

## Venture Capital Alert: Venture Capital and Private Equity Funds Need to Reconsider the Indemnification Rights of its Director Designees

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A recent decision of the Delaware Court of Chancery changes the previously prevailing view among venture capital and private equity funds ("Funds") that in the event of litigation against a Fund's director designee, serving in his or her capacity as a director on the board of the Fund's portfolio company, the portfolio company provides full indemnification to the director representative, and the Fund acts as a secondary source providing such indemnification only in the event the portfolio company is unable to pay. Following the decision in *Levy v. HLI Operating Company, Inc.*, absent a contractual agreement to the contrary, the Fund and its portfolio company may be considered co-indemnitors, sharing indemnification responsibilities to the directors serving the portfolio company on behalf of the Funds. The Court explained that: "[a]s a general rule, in absence of contractual language to the contrary, two insurers who insure the same person for the same risk must share the loss."

### Summary of the Case

The former outside directors of HLI Operating Company ("HLI"), a company that emerged from bankruptcy, sought indemnification from HLI for the amounts paid to settle breach of fiduciary duty actions brought against them. During discovery, and contrary to the directors' initial disclosures, it was revealed that the investment fund, on behalf of which the directors served HLI prior to its bankruptcy, had a contractual obligation to indemnify the directors and had actually already paid a total of \$4.8 million in a settlement agreement on behalf of the directors. Nevertheless, the directors sought indemnification from HLI.

The Court held that the directors were entitled to indemnification for amounts paid out-of-pocket, but were not entitled to indemnification for amounts already paid on their behalf as the directors did not suffer any actual monetary loss. The Court held that the appropriate cause of action is for the investment fund to seek equitable contribution directly from HLI to pay its fair share of the settlement amount, rather than to seek indemnification or subrogation through the directors. The Court based its reasoning on the fact that both the investment fund and HLI possessed a contractual commitment to indemnify the directors.

Thus, under this decision, both the Fund and the portfolio company could be held *jointly* liable to indemnify a director designee.

### Our Recommendations

In order to avoid the potential outcome of joint indemnification liability under *Levy*, we recommend the following:

#### Investment Documents

- A. In connection with any investment into a portfolio company, a Fund should require a provision in the Purchase Agreement or a separate Indemnity Agreement whereby the portfolio company expressly agrees that any indemnification obligation of the Fund to its director designee shall be secondary and junior to the senior indemnification obligation of the portfolio company; and further, to indemnify and reimburse the Fund for any indemnification payments or advancements made by the Fund directly to its director designee.
- B. In connection with any investment into a portfolio company, the Purchase Agreement should provide an express waiver by the portfolio company as to any right of contribution from the Fund with respect to any indemnification that the portfolio company may provide to the Fund's director designee.

#### Fund Documents

- A. To the extent a Fund provides indemnification rights to its principals or other representatives as a matter of contract in either the Limited Partnership Agreement, LLC Agreement, or other form of contract, the language therein should expressly make clear that such indemnification rights are secondary and junior to any valid and collectible indemnification or advancement rights provided by a portfolio company; and shall only be available to the extent such director designee is not fully indemnified and made whole by the portfolio company. Additionally, the Fund should require the director designee to reimburse the Fund for any amounts paid by the Fund as advancements or indemnification to the extent that its director designee receives payment of any advancement or indemnification payments directly from the portfolio company.
- B. The Fund may consider including in such indemnification provisions that the Fund also has a right of subrogation to the director designee's rights of indemnity against a portfolio company.

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