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September 5, 2013

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Re: Edmond Costantini, et al. v. Swiss Farm Stores Acquisition LLC
Civil Action No. 8613-VCG
Date Submitted: August 22, 2013

Dear Counsel:

In this matter, the Plaintiffs Edmond D. Costantini, Jr. and James Kahn seek indemnification for their fees and costs in underlying litigation involving the Defendant, Swiss Farm Stores Acquisition LLC ("Swiss Farm"). In that action, Swiss Farm sought damages against Costantini and Kahn for breach of fiduciary duty. After finding that the applicable limitations period had run, I dismissed that litigation based on laches; the case was appealed and affirmed by the Delaware Supreme Court.[1] Now, Costantini and Kahn seek indemnification for their fees and costs in the fiduciary duty action. Because Costantini was a member of the

[1] *Swiss Farm Stores Acquisition LLC v. Redeemed Properties, LP*, 2013 WL 2297090 (Del. May 22, 2013).

board of managers of Swiss Farm and Kahn was not, I will examine their indemnification claims individually.

Costantini

It is axiomatic that a corporation is run by its directors, and through powers delegated by the directors to officers and agents. To encourage able people to serve in these positions, public policy, expressed through statute, provides indemnification rights for corporate actors. Corporations may indemnify any such actor "who was or is a party or is threatened to be made a party" to any action brought by a third party "by reason of the fact that the person is or was a director, officer, employee or agent of the corporation" so long as "the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation. . . ."[2]

A corporation may also choose to indemnify similar individuals in case of suit "by or in the right of the corporation to procure a judgment in its favor," again, so long as the individual acted in good faith.[3] In addition to these permissive indemnifications, 8 *Del. C.* § 145 also provides for mandatory indemnification:

> To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in

[2] 8 *Del. C.* § 145(a).
[3] 8 *Del. C.* § 145(b).

> defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.[4]

The same policy reasons supporting indemnification for corporate actors apply to actors for other entities, including LLCs such as Swiss Farm. However, LLCs are creatures of contract, and our law provides broad latitude for LLCs to allocate the rights and responsibilities of its members.[5] Swiss Farm, however, chose to import into its Operating Agreement, near verbatim, the permissive and mandatory indemnification rights for its managing members, officers, employees or agents as provided to corporate actors in 8 *Del. C.* § 145. Costantini argues that the mandatory indemnification provisions of Section 145 apply by analogy to the LLC; or that, having chosen to import its language, Swiss Farm is bound by the case law that interprets the statute. Swiss Farm, on the other hand, argues that it is free to import statutory language without importing case law decisions on the

[4] 8 *Del. C.* § 145(c).
[5] *See* 6 *Del. C.* § 18-1101(b) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); *Kuroda v. SPJS Holdings, LLC*, 971 A.2d 872, 880 (Del. Ch. 2009) ("Limited liability companies are creatures of contract, and the parties have broad discretion to use an LLC agreement to define the character of the company and the rights and obligations of its members."); *TravelCenters of Am., LLC v. Brog*, 2008 WL 1746987, at *1 (Del. Ch. April 3, 2008) ("[L]imited liability companies are creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.'").

meaning of the language therein; that in any event, language in its Operating Agreement modifies the language of the statute in a way that makes the case law inapplicable; and that a fair reading of its Operating Agreement indicates that Costantini is not entitled to indemnification. Because I find that Article 14 of the Operating Agreement unambiguously provides for indemnification for Mr. Costantini under the undisputed facts here, I need not consider the issue of whether the statute itself is binding on Swiss Farm.

In seeking indemnification, Costantini relies on the rights conferred on him by Article 14, paragraph 3 of Swiss Farm's Operating Agreement, which provides:

> To the extent that a member of the Board of Managers, an officer, an employee, or an agent of the Company has been successful on the merits or otherwise in defense of any proceeding referred to in this Article 14, or in defense of any claim, issue, or matter therein, he or she shall be indemnified against expenses actually and reasonably incurred by him or her in connection therewith.

Swiss Farm, surprisingly, first argues that, because Costantini prevailed on a technical defense—laches by analogy to the statute of limitations—he has not prevailed "on the merits" and therefore is not entitled to indemnification. The plain language of paragraph 3, quoted above, provides for indemnification where a member of the Board of Managers (such as Costantini) prevails "on the merits or otherwise." Swiss Farm's argument is that "or otherwise" should be read either as

surplusage, or to mean "in a manner similar to on the merits." But this complies neither with the canons of construction[6] nor common sense. The language "on the merits or otherwise" is meant to indicate that where a managing member prevails in any manner, she is entitled to indemnification.[7]

Swiss Farm's next argument is more substantial, although still unavailing. Article 14 contains three paragraphs analogous to the two permissive indemnification provisions of 8 *Del. C.* § 145(a) and (b) (set out at paragraphs 1 and 2 of Article 14 of the Operating Agreement) and to the mandatory indemnification provision of 8 *Del. C.* § 145(c) (set out at the third paragraph of Article 14). As in the statute, the language of paragraphs 1 and 2 indicates that the indemnification rights contained therein, rather than being conditioned on success on the merits or otherwise, are instead conditioned on the good faith actions of the indemnitee. Again, analogous to 8 *Del. C.* § 145, the provisions of paragraph 3 are not conditioned on good faith, but only provide indemnification where the actor

[6] *See NAMA Holdings v. World Mkt. Ctr. Venture, LLC*, 948 A.2d 411, 419 (Del. Ch. 2007) ("Contractual interpretation operates under the assumption that parties never include superfluous verbiage in their agreement, and that each word should be given meaning and effect by the court.").
[7] *See* 1 R. Franklin Balotti & Jesse A. Finkelstein, Del. L. of Corp. and Bus.Org. § 4.12 ("The phrase found in Section 145(c)—'on the merits or otherwise'—permits the indemnitee to be indemnified as a matter of right if he or she wins a judgment on the merits or if he or she successfully asserts a 'technical' defense, such as a defense based upon a statute of limitations.").

has prevailed in defense of an action brought by Swiss Farm. This, of course, is the situation in which Costantini finds himself.

Swiss Farm, however, points to paragraph 4 of Article 14:

> Any indemnification under this Article 14, unless pursuant to a determination by a court, shall be made by the Company only as authorized in the specific case upon a determination that indemnification of the Member of the Board of Managers, an officer, an employee, or an agent is proper in the circumstances because he or she has met the *applicable standard of conduct* set forth in this Article 14….

Swiss Farm argues that this language unambiguously imports into paragraphs 1, 2 and 3 of Article 14 the good faith requirements set out in paragraphs 1 and 2 but omitted in paragraph 3 of the Article. But this is not a fair reading of the contractual language. Paragraph 4 charges the Board of Managers, in determining issues of indemnification, to apply the "applicable standard of conduct" set forth in Article 14. The standard of conduct set forth in Article 14 requires good faith conduct as a prerequisite for indemnification in circumstances where a covered actor is involved in a suit by reason of his relationship with the LLC, but Article 14 omits that requirement in circumstances where 1) the actor is a defendant in an action brought against him by reason of his relationship with the corporation, and 2) he is "successful on the merits or otherwise." The fact that the Board of Managers is directed to apply the standard of conduct as set out in Article 14 does

not change the applicable standard of conduct in circumstances governed by paragraph 3: that paragraph provides that managers *shall be indemnified*, regardless of the good faith of the indemnitee. That is, the "good faith" standard is not "applicable" to paragraph 3.

In addition to comporting with the clear language of the provision, this reading is consistent with its purpose. If the drafters had meant to incorporate a requirement that the prevailing actor demonstrate the good faith of his actions before receiving indemnification under circumstances where a manager (1) was sued because of his status as manager, (2) prevailed on the merits *or otherwise*, and (3) is therefore entitled to indemnification, the drafters would have invited precisely what Swiss Farm now proposes here: a trial within a trial on the now-dismissed underlying fiduciary duty claims under the guise of demonstrating Costantini's good faith or lack thereof. Such an intent seems unlikely.

This Court has previously noted the unfortunate fact that corporations and other entities often find broad advancement and indemnification clauses useful for enticing talented people to associate themselves with the entity, only to spurn them once the time for payment arrives.[8] Here, Costantini was a manager of the LLC, he

[8] *See, e.g.*, *Stockman v. Heartland Indus. Partners, LP*, 2009 WL 2096213, at *5 (Del. Ch. July 14, 2009) (explaining that, because directors "base their decision to serve [in reliance] on the terms of the limited partnership agreement," "any ambiguities in Heartland's Partnership

was sued by Swiss Farm and prevailed, and he is entitled to indemnification under Article 14, paragraph 3. He is also entitled to indemnification for reasonable fees and costs incurred in pursuing his indemnification rights.[9]

Kahn

Mr. Kahn was not a manager of the LLC. Nor was he an officer, employee or agent of Swiss Farm, or even a member. He is, however, a partner in a partnership that is a member and has the ability to designate a manager of the LLC.

Agreement should be resolved in favor of the reasonable expectations of Heartland's Indemnitees regarding their indemnification and advancement rights"); *Chamison v. Health Trust Inc.-The Hospital Co.*, 735 A.2d 912, 922 (Del. Ch. Jan. 12, 1999) (interpreting an indemnification agreement to protect a director's right to pursue his best defense, despite a provision in the agreement permitting the company to choose the director's counsel, because "§ 145's purpose to enable Delaware companies to attract competent directors by offering them indemnification for suits arising from their service to the company runs counter to the notion that an indemnitor could, through a counsel selection clause, foist a less-than-the-best defense upon an indemnitee").

[9]*See Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561-62 (Del. 2002) (awarding fees on fees where the company's bylaws provided for indemnification "to the full extent permitted by law"). Although Swiss Farm's Operating Agreement does not explicitly provide for indemnification "to the full extent permitted by law," the policy underlying the *Stifel* decision–namely, that 8 *Del. C.* § 145 was enacted to encourage directors to resist unjustified suits, and to encourage capable people to serve as directors–also applies to other indemnification provisions that do not specifically exclude fees on fees. *See Weaver v. ZeniMax, Inc.*, 2004 WL 243163 (Del. Ch. Jan. 30, 2004) (awarding fees on fees under an indemnification provision that did not contain the language "to the full extent permitted by law," and explaining that such language was not controlling in *Stifel*). Fees on fees are an appropriate award even in an indemnification action in which the entity is an LLC. *See DeLucca v. KKAT Mgmt, LLC*, 2006 WL 224058, at *15 (Del. Ch. Jan. 23, 2006) ("Although the KKAT Companies argue that their status as LLCs counsels for not following *Stifel* here, I discern no rational basis for creating a conflict between the default rules of construction between corporations and LLCs on this question.").

At the time of the events in the underlying litigation, the manager so designated was Hank Quinn.

The allegations against Mr. Kahn in the underlying action were set out at paragraph 31 of the Complaint:

> At the time of the events complained of above, Defendant Kahn was a partner in the Kahn Quinn Partnership, which in turn was a member of Swiss Farm with the right and ability to designate a member of the Board of Managers of Swiss Farm. At the time of the events complained of, the Kahn Quinn Partnership designated Hank Quinn to serve on the Board of Managers, but in effect, the Kahn Quinn Partnership itself so served and in the process assumed for all of its partners, including Defendant Kahn, multiple fiduciary duties to Swiss Farm.

Kahn argues that "the simple fact that the underlying action asserted that Mr. Kahn owed Swiss Farm a fiduciary duty of loyalty ipso facto proved that Swiss Farm sued him in the capacity of a manager."[10] Kahn points out that fiduciary duties to Delaware LLC's are owed only by controllers, managing members and persons assuming such duties contractually.[11] Since the Complaint did not allege that Kahn was a controller or a contract fiduciary, according to the Plaintiffs, Kahn must have been sued as a managing member.

[10] All Plaintiffs Reply Brief, at 6.
[11] *Id.* at 6 (citing *Imbert v. LCM Interest Holding LLC*, 2013 WL 1934563 (Del. Ch. May 7, 2013); *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012); *Kuroda v. SPJS Holdings, LLC*, 971 A.2d 872, 880 (Del. Ch. 2009)).

The Plaintiffs may be correct to suggest that in order for Kahn to be successfully sued as a fiduciary, Swiss Farm would have had to demonstrate that he had some status other than partner of a member. But in this case, where a defendant has prevailed against Swiss Farm on a motion to dismiss and seeks indemnification under Article 14, paragraph 3, I must look at the allegations of the Complaint, the relevant agreement and the facts of record to determine whether he is among the parties who have a contractual right to indemnification. The parties concede that Kahn did not have a relationship with Swiss Farm that put him in the class of indemnitees identified in Article 14; that is, he was not a managing member, officer, employee or agent.[12] I asked Swiss Farm's counsel to articulate the theory under which it would have demonstrated in the underlying action that Mr. Kahn owed fiduciary duties to Swiss Farm. Counsel explained Swiss Farm's theory, but I was unable to comprehend it. What I did understand is that Swiss Farm attempted to impose fiduciary liability on an individual who was not a managing member, officer, employee or agent (and in fact, not even a member), who had participated in alleged breaches of duty with a managing member, Mr. Costantini. A more traditional allegation against an individual in Mr. Kahn's

[12] Kahn suggests that the "agent" designation may be broad enough to encompass the allegations against him, but nothing in the record or the Complaint suggests an agency relationship between Kahn and Swiss Farm.

position might have been an aiding and abetting claim. The fundamental problem here is that such a claim against a third party would give the third party no indemnification rights under the Operating Agreement.

The purpose of the statutory language imported into the Operating Agreement is to allow (and in the case of mandatory indemnification, require) entities to attract talented individuals to act on behalf of the company by limiting the burdens of potential litigation against them. That purpose, obviously, does not extend to those who, like Mr. Kahn, were not acting on behalf of the entity. An LLC could, I suppose, provide indemnification to others besides managers, officers, employees and agents, but there is nothing in 8 *Del. C.* § 145 or otherwise that requires them to do so. Here, Kahn was simply not an indemnitee under the terms of the Operating Agreement.

The Plaintiffs point out that it appears unfair that a managing member sued for breach of fiduciary duty who prevails on a technical defense receives indemnification, while a third party who is sued for a similar breach of fiduciary duty—where the predicate for such liability appears not even to exist—does not. But this is simply the unfairness (if unfairness it is) that results from application of the traditional American Rule on legal fees and costs, which provides that the prevailing party must bear her own fees and costs. The Plaintiffs point to *Imbert v.*

LCM Interest Holding LLC as persuasive here.[13] *Imbert* involved a claim for advancement by a manager of the company under an applicable LLC Agreement. The case involved a dispute as to whether the allegations against the potential indemnitee had been brought in his capacity as a manager, in which case advancement rights applied, or as a member, for whom advancement was not provided in the LLC Agreement. It was undisputed that the potential indemnitee was a manager; the issue was in what capacity the allegations against him were brought. The holding in *Imbert*, therefore, is not persuasive here.

If Kahn had been sued as a manager, and had prevailed by demonstrating that he was in fact not a manager, he would not be entitled to indemnification because he was not a member of the class so entitled under Article 14. The outcome must be no different here. Kahn was sued under a theory that, despite not being a manager, he nonetheless owed and breached fiduciary duties to Swiss Farm. Kahn prevailed, and if he were within the class of indemnitees listed in the Operating Agreement, he would be entitled to indemnification. Since he is not within that class, however, he cannot prevail.

[13] *Imbert v. LCM Interest Holding LLC*, 2013 WL 1934563 (Del. Ch. May 7, 2013).

CONCLUSION

Mr. Costantini was a manager of Swiss Farm. He was sued by Swiss Farm in that capacity, and prevailed. He is therefore entitled to indemnification under Article 14 of the Operating Agreement. Mr. Kahn was also sued for breach of fiduciary duty, and prevailed. However, since he was not "member of the Board of Managers, an officer, an employee or an agent of the Company," he is not entitled to indemnification under the Operating Agreement.[14] The Plaintiff's Motion for Judgment on the Pleadings is granted in part and denied in part. IT IS SO ORDERED.

Sincerely,

/s/ Sam Glasscock III

Sam Glasscock III

[14] Operating Agreement, Article 14.