

## *Delaware Indemnification Rights for Former Officers and Directors—Marino v. Patriot Rail*

In *Marino v. Patriot Rail* (Feb. 29, 2016), the Delaware Court of Chancery confirmed that, under the Delaware statute, indemnification rights for officers and directors, for actions they take in that capacity while in office, (i) continue after they are no longer in office, (ii) do not cover actions they took after leaving office, and (iii) cannot be amended or eliminated retroactively—in each case, unless the source of the rights (*i.e.*, the certification of incorporation, bylaws or indemnification agreement) specifically provided otherwise at the time it was authorized or ratified.

### Key Points

- **Continued indemnification for actions taken while a director or officer.** Indemnification rights and rights with respect to advancement of expenses continue to provide coverage for actions that a director or officer took in that capacity during his or her period of service, even after the individual has left office and has become a former officer or director—unless the original grant of the rights specifically stated otherwise.
- **No indemnification for actions taken after ceasing to be a director or officer.** Indemnification rights and rights with respect to advancement of expenses cover only actions that a director or officer took during his or her period of service, and not actions that he or she took after leaving office—unless the original grant of the rights specifically stated otherwise.
- **No amendment of indemnification after the fact.** Indemnification rights and rights with respect to advancement of expenses cannot be altered or eliminated retroactively (after directors and officers have exposed themselves to potential suit by acting while in office)—unless the original grant of the rights specifically stated otherwise, so that the directors and officers were on notice that a future amendment was possible.
- **Typical indemnification provision.** A typical indemnification provision of a Delaware corporation provides that indemnification and advancement of expenses will be provided to officers and directors for actions taken in that capacity during their service, to the fullest extent permitted by law. A typical provision does *not* provide that coverage for actions taken during the period of service will cease once the individual leaves office; that coverage will extend to actions taken after the period of service; or that the provision can be amended retroactively. We note that the indemnification and advancement of expenses provisions typically are included in the charter so that they are not amendable by stockholders—

including, for example, an activist stockholder or a hostile bidder—without approval by the board.

- **Treatment of contingent liabilities in purchase agreement.** The fact situation in *Patriot Rail* underscores the importance of allocating in a sale agreement the risk of a negative outcome of any material contingent liabilities of the company—for example, as in *Patriot Rail*, pending material litigation. Please see the Practice Point below.

**Background.** Patriot Rail had a typical indemnification provision in its charter, which conferred indemnification and advancement rights on the directors and officers of the corporation “to the fullest extent of Delaware law.” The charter did not state that directors and officers would lose coverage when they ceased to serve, nor that the provision could be amended retroactively.

The decision was issued in the context of a request by Marino—the former Chair, President and CEO and indirect 23% equity owner of Patriot Rail, as well as the controller of Patriot Rail’s parent (“Parent”) and grandparent (“Grandparent”) companies—for advancement of expenses from Patriot Rail in opposing a post-judgment motion to add him as a judgment debtor responsible for post-trial damages payable in an underlying action (the “Underlying Action”) that had challenged various actions Marino had taken when a director and officer of Patriot Rail. Patriot Rail and Grandparent were the defendants in the Underlying Action. During the pendency of the trial in the Underlying Action, Parent sold all of the stock of Patriot Rail. After the stock sale, Marino resigned all of his positions at Patriot Rail, and Parent transferred almost all of the proceeds of the sale to investors of Grandparent. As a result of the fund transfers (effected through mechanisms that prevented the funds from flowing through Grandparent’s accounts), the combined value of Patriot Rail and Grandparent decreased from as much as \$171 million to about \$1.3 million at the time of the trial.

Marino argued that he was entitled to advancement of expenses in connection with opposing the motion on the basis that the motion was a continuation of the claims made in the Underlying Action, and therefore was related to the challenged actions that he had taken while a director and officer of Patriot Rail. The plaintiffs argued, to the contrary, that Marino was not entitled to advancement of expenses because the motion related primarily to his actions in causing Parent to transfer the proceeds of the stock sale and in make a representation to the court that it would not take any actions that would render the defendants unable to pay a judgment if they ultimately did not prevail in the Underlying Action. The plaintiffs contended that Marino was not entitled to advancement of expenses because these actions occurred after Marino had resigned his offices with Patriot Rail.

Vice Chancellor Laster noted that there was no dispute that if Marino had been sued by reason of his status as an officer or director of Patriot Rail while he was serving as an officer or director, the company would have been obligated to advance expenses to him. The dispute was whether the indemnification provision continued to cover Marino for the same type of claims given that he had ceased to be an officer or director. The Vice Chancellor held that Marino continued to be covered for the actions he had taken while an officer and director, even though he now no longer was an officer or director. However, the Vice Chancellor held that Marino was *not* covered for the actions he had taken after he had ceased to be an officer or director—*i.e.*, the fund transfers and representation to the court that were the subject of the motion at issue. Therefore, the court refused to order advancement of expenses to Marino in connection with his opposing the motion.

**Relevant statutory provisions.** The decision was based on the following provisions of the Delaware General Corporation Law:

- DGCL Section 145(j) (the “Continuation Clause”) provides: “The indemnification and advancement of expenses provided by, or granted pursuant to, this section shall, unless otherwise provided when authorized or ratified, continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.”
- DGCL Section 145(f) (the “No Termination Provision”) provides: “A right to indemnification or to advancement of expenses arising under a provision of the certification of incorporation or a bylaw shall not be eliminated or impaired by an amendment ...after the occurrence of the act or omission that is the subject of the [action] for which the indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.”

**Rationale.** Vice Chancellor Laster noted that these statutory provisions implement the public policy foundation for indemnification and advancement rights, which is to encourage capable people to serve as officers and directors, “secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve.” The Vice Chancellor noted that the public policy foundation for indemnification and advancement rights “has particular salience” when suits target former directors and officers for actions taken while they were in office—because the directors serving when a lawsuit is filed have a “natural inclination” to perceive the former directors and officers as having harmed the corporation and, therefore, to want to deny advancement of expenses to them in defending themselves. The Vice Chancellor explained that: “By establishing a statutory presumption of continuing coverage for actions taken during the period of service, the Continuation Clause and the No Termination [Provision] ensure that the public policy interest prevails, unless the individuals know when they choose to serve that their rights will terminate or can be cut off later.”

**Practice Point: Treatment of contingent liabilities in purchase agreement.**

*Patriot Rail* underscores the importance of parties addressing how to deal with the issue of contingent liabilities—for example, pending material litigation—in connection with the purchase of a company.

In *Patriot Rail*, the stock purchase agreement for the sale of Patriot Rail provided for a special indemnification procedure relating to the Underlying Action, with the indemnity obligation secured by an escrow fund of \$20 million (\$16 million of which could be released after one year if the Underlying Action was not resolved by then). As noted above, after the sale, Marino caused Parent to transfer sale proceeds (more than \$112 million of the \$230 million of gross proceeds) from Parent to investors in Grandparent (with Marino and his trust receiving \$48 million of the transfers). The jury in the Underlying Action ultimately awarded compensatory, punitive and exemplary damages against Patriot Rail and/or Grandparent totaling almost \$53 million.

*If a target company is subject to pending material litigation:*

**The buyer** will want, to the extent practicable, to provide for appropriate protections with respect to a potential adverse outcome in the litigation, including:

- An escrow fund with an amount that approximates the potential liability of the company in the litigation, and that does not provide for release of a substantial amount of those funds until final resolution of the litigation;
- Restrictions on the disbursement of the sale proceeds to the extent that the company's ability to pay claims related to the litigation could be jeopardized;
- Notice of transfers of the proceeds that are not specifically prohibited, so that there is an opportunity to seek judicial intervention if appropriate; and/or
- A requirement that the seller obtain insurance to cover the indemnity obligation or the underlying litigation exposure.

**The seller** will want, to the extent practicable, to minimize its indemnity obligation and the related security and escrow, as well as restrictions on disposition of the sale proceeds.

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**Authors:**

Andrew J. Colosimo  
Aviva F. Diamant  
Christopher Ewan  
Arthur Fleischer, Jr.  
David J. Greenwald  
Mark Lucas

Scott B. Luftglass  
Brian T. Mangino  
Robert C. Schwenkel  
David L. Shaw  
Matthew V. Soran  
Steven J. Steinman  
Gail Weinstein

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**Contacts:**

**New York**

Jeffrey Bagner	+1.212.859.8136	jeffrey.bagner@friedfrank.com
Abigail Pickering Bomba	+1.212.859.8622	abigail.bomba@friedfrank.com
Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Warren S. de Wied	+1.212.859.8296	warren.dewied@friedfrank.com
Aviva F. Diamant	+1.212.859.8185	aviva.diamant@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr.*	+1.212.859.8120	arthur.fleischer@friedfrank.com
Peter S. Golden**	+1.212.859.8112	peter.golden@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Mark Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Tiffany Pollard	+1.212.859.8231	tiffany.pollard@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein*	+1.212.859.8031	gail.weinstein@friedfrank.com

**Washington, D.C.**

Jerald S. Howe, Jr.	+1.202.639.7080	jerry.howe@friedfrank.com
Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com

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\*Senior Counsel; \*\*Of Counsel

