

Chancery Denies Advancement for Ex-CEO of American Apparel

By Eduardo Gallardo and Christina Greenberg

Delaware court decisions on director and officer indemnification and advancement of litigation expenses are of particular interest to both corporations, which wish to attract qualified directors and officers, and directors and officers, who desire to protect themselves against exposure in their capacity as fiduciaries. The Delaware Court of Chancery's recent decision in *Charney v. American Apparel*, C.A. No. 11098-CB (Del. Ch. Sept. 11, 2015), illustrates the importance of careful drafting of indemnification and advancement provisions.

The *Charney* opinion does not discuss whether there was any misconduct or breach, but only addresses whether the alleged misconduct in the underlying case against Dov Charney had a sufficient nexus to Charney's role as a former director and officer of American Apparel to entitle him to advancement of defense costs. Advancement, which is a distinct (but complementary) right from indemnification under the Delaware General Corporation Law, is of significant practical concern because many directors and officers would not be able to afford to defend themselves against unjustified lawsuits before the right to indemnification is triggered by a final resolution of the matter. Because of the comparatively limited resources of individuals and because amounts advanced to an individual may be clawed back if it is later determined that an



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individual is not entitled to indemnification, most companies offer advancement to individuals sued in their capacity as a director or officer. Delaware courts have generally drawn the "line between being sued in one's personal capacity and one's corporate capacity ... in favor of advancement" in borderline cases, as quoted in *Mooney v. Echo Therapeutics*, C.A. No. 10054-VCP (Del. Ch. May 28, 2015).

In *Charney*, the court denied advancement of expenses for Charney under both American Apparel's charter and Charney's indemnification agreement based on the court's determination that there was no causal connection between American Apparel's claims in the underlying lawsuit and Charney's role as a former fiduciary of the company. Charney is the founder, former director and CEO, and beneficial owner of approximately

42.3 percent of American Apparel, who was suspended from his role as CEO in June 2014. In July 2014, he entered into a standstill agreement in his personal capacity and shortly thereafter resigned as a director of American Apparel. Pursuant to the standstill agreement, Charney agreed not to disparage American Apparel or act to replace its directors, and American Apparel agreed to form a committee to investigate Charney's alleged misconduct and make a determination as to whether Charney should be reinstated as CEO. In December 2014, following the investigation, Charney was terminated as CEO, the opinion said. In May, American Apparel sued Charney, alleging that he had violated the standstill agreement by, among other things, discussing a potential takeover of the company with a private equity firm and participating in employee

meetings where he expressed anti-board sentiments. Shortly after the standstill lawsuit was filed, Charney made a demand on American Apparel to advance his litigation expenses. The demand was rejected, and Charney filed a claim for advancement in the Court of Chancery. Charney argued that he was entitled to advancement because he was still the CEO, although suspended, when some of the alleged misconduct took place and because he would not have been able to take many of the alleged actions, including participating in employee conference calls and accessing company property, but for his knowledge and experience gained in his former position as a director and the CEO of the company, the opinion said. American Apparel argued that Charney was not entitled to advancement because he acted in his personal capacity when he engaged in the alleged misconduct, without using any corporate power.

The court first looked at American Apparel's charter, which provided indemnification to a person who "is or was" a director or officer, but provided for advancement of expenses incurred by "an officer or director." The court found that because the advancement provision did not specifically mention "former" officers and directors, it only applied to current officers and directors. Because Charney was not a director or officer when the standstill lawsuit was filed, the court held that he was not entitled to advancement under the charter.

Next, the court looked to Charney's indemnification agreement, which was broader than the charter and expressly covered advancement for Charney both during and after his time as a fiduciary. The indemnification agreement provided for advancement of expenses for claims with

respect to events "related to the fact" that Charney is or was a fiduciary of American Apparel. For purposes of the indemnification agreement, the court interpreted "related to the fact" to be the same as "by reason of the fact," which is the language found in the Delaware indemnification statute that has been widely interpreted by the Delaware courts to require a causal connection between the alleged claims and a person's official corporate capacity. The court explained that a causal connection exists "if the corporate powers were used or necessary for the commission of the alleged misconduct." The court found that although Charney's former status may have made the alleged violations more damaging, it was not necessary for the alleged violations themselves. It distinguished this case from *Pontone v. Milso Industries*, 100 A.3d 1023 (Del. Ch. 2014), where the court granted advancement to a former director and officer for claims that he had exploited confidential information he obtained as a fiduciary when he later went to work for a competitor. The court explained that in *Pontone*, the confidential information Scott Pontone learned while acting as a fiduciary was necessary for the violations, whereas in the *Charney* case, American Apparel did not allege that Charney had inappropriately misused company information to violate the standstill agreement.

The takeaways from this case are twofold. First, practitioners should consider the advisability of having a company's governing documents and indemnification agreements expressly call out former fiduciaries so that there is no gap in a company's indemnification and advancement regime for former fiduciaries. While this may not have changed the outcome in the

Charney case, many directors and officers would expect to be covered beyond their time of service if the incident for which they were being sued was related to their role as a fiduciary. In addition, since advancement rights are permitted to be broader than indemnification rights, these documents should also be explicit in how broad the advancement rights are intended to be, whether to the full extent permitted by Delaware law or something less, and should not automatically use the same terms for the advancement provisions as are used with respect to indemnification. Second, this opinion highlights that the question of whether a fiduciary is entitled to advancement is a very fact-specific inquiry that largely turns on what plaintiffs allege in the underlying lawsuit, which suggests more than ever the need for careful contract-drafting to make clear the intent of the parties on the scope of advancement rights.

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