable hope of light at the end of this tunnel," the Court of Chancery appointed a Special Master to determine reasonable fees. Despite Homestore's resistance, the Special Master awarded 96% of the requested fees—an award upheld by the Court of Chancery and the Delaware Supreme Court. The Supreme Court noted that the "protracted and non-summary nature of this proceeding is an aberration that, fortunately, is rarely necessary for an adjudication of contractual claims for advancement." *Id.* at 219.

indemnification and advancement rights to "coordinate the[ir] defense with a view to minimizing the usual heavy expenses of this type of litigation." *Mooney v. Willys-Overland Motors, Inc.*, 204 F.2d 888, 899 (3d Cir. 1953) ("The Delaware statute must not be abused to authorize each individual defendant to employ counsel to prepare his defense as though he alone were sued."). Troy's *pro rata* rule would penalize parties for acting efficiently and incentivize parties to engage different counsel, thereby complicating the litigation.

In the analogous context of insurance law, similar principles govern the allocation of defense costs between covered and non-covered parties. Although courts use various tests, they generally seek to determine whether the work performed was "reasonably related" to the defense of covered claims or parties. If so, then the insurer must pay the defense costs. *Cont'l Cas. Co. v. Bd. of Educ. of Charles Cty.*, 489 A.2d 536, 545 (Md. 1985) ("So long as an item of service or expense is reasonably related to defense of a covered claim, it may be apportioned wholly to the covered claim."). A *pro rata* approach to defense costs is generally regarded as "inequitable" in the insurance context. William E. Knepper & Dan A. Bailey, 2 *Liability of Corporate Officers & Directors* §§ 21.03-21.07 (7th ed. 2007).

The traditional rules governing Delaware advancement actions should apply in this case. In the absence of any evidence of abuse, counsel's good faith allocation of fees and expenses is sufficient to support advancements. *Fasciana*, 829 A.2d at 177.

CONCLUSION

For the foregoing reasons, Schoon and Bohnen respectfully request that this Court find that they are entitled to (i) advancements for the legal fees and expenses they have incurred, are incurring and will incur defending the Breach of Fiduciary Duty Claims, including in the Section 220 Action, and (ii) indemnification for the legal fees and expenses they have incurred, are incurring and will incur in prosecuting this action for advancements.

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