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Delaware Supreme Court Precludes Fraudulent Inducement of LLC Agreement and Employment Agreement as Defense in Advancement Proceeding

By [Jason C. Jowers](#)

In the corporate context, Delaware has long recognized a public policy in favor of both indemnification and advancement. “Indemnification encourages corporate service by capable individuals by protecting their personal financial resources from depletion by the expenses they incur during an investigation or litigation that results by reason of that service.” *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005). Similarly, in an effort to induce able corporate managers to serve in Delaware corporations, “[a]dvancement provides corporate officials 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.”

Despite the policy reasons favoring indemnification and advancement, the Delaware Limited Liability Company Act (the LLC Act) does not mandate either. This is unsurprising given the LLC Act’s policy “to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” 6 *Del. C.* § 18-1101(b). However, recognizing the importance of the dual incentives of indemnification and advancement, the LLC Act provides that “a limited liability company may, and shall have the power to, indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever.”

6 *Del. C.* § 18-108 (emphases added). The Court of Chancery has repeatedly interpreted this language as granting LLC agreement drafters complete discretion on the issues of whether to grant members or managers indemnification or advancement. *See, e.g., Philip v. Centerstone Linen Servs., LLC*, 2014 WL 793123, at *3 (Del. Ch. Feb. 27, 2014).

This freedom of contract on the issue of advancement raises the question: are typical contractual defenses, such as fraudulent inducement, available in a summary proceeding seeking to enforce a party’s advancement rights? In the recent decision of *Trascent Management Consulting, LLC v. Bouri*, __A.3d __, 2016 WL 6947014 (Del. Nov. 28, 2016), the Delaware Supreme Court found that a defendant may not avoid advancing fees by arguing that the underlying LLC agreement was fraudulently induced. According to the court, to allow such a defense “would permit Trascent to escape its clear promise to make advancement until a court found indemnification inappropriate.”

Background Facts

When George Bouri was hired as an executive of Trascent, he also became a manager. After approximately 16 months in these positions, Trascent terminated Bouri and sued him for, among other things, breach of his employment agreement. Bouri’s employment agreement provided:

Unless a determination has been made by final, nonappealable order of a court of competent jurisdiction that indemnification is not required, [Trascent] shall, upon the request of Executive, advance or promptly reimburse Executive’s reasonable costs of investigation, litigation or appeal, including reasonable attorneys’ fees; provided, however, that Executive shall, as a condition of Executive’s right to receive such advances or reimbursements, undertake in writing to repay promptly the Company for all such advancements and reimbursements if a court of competent jurisdiction determines that Executive is not entitled to indemnification. . . .

The Trascent LLC agreement contained almost identical language, except “Executive” was replaced with “Covered Person.” Trascent admitted that Bouri was an “Executive” under the terms of the employment contract and a “Covered Person” under the terms of the Trascent LLC agreement.

Based on the language in the Trascent LLC agreement and his employment agreement, Bouri sought advancement from Trascent to defend the underlying litigation. When Trascent refused to advance legal fees, Bouri filed an action in the Court of Chancery seeking to enforce his right to advancement under both agreements.

Background on Delaware's Summary Advancement Proceedings

Under the Delaware General Corporation Law (DGCL), certain types of court proceedings are “fast-tracked” based on the inherent need to decide the matter in dispute quickly. For example, when there is a challenge to the election of directors, an action filed pursuant to Section 225 of the DGCL to decide the outcome is summary in nature so as to provide “a quick method for review of the corporate election process to prevent a Delaware corporation from being immobilized by controversies about whether a given officer or director is properly holding office.” *Box v. Box*, 697 A.2d 395, 398 (Del. 1997). Similarly, advancement proceedings are summary in nature and are, accordingly, “limited to determining the issue of entitlement” to advancement. *Homestore*, 888 A.2d at 213.

Section 145(k) of the DGCL specifically provides that advancement proceedings should be summary in nature. This reflects a policy of “providing prompt reimbursement to present and former directors and officers who have had to incur attorneys’ fees and related expenses.” *Mooney v. Echo Therapeutics, Inc.*, 2015 WL 3413272, at *8 (Del. Ch. May 28, 2015). Although the LLC Act does not contain a provision with language tracking Section 145(k), the Court of Chancery also treats actions seeking to enforce advancement rights in the LLC context as summary proceedings because “policy objectives surrounding 8 Del. C. § 145 . . . extend to similar provisions found in operating agreements in the LLC context.” *Tulum Mgmt. USA LLC v. Casten*, 2015 WL 7269811, at *3 (Del. Ch. Nov. 9, 2015).

Contract May Not Be Challenged in Summary Advancement Proceeding on Fraudulent Inducement Grounds

In *Trascent*, the defendant attempted to avoid advancing attorneys’ fees by arguing that both the employment agreement and LLC Agreement had been fraudulently induced by Bouri. The Court of Chancery found that the plain language of the contracts at issue mandated advancement unless and until “a determination has been made

by final, nonappealable order of a court of competent jurisdiction that *indemnification* is not required. . . .” *Trascent*, 2016 WL 6947014, at *2-3 (emphasis added). Advancement and indemnification are two separate issues. Although advanced fees usually have to be clawed-back if a court ultimately finds indemnification is not warranted, that does not mean that fees must not be promptly advanced before that determination is made. Indeed, one of the primary benefits of advancement is that fees are advanced to defend the underlying litigation *before* the entitlement to indemnification is litigated. According to the Court of Chancery, if it permitted the fraudulent inducement defense in this case, advanced fees would be effectively denied until the underlying plenary action over the contracts was decided. Accordingly, the court rejected the defense and awarded advancement.

On appeal, the Delaware Supreme Court affirmed the Court of Chancery’s decision. Relying on the plain language of the LLC agreement in rejecting the injection of a fraudulent inducement defense into an advancement proceeding, the Delaware Supreme Court explained:

Trascent knew when it entered the contract that Bouri would be entitled to advancement “[u]nless a determination has been made by final, nonappealable order of a court of competent jurisdiction that indemnification is not required.” Thus, Trascent knew it agreed to provide a right, subject to expedited specific enforcement, and it could not reasonably believe that it could deny that right simply by alleging that the contract was invalid. Trascent may later show that Bouri is not entitled to indemnification by proving that the entire employment agreement or the advancement provision was invalid and fraudulently induced. But, Trascent cannot refuse to provide advancement by arguing that Bouri has the duty in an advancement proceeding to disprove Trascent’s belated allegations. That is especially so in this case when Trascent sued Bouri to enforce its

rights under the same contract in which Bouri’s right to advancement is set forth, when it was Trascent’s own decision to sue that triggered Bouri’s right to advancement, and when there is a great deal of overlap with Trascent’s substantive claims which seek to deprive Bouri of the benefits of his previous employment and lose any further rights under the employment agreement and LLC agreement, including advancement, on the grounds that he induced his hire by fraud.

The Delaware Supreme Court also found that permitting a party to argue fraudulent inducement in an advancement proceeding would undermine policies for providing efficient, summary proceedings in the advancement context.

Conclusions

A number of conclusions can be drawn from the *Trascent* decision. First, Delaware courts will continue to treat advancement cases arising out of LLC agreements as summary proceedings, which are meant to be efficient and quick. Second, because of the summary nature of advancement proceedings, defenses such as fraudulent inducement that would derail the proceeding and effectively transform into a litigation over the validity of the underlying contract are unlikely to be permitted. Finally, LLCs are creatures of contract. Section 18-108 of the LLC Act leaves to the drafters’ sole discretion whether to include advancement provisions in the LLC agreement. LLCs remain free to operate without such provisions. However, if the drafters use their discretion to include advancement provisions in the LLC agreement and the member, manager, or officer qualifies for advancement under the terms of the contract, Delaware courts will hold the parties to the terms of that agreement.

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