Do the advancement rights of directors and officers have priority over the rights of creditors to the assets of a limited liability company in receivership? In two recent Delaware Court of Chancery decisions—Andrikopoulos v. Silicon Valley Innovation LLC, C.A. No. 9899-VCP (Del. Ch. July 30, 2015), and Henson v. Sousa, C.A. No. 8057-VCG (Del. Ch. Aug. 4, 2015)—Vice Chancellors Donald F. Parsons Jr. and Sam Glasscock III both concluded the claims for advancement were not entitled to priority treatment as administrative expenses of the receivership. The cases underscore the importance of obtaining directors and officers liability insurance regardless of the existence of advancement and indemnification provisions in the entity's organizational documents or the party's employment agreement.

The main dispute between the parties in both cases was whether, in the context of a receivership under Delaware law, advancement claims are administrative expenses or unsecured creditor claims. Under federal bankruptcy law, the filing of a bankruptcy petition significantly affects the ability of a creditor to obtain payment of defense costs from a debtor corporation. Such payments are only permitted if they constitute administrative expenses under Section 503(b) of the Bankruptcy Code. To qualify as an administrative expense, the expense must have arisen from a post-petition transaction between the creditor and the trustee/debtor-in-possession and the transaction must have benefited the estate in the post-petition period. If claims are not administrative expenses, they are treated as ordinary pre-petition claims not subject to priority.

In the Andrikopoulos case, the receiver argued by analogy to bankruptcy law that advancement is a pre-petition claim, because it is based on conduct that occurred before the receivership was established and essentially is a form of compensation for services that the plaintiff members rendered before the receivership began. Therefore, the advancement claims should be paid pro rata with those of other unsecured creditors. The plaintiffs, on the other hand, argued advancement is a cost of the receiver's having brought a lawsuit against former officers with
advancement rights, and more significantly, there is a strong public policy in favor of advancement, and a receivership is different from bankruptcy.

In the *Henson* case, the receiver actually proposed to pay the defendant members' defense costs in priority to the claims of creditors of the company, and the plaintiffs, who had instituted the underlying action against the member managers for malfeasance related to the company, objected.

The *Andrikopoulos* court found no controlling Delaware authority, and the Delaware statute on receivership provided minimal guidance. On the one hand, Delaware's strong policy in favor of advancement and a recent decision from another jurisdiction, *U.S. Securities and Exchange Commission v. Illarramendi* (D. Conn. Feb. 10, 2014), reconsideration den. (Mar. 7, 2014), applying Delaware law and holding that the payment of advancement claims during receivership was entitled to administrative priority, favored giving the advancement claims priority over other creditors. On the other hand, there existed a strong analogy between receiverships and bankruptcy that favored denying priority to the advancement claims.

The *Andrikopoulos* court concluded that the advancement claims should be treated the same as the claims of other creditors. First, while advancement is important, so is the successful winding up of a corporation or other business entity. Because the focus of a receivership is on winding up the company's affairs, the relevant importance of the policy justification of advancement as an inducement to attract qualified individuals to manage the company is diminished, and granting administrative priority to advancement claims could seriously undermine the ability of companies in receivership to pursue claims against former management. In contrast, the *Illarramendi* court viewed the advancement costs as a cost of doing business: "The receiver presumably determined that despite the administrative costs attendant to pursuing the lawsuit—including his own fees and potentially those advanced to movants—the potential recovery will produce a net benefit for the receivership estate. ... Should the receiver be required to advance fees to movants in the suit in which he ultimately prevails, movants will have to refund the advanced fees, and thus, at least theoretically, advancement will result in no economic detriment to the estate."

Second, the *Andrikopoulos* court, while expressing some reservations about the analogy to bankruptcy law, found support in the idea that the pre-receivership entity and the receivership entity are meaningfully different: They are managed by different individuals for different purposes and are governed by different rules. Advancement obligations are contractual in nature and generally arise from pre-receivership transactions, and in that respect, are no different than other creditors' claims. Third, the *Andrikopoulos* court noted the existence of "market-based solutions" for ameliorating the challenges that may arise from balancing the existence of advancement rights against the realities of insolvent entities. Specifically, the ability to protect against the entity's insolvency through the purchase of D&O insurance. Finally, the *Andrikopoulos* court expressed concern that giving priority to advancement claims would embroil the court in a myriad of other claims to administrative priority and involve the court in time-consuming, line-item accounting disputes.
The *Henson* court, citing the same rationales as the *Andrikopoulos* case, also found that the advancement claims should not receive priority and should be treated on a par with all other unsecured creditors' claims.

These two cases underscore the importance of obtaining D&O liability insurance to protect the indemnification and advancement rights of directors, officers and managers in the event that the company becomes insolvent and a receiver is appointed or a bankruptcy petition is filed. D&O insurance policies generally include coverage for individuals when the company cannot indemnify them, either because it is not permitted under applicable law or because it is financially incapable of doing so. These policies typically provide for payment of defense costs as well. As Parsons noted in the *Andrikopoulos* case, insurance is often the best solution to the problem of obtaining advancement from an insolvent entity.

**Barry M. Klayman** is a member in the commercial litigation group and the bankruptcy, insolvency and restructuring practice group at Cozen O’Connor. He regularly appears in Chancery Court.

**Mark E. Felger** is co-chair of the bankruptcy, insolvency and restructuring practice group at the firm.