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What Delaware LLCs Need to Know About Advancement of Legal Fees

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Many business owners choose to form their limited liability company (LLC) in Delaware. While registering in Delaware may provide certain advantages for LLCs of all sizes regardless of where the business operates, Delaware LLC's must beware of the aspects of Delaware law concerning the advancement of legal fees.

Indemnification and Advancement

Board members, shareholders, members, principals and other owners or executives of a company can potentially be sued for something they did presumably in their line of work for the company. Companies often provide these key parties with protections from liability in their LLC operating agreements and/or employment agreements, provided that the parties meet a specified minimum standard of conduct, such as acting in good faith and in a way that the party reasonably believes to be lawful and in the best interest of the company.

Specifically, these agreements often provide indemnification rights. This means that, in the event a covered party is sued, the company will pay the covered party's losses, including any judgments, settlements and reasonable legal fees. The agreements may also mandate advancement, which means the company will "advance" the covered party's legal fees and other litigation expenses as they are incurred, with an understanding that if the party's conduct does not meet the minimum standard for indemnification (or the party is otherwise not entitled to indemnification), the party will have to reimburse the company for these legal expenses at the end of the dispute.

Delaware Law

Delaware law provides considerable flexibility to LLCs and their executives and other parties to negotiate the terms of their relationship. Companies are given leeway to create indemnification and advancement provisions to suit their needs, and Delaware courts treat these provisions as contractual obligations. Companies need to be aware that if their operating agreement and/or other documentation broadly grant mandatory advancement, the covered parties may be entitled to advancement of their legal expenses in a wide range of lawsuits. This reality gets particularly tricky in so-called first-party claims, in which the company is suing the covered party for wrongdoing.

First-Party Claims

Say a company's manager engaged in self-dealing, leading the company to fire and sue him. The manager can say, "I have this advancement right. You have to pay my legal fees as they are incurred."

Delaware has a well-established policy favoring advancement of legal expenses to dismissed managers and other parties. Unless the Company has precise language limiting the advancement rights to third-party claims, Delaware courts may enforce advancement obligations even as to first-party claims. In such a case, you as the company would have to pay your opponent's legal expenses as they are incurred during the litigation.

This can prove harmful to you, the company, for several reasons. As an initial matter, there is the cost. Litigation is twice as expensive if you have to pay the fees for both sides. And, your opponent may be more aggressive and less likely to settle if it knows that you are paying its litigation expenses. Further, even if at the end of the case you prove that the fired manager's conduct was egregious enough that he is not entitled to indemnification and has to reimburse you for the legal fees, he may not have the money to pay you back. Of course, most cases do not get to trial, as both parties often prefer a settlement. However, to recoup your legal expenses, you would have to bake them into the settlement or fully litigate the case to prove that your opponent is not entitled to advancement.

Keep in mind that the party being sued may not necessarily be an individual; it could be an LLC that you hired to manage your business. You may have fired and sued the LLC for stealing your confidential information. While this likely would qualify as conduct requiring the management company to reimburse you for the advanced legal expenses, you may have to go through the entire lawsuit to prove this before you can recoup the legal fees you advanced.

Watch your Contract Language

Company owners that choose to form their LLC in Delaware need to pay close attention to the language in their operating agreements and other documents to avoid having to advance their opposition's legal fees.

Savvy executives and management companies may insist on indemnification and advancement protections. Where possible, explicitly limiting these rights to third-party claims is advisable.

It is important to work with a business lawyer with expertise in operating and indemnification agreements and the nuances of Delaware law. Once your business lawyer has helped you draft an agreement that you and the other party tentatively agree to, you may want to have a business litigator examine the agreement with an eye toward limiting your risks in case of future litigation.

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