February 12, 2009

INVESTMENT FUNDS ALERT

DELAWARE CHANCERY COURT RULING MAY ALTER INDEMNIFICATION EXPECTATIONS FOR PRIVATE EQUITY FUNDS

In Levy v. HLI Operating Co., Inc.[1], the Delaware Court of Chancery held that a private equity fund and its portfolio company will be jointly liable for indemnifying directors appointed by the fund. Following this reasoning, a fund that advances settlement amounts and defense costs to its director representatives would be able to maintain an action for contribution against the portfolio company for only a portion of the indemnification amounts advanced, absent a provision for relative priority of indemnification responsibility.

Sponsors of private equity funds and certain other funds[2] should review their agreements with portfolio companies, as well as their fund limited partnership agreements, and consider making revisions to clarify that portfolio companies will have the primary liability for any indemnification obligations of fund representatives who serve as portfolio company directors, as was the assumption prior to Levy.

OPINION

The case arose from a typical request for the payment of indemnification costs from defendant directors. Security holders of HLI Operating Company, Inc. (HLI) filed a lawsuit against HLI and its directors, including the director representatives of Joseph Littlejohn & Levy Fund II, L.P. (JLL), following a restatement of HLI's financials. After a settlement was reached, JLL's representatives requested—and were denied—indemnification from HLI under HLI's bylaws and indemnification agreements. JLL's representatives then sued HLI for indemnification. In the interim, JLL paid its representatives' settlement and defense expenses relating to the security holder litigation pursuant to an indemnification provision in JLL's limited partnership agreement.

The court held, inter alia, that JLL's representatives did not have a cause of action because their right to receive indemnification from HLI was extinguished by JLL's payments, but JLL could sue HLI for equitable contribution and recover some of the cost of indemnification for the directors. The court ruled that when a fund and a portfolio company both make fullest-extent-of-the-law commitments to indemnify the directors without contractual language that establishes

[1] 924 A.2d 210 (Del Ch. 2007)
[2] The above indemnification issue may be relevant to activist hedge funds that nominate directors for the boards of their portfolio companies.

priority of payment, those agreements create a joint and several obligation to an indemnitee. Therefore, if an indemnitee proceeds against only one indemnitor, that indemnitor would not be entitled to a full recovery of its advance under subrogation (a suit by a person against a person that caused a loss, to obtain reimbursement of the amount of the loss), but could only sue the other indemnitor for a contribution of its portion of the amounts paid.

POTENTIAL SOLUTIONS

Funds may attempt to overcome the ruling in the Levy decision by contract. The clearest method for overcoming the ruling is to enter into an indemnification contract with a portfolio company that stipulates that the portfolio company is primarily liable for indemnification obligations to directors appointed by a fund. A fund may also be able to mitigate the consequences of the decision by amending its limited partnership agreement to expressly state that any indemnification that a fund would provide to persons serving as directors of a portfolio company at its request would be secondary. Similarly, fund sponsors should consider clarifying indemnification provisions in their upper tier documentation to establish order of priority in relation to their funds with respect to fund matters, as presumably the same principle could apply in respect of advances made by a general partner or fund manager properly reimbursable by the fund.

CONTACT INFORMATION

If you have any questions regarding this alert, please contact—

Mark H. Barth	212.872.1065	mbarth@akingump.com	New York
David M. Billings	44.20.7012.9620	dbillings@akingump.com	London
J.P. Bruynes	212.872.7457	jpbruynes@akingump.com	New York
James A. Deeken	214.969.4788	jdeeken@akingump.com	Dallas
Christopher M. Gorman-Evans	44.20.7012.9656	cgorman-evans@akingump.com	London
Barry Y. Greenberg	214.969.2707	bgreenberg@akingump.com	Dallas
Robert M. Griffin Jr.	44.20.7012.9676	bgriffin@akingump.com	London
Leon B. Hirth	212.872.1059	lhirth@akingump.com	New York
Ira P. Kustin	212.872.1021	ikustin@akingump.com	New York
Arina Lekhel	212.872.8018	alekhel@akingump.com	New York
Burke A. McDavid	212.872.1083	bmcdavid@akingump.com	New York
Prakash H. Mehta	202.887.4248	pmehta@akingump.com	Washington, D.C.
Lisa A. Peterson	817.886.5070	lpeterson@akingump.com	Dallas
Eliot D. Raffkind	214.969.4667	eraffkind@akingump.com	Dallas
Fadi G. Samman	202.887.4317	fsamman@akingump.com	Washington, D.C.
William L. Sturman	212.872.1035	wsturman@akingump.com	New York
Ann E. Tadajweski	212.872.1087	atadajweski@akingump.com	New York
Simon Thomas	44.20.7012.9627	swthomas@akingump.com	London
Stephen M. Vine	212.872.1030	svine@akingump.com	New York