

COURT OF CHANCERY  
OF THE  
STATE OF DELAWARE

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Re: *Karl Phillip v. Centerstone Linen Services, LLC*  
C.A. No. 8712-ML

Dear Counsel:

Anecdotally, it often seems that a company challenging a former official's right to advancement faces the same odds as a gambler placing a large bet on a long-shot at the racetrack. Although rational heads frequently prevail in business litigation, advancement cases rarely boast that feature, and this case is no different. This advancement proceeding has been pending for more than nine months and the company has pressed its arguments at length before two different judicial officers, but has yet to achieve anything more than a pyrrhic victory that likely was erased by the fees it has paid its own attorneys

and the fees it has been ordered to pay on behalf of the plaintiff. That trend continues in this latest iteration of the parties' dispute. Unfortunately, Centerstone has been victorious in delaying the inevitable and this case has tested the outer limits of any reasonable definition of a "summary proceeding."

## **BACKGROUND**

The underlying facts are both undisputed and recited at length in the final report I issued on December 3, 2013, and in Vice Chancellor Glasscock's opinion dated February 27, 2014. To briefly summarize, the plaintiff, Karl Phillip ("Phillip"), was the co-founder of Alliance Laundry and Textile Services, a company he sold to the defendant, Centerstone Linen Services, LLC ("Centerstone") in 2008. In connection with the sale, Phillip received a preferred membership interest in Centerstone, which he holds through a wholly-owned Georgia LLC, KF Equity Holdings, LLC ("KF Equity"). When it acquired its equity stake in Centerstone, KF Equity executed a \$1 million promissory note in favor of Centerstone (the "Promissory Note").

After the sale, Phillip became a Manager of Centerstone and served as Centerstone's CEO under a Member Service Agreement (the "Employment Agreement"). Phillip resigned as CEO in October 2012 for what he contends was "Good Reason" under the terms of the Employment Agreement.<sup>1</sup> If Phillip resigned for Good Reason, he is entitled to certain severance payments.

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<sup>1</sup> Phillip resigned as Manager of Centerstone on October 14, 2013. *See* Defendant's Third Amended Counterclaims and Third Party Claim and Amended Affirmative Defenses (hereinafter cited as the "Third Am. Countercl.") ¶ 6.

When Centerstone disagreed that Phillip resigned for Good Reason and refused his demands for severance, Phillip filed an action in Georgia state court (the “Georgia Action”). Shortly thereafter, Phillip and Centerstone engaged in settlement negotiations and executed a term sheet (the “Term Sheet”), but Centerstone later refused to proceed with the settlement on the basis that the company had “discovered facts suggesting that Phillip had engaged in practices designed to manipulate Centerstone’s revenue.” In response to Phillip’s motion to enforce the settlement, Centerstone argued to the Georgia court that Phillip “fraudulently induced” Centerstone to enter into the Term Sheet and breached his fiduciary duties by failing to disclose during settlement negotiations that he had manipulated revenue to inflate his bonus. The Georgia court ultimately denied the motion to enforce the settlement, finding that there were factual questions as to whether the parties reached a meeting of the minds and as to whether Phillip fraudulently induced Centerstone to enter into the Term Sheet.<sup>2</sup>

Centerstone then filed an answer and several counterclaims against Phillip in the Georgia Action. When Phillip demanded advancement under Article 3.7 of Centerstone’s LLC Agreement (the “LLC Agreement”) for his attorneys’ fees relating to the defenses and counterclaims, Centerstone filed its first amended counterclaims and affirmative defenses (the “Amended Counterclaims”), wherein Centerstone withdrew certain fiduciary duty claims (the “Dismissed Counterclaims”) and asserted three counts against

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<sup>2</sup> *Phillip v. Centerstone Linen Servs., LLC*, C.A. No. 2012CV224517, Order Granting in Part and Denying in Part the Parties’ Cross Motions for Summary Judgment (hereinafter cited as “Georgia Summ. J. Order”) at 15 (Ga. Super. Ct. Apr. 4, 2014).

Fillip. In the Amended Counterclaims, which were styled as contractual claims, Centerstone alleged: (a) Phillip breached the Employment Agreement “by causing his annual bonus for the period 2008 through 2012 to be significantly overstated” (Count I); (b) Phillip breached the Promissory Note by modifying its terms without authorization (Count II); and (c) the company was entitled to a declaratory judgment regarding the interpretation of Article 14.13 of the LLC Agreement (Count III). Centerstone also asserted a number of affirmative defenses to Phillip’s claims, including that Phillip was barred from recovery under the doctrine of unclean hands and based on his own breaches of the Employment Agreement and the LLC Agreement. Centerstone refused to advance Phillip’s attorneys’ fees and expenses for either the Amended Counterclaims or the affirmative defenses. Phillip then filed this advancement action.

The initial stages of this case required me to resolve two issues: (1) the scope of Phillip’s advancement rights under Article 3.7 of the LLC Agreement; and (2) the extent to which Phillip was entitled to advancement in the Georgia Action. After I issued a final report interpreting Article 3.7 and recommending that the Court find that Phillip was entitled to advancement for Counts I and II of the Amended Counterclaims, two of the affirmative defenses, and the Dismissed Counterclaims (the “December 2013 Report”), Centerstone filed timely exceptions under Court of Chancery Rule 144. Those exceptions were referred to Vice Chancellor Glasscock, who issued an opinion on February 27, 2014, finding, consistent with my final report, that Article 3.7 of Centerstone’s LLC Agreement “mandates advancement of expenses, including costs,

incurred by any Centerstone Manager or Officer by reason of his position as officer or manager.”<sup>3</sup> Because the pleadings in the Georgia Action had been amended in the interim, and those amendments may have affected my recommendation regarding the portions of the Georgia Action that were subject to advancement, the Vice Chancellor referred the matter back to me for further proceedings. I then directed the parties to meet and confer, held an office conference with counsel, and asked the parties to submit short letters summarizing the remaining issues requiring resolution and attaching the operative pleadings in the Georgia Action.

Centerstone filed its Second Amended Counterclaims in the Georgia Action on November 25, 2013.<sup>4</sup> In addition to adding KF Equity as a third-party defendant, and adding allegations relating to that third party claim, the Second Amended Counterclaims stripped away much of the detailed factual allegations supporting Centerstone’s claim that Phillip overstated his bonus, such as the allegations that he “put his digital foot on the scale” and artificially inflated revenue to manipulate Centerstone’s EBITDA, on which Phillip’s bonus was based. The Company also removed some of the background supporting its allegation that Phillip breached the Promissory Note by purporting to modify its terms. Nevertheless, the bases for Counts I and II of the Second Amended Counterclaims did not change; Centerstone continued to allege that Phillip breached the Employment Agreement by “reporting” significantly overstated bonuses, and breached

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<sup>3</sup> *Phillip v. Centerstone Linen Servs., LLC*, 2014 WL 793123, at \*6 (Del. Ch. Feb. 27, 2014).

<sup>4</sup> Although the pleadings in the Georgia Action were amended before I issued the December 2013 Report, the parties did not advise the Court of those amendments until the matter was before Vice Chancellor Glasscock on Centerstone’s exceptions to the final report.

the Promissory Note by “purporting to offset the Note with bonus payments to which Phillip was not entitled.”<sup>5</sup>

The day before the parties’ letter submissions were due in this action, Centerstone filed its Third Amended Counterclaims and Third-Party Claim and Amended Affirmative Defenses (“the Third Amended Counterclaims”). The Third Amended Counterclaims did not change any of the counts or allegations against Phillip beyond those changes made in the Second Amended Counterclaims. Rather, the Third Amended Counterclaims added several new affirmative defenses against Phillip (the “Affirmative Defenses”). In addition to the second and fourth defenses, which I previously concluded were subject to advancement, Phillip now contends that he also is entitled to advancement for the newly pled fifth, eighth, and ninth affirmative defenses. In all, Phillip argues he is entitled to advancement for Centerstone’s defenses alleging (1) Phillip breached the Employment Agreement and the LLC Agreement (the “Second Affirmative Defense”), (2) Phillip’s claims are barred by the doctrine of unclean hands (the “Fourth Affirmative Defense”), (3) Phillip breached his “duty of good faith and fair dealing and/or his obligation to act with fidelity toward Centerstone” (the “Fifth Affirmative Defense”), (4) Phillip’s claim to enforce the Term Sheet is barred by the doctrine of fraudulent inducement (the “Eighth Affirmative Defense”), and (5) Phillip’s claim to enforce the Term Sheet is barred by the doctrine of mistake (the “Ninth Affirmative Defense”).

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<sup>5</sup> Defendant’s Verified Second Amended Counterclaims (hereinafter cited as the “Second Am. Countercl.”) ¶¶ 19, 24.

During the post-remand office conference, the parties discussed what should constitute the record for purposes of resolving Phillip's entitlement to advancement in the Georgia Action, and specifically whether the parties' summary judgment briefs submitted to the Georgia court should be considered by this Court. I declined to consider the summary judgment briefs and other submissions to the Georgia court, concluding that expanding the record beyond the operative pleadings would unduly complicate these summary proceedings and threaten to devolve into a second plenary proceeding regarding the merits of the underlying litigation. After the office conference, however, the Georgia court issued an order granting in part and denying in part the parties' cross-motions for summary judgment (the "Georgia Order"). Both parties alerted me to the Georgia Order, and I have considered that order for purposes of my analysis. Although generally I believe that advancement actions should be resolved based on the contract at issue and the operative pleading in the underlying litigation, this Court cannot ignore a decision issued in the underlying litigation without risking the possibility of inconsistent results.

Between them, the parties identified six issues that require resolution after Vice Chancellor Glasscock's opinion interpreting Article 3.7: (1) the extent of Phillip's entitlement to advancement for the Dismissed Counterclaims; (2) whether Phillip is entitled to advancement for Counts I and II of the Third Amended Counterclaims; (3) whether Phillip is entitled to advancement for certain of Centerstone's Affirmative Defenses; (4) whether Phillip is entitled to advancement relating to his efforts to enforce the alleged settlement agreement in the Georgia Action; (5) whether Phillip's advancement

right is subject to a repayment obligation; and (6) the extent to which Phillip is entitled to “fees on fees” in this action. Having considered the parties’ arguments, the Vice Chancellor’s interpretation of Article 3.7, the Third Amended Counterclaims, and the Georgia Order,<sup>6</sup> I make the following recommendations.

### **ANALYSIS**

Phillip’s advancement right is contained in Article 3.7 of the LLC Agreement, which provides:

3.7. INDEMNIFICATION. The Company shall indemnify, defend and hold harmless each Manager and Officer for all costs, losses, liabilities, and damages whatsoever paid or incurred by such Manager or Officer in the performance of his duties in such capacity, including, without limitation, reasonable attorney’s fees, expert witness and court costs, to the fullest extent provided or permitted by the [Delaware Limited Liability Company] Act or other applicable laws. Further, in the event fraud or bad faith claims are asserted against such Manager or Officer, the Company shall nonetheless bear all of the aforesaid expenses subject to the obligation of such Manager or Officer to repay all such expenses if they are finally determined to have committed such fraud or bad faith acts.

Centerstone previously argued that only the second sentence of Article 3.7 afforded advancement rights to managers and officers and, for that reason, Phillip’s advancement rights were limited to claims for fraud and bad faith. Both Vice Chancellor Glasscock and I have found that argument unpersuasive, and the Vice Chancellor held that Article 3.7 “unambiguously mandates advancement to Centerstone Managers and Officers of all expenses incurred by reason of their position, and not solely those expenses incurred

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<sup>6</sup> Shortly after the parties filed their post-remand letter submissions, trial began in the Georgia Action. The trial ended in a mistrial; a new trial date has not been set.

when ‘fraud or bad faith claims are asserted’ against such Manager or Officer.”<sup>7</sup> The Vice Chancellor further held that the phrase “in the performance of his duties in such capacity” in the first sentence of Article 3.7 should be applied consistently with the “by reason of the fact” standard applicable to advancement cases under 8 *Del. C.* § 145.

I expounded on that standard at length in the December 2013 Report, and, not being desirous of delaying a resolution of this case for the purpose of reinventing the wheel, I will resort to the textually odd, and generally unsound, practice of quoting myself:

Section 145 of the Delaware General Corporation Law gives corporations the power to provide indemnification and advancement to “any person who was or is a party ... to any ... action ... *by reason of the fact* that the person is or was a director, officer, employee or agent of the corporation.” Interpreting that language, the Delaware courts have held “if there is a nexus or causal connection between any of the underlying proceedings ... and one’s official capacity, those proceedings are ‘by reason of the fact’ that one was a corporate officer.” If the corporate powers were used or necessary for the commission of the alleged misconduct, that nexus is established. The language in Section 145 has been interpreted broadly to include all actions brought against an officer or director “for wrongdoing that he committed in his official capacity,” and for all misconduct that allegedly occurred “in the course of performing his day-to-day managerial duties.”<sup>8</sup>

Having lost its bid to narrow Phillip’s advancement rights with a restrictive interpretation of Article 3.7, Centerstone turned its sights to arguing that Phillip is entitled to little, if any, advancement in the Georgia Action because of the nature of the counterclaims

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<sup>7</sup> *Phillip*, 2014 WL 793123, at \*4 (internal citations omitted).

<sup>8</sup> *Phillip v. Centerstone Linen Servs., LLC*, 2013 WL 6671663, at \*7 (Del. Ch. Dec. 3, 2013) (internal citations omitted).

asserted against him. Although I addressed many of Centerstone's arguments in the December 2013 Report, my recommendations were based on the Amended Counterclaims, which no longer are part of the operative pleadings in the Georgia Action. I therefore must resolve whether Centerstone's amendments to its counterclaims and affirmative defenses altered my analysis and recommendation. In brief, and for the reasons that follow, the amendments do not alter my recommendation, and the Georgia Order only serves to confirm my initial conclusions.

### **1. The Dismissed Counterclaims**

Centerstone originally disputed Phillip's right to advancement for the Dismissed Counterclaims, which directly alleged that Phillip had breached his fiduciary duties as an officer. Centerstone later revised its position and conceded that Phillip was entitled to advancement for those counterclaims, but only for the brief period of time that those claims were pending before Centerstone informed Phillip that the company intended to dismiss the fiduciary duty claims. This distinction is both artificial and unwarranted given Centerstone's repeated representations to the Georgia court that the company intended to reassert the fiduciary duty counterclaims at a later date, using the discovery it obtained in the Georgia Action to bring a separate action against Phillip.<sup>9</sup> Centerstone maintained before the Georgia court that it would attempt to limit Phillip's advancement rights in that separate action by seeking an early dispositive motion using the discovery it

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<sup>9</sup> *Phillip*, 2013 WL 6671663, at \*4.

obtained in the Georgia Action.<sup>10</sup> It was only after Phillip’s counsel continued to insist Phillip was entitled to advancement for the Dismissed Counterclaims that Centerstone represented it would dismiss the fiduciary duty claims “with prejudice.” The parties then incurred additional fees litigating the proper manner in which that “with prejudice” dismissal could be accomplished. Phillip is entitled to advancement for all of his fees and costs related to the Dismissed Counterclaims, through the date on which the “with prejudice” dismissal was (or is) accomplished.<sup>11</sup>

## **2. The Third Amended Counterclaims**

Centerstone takes the position that the second and third amendments to its counterclaims did not work any substantive change in the claims alleged against Phillip, and that the amendments only sought to remove language that had “concerned” Phillip’s counsel and had formed the basis for Phillip’s argument that Counts I and II involved allegations against Phillip in his capacity as an officer and manager of the company.<sup>12</sup> As it has for months regarding previous iterations of the Georgia pleadings, Centerstone argues that neither Count I nor Count II of the Third Amended Counterclaims is subject to advancement because those claims are based on Phillip’s alleged breaches of the Employment Agreement and the Promissory Note, respectively, and not on any claim that Phillip breached his fiduciary duties to the company. Phillip argues the opposite, asserting

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<sup>10</sup> *Id.*

<sup>11</sup> It is unclear from the record whether the Dismissed Counterclaims have been dismissed with prejudice by the Georgia court.

<sup>12</sup> *Phillip v. Centerstone Linen Servs.*, C.A. No. 8712-ML (Apr. 2, 2014) (Office Conference) (TRANSCRIPT) at 19-21.

that Counts I and II of the Third Amended Counterclaims are subject to advancement for the reasons explained in the December 2013 Report.<sup>13</sup>

In the December 2013 Report, I rejected Centerstone's argument that Counts I and II were based on Phillip's personal contractual obligations, rather than on his performance of his duties as CEO or manager, explaining that – as in *Reddy v. Electronic Data Systems Corp.*<sup>14</sup> – “Centerstone's claims against Phillip, although styled as breach of contract claims, are premised entirely on the proposition that Phillip used his position as CEO to engage in certain conduct that Centerstone contends resulted in a breach of the Employment Agreement and the Promissory Note.”<sup>15</sup> Centerstone nonetheless continues to press its previously unsuccessful argument in its post-remand submission, asserting that Count I “rises and falls under the Employment Agreement, not an independent fiduciary claim.”<sup>16</sup> In the next breath, however, Centerstone acknowledges that Phillip's conduct as an officer and manager is relevant to Count I, but “only insofar as it serves as

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<sup>13</sup> Phillip also argues that his advancement rights should be determined by the pleading that governed the Georgia Action at any given time. In other words, Phillip contends that his advancement rights through November 24, 2013 should be governed by the Amended Counterclaims, that his advancement rights from November 25, 2013 through April 9, 2014 should be governed by the Second Amended Counterclaims, and that his advancement rights beginning April 10, 2014 should be governed by the Third Amended Counterclaims. Although I agree as a general matter that the pleading in effect at the time attorneys' fees are incurred should govern the Court's analysis of whether an official is entitled to advancement, without regard for amendments to the pleadings that occurred after the fees were incurred, it is not necessary to draw that distinction here because I find that Centerstone's serial amendments to the pleadings did not alter Phillip's entitlement to advancement in the Georgia Action.

<sup>14</sup> 2002 WL 1358761 (Del. Ch. Jun. 18, 2002).

<sup>15</sup> *Phillip v. Centerstone Linen Servs., LLC*, 2013 WL 6671663, at \*10 (Del. Ch. Dec. 3, 2013).

<sup>16</sup> Ltr. to the Court from John P. DiTomo, Esq., dated April 14, 2014, at 3.

a basis to bar Phillip's ability to recover under [the Employment Agreement]."<sup>17</sup> Centerstone appears to be advancing two slightly distinct arguments: (1) Count I is not subject to advancement because it does not directly allege a claim for breach of Phillip's fiduciary duties, and (2) Count I is not subject to advancement because Centerstone is not seeking any damages for that claim, but instead simply is arguing that Phillip's misconduct bars him from relief under the Employment Agreement.<sup>18</sup>

For the reasons explained in the December 2013 Report, the first argument is contrary to settled Delaware law, particularly this Court's decisions in *Reddy* and *Paulino v. Mace Security International, Inc.*<sup>19</sup> The second argument is equally baseless. First, despite Centerstone's recent contention otherwise, Count I does appear to seek damages for Centerstone's alleged overpayment of bonuses to Phillip.<sup>20</sup> Second, even if Centerstone were not seeking any damages related to Count I, Article 3.7 of the LLC Agreement does not condition Phillip's advancement right on whether a claim seeks damages, but whether the claim arises "in the performance of his duties" in his capacity as an officer or manager. Under *Reddy*, contractual claims premised on alleged improper actions taken by an officer in his official capacity are subject to advancement.<sup>21</sup> Centerstone's recent concession that Phillip's conduct as an officer or manager is relevant

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<sup>17</sup> *Id.* at 3-4.

<sup>18</sup> *See, e.g., id.* at 4 & n. 1, 2.

<sup>19</sup> 985 A.2d 392 (Del. Ch. 2009).

<sup>20</sup> *See* Third Am. Countercl. ¶ 20 ("As a result of Phillip's breach of the Employment Agreement, Centerstone has suffered damages in the amount by which Phillip's annual bonus was overstated") and Prayer for Relief ¶ (a) (seeking compensatory damages in an amount to be proven at trial).

<sup>21</sup> 2002 WL 1358761, at \* 8 (Del. Ch. Jun. 18, 2002).

to Count I confirms that the counterclaim is subject to advancement, as does the Georgia Order, in which the Georgia court described Count I as based on Centerstone's contention that "Fillip breached his duties to Centerstone by implementing and/or overseeing a practice of overbilling, failing to fully investigate the extent of overbilling, and/or failing to report to the Board his awareness of overbilling or potential overbilling."<sup>22</sup>

Centerstone's argument that Phillip is not entitled to advancement for Count II of the Third Amended Counterclaims fails for similar reasons, and for the reasons explained in the December 2013 Report. Although Count II arises under the Promissory Note, it alleges that Phillip breached the note by overstating his bonus and then using that overstated bonus to offset (improperly) the payments due under the Note. Count II therefore turns, as the Georgia court recognized, on whether Phillip artificially inflated revenues by overbilling or otherwise breached his fiduciary obligations to Centerstone under the LLC Agreement.<sup>23</sup>

### **3. The Affirmative Defenses**

In the December 2013 Report, I held that Phillip was entitled to advancement relating to the Second and Fourth Affirmative Defenses, reasoning that Article 3.7, read in the context of the broad enabling language in Section 18-108 of the Delaware Limited Liability Company Act (the "LLC Act"), provides Phillip advancement rights that

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<sup>22</sup> Georgia Summ. J. Order at 10. *See also id.* ("According to Centerstone, Phillip's conduct breached not only the express terms of the LLC Agreement, but also the Employment Agreement and the implied covenant of good faith and fair dealing inherent in the LLC Agreement.").

<sup>23</sup> *See id.* at 12 ("The open question of whether or not Phillip intentionally inflated Centerstone's revenue by Overbilling also affects his liability under Centerstone's Count II – Breach of the Note.").

encompass affirmative defenses directly implicating Phillip's performance of his duties as an officer and manager of Centerstone.<sup>24</sup> Phillip also argues he is entitled to advancement for the Fifth, Eighth, and Ninth Affirmative Defenses raised in the Third Amended Counterclaims. Centerstone argues, however, that Phillip is not entitled to advancement for fees and expenses related to any of the company's affirmative defenses "[b]ecause Phillip's advancement right flows from the word 'defend,' [and] such an advancement right must be limited to expenses incurred in defense of claims, and ... [not in] prosecuting claims against Centerstone or for Centerstone's defenses thereto."<sup>25</sup>

Contrary to Centerstone's argument, I do not understand Vice Chancellor Glasscock's conclusion that the word "defend" confers advancement rights on Phillip to limit Phillip's advancement right in this contrived manner. The word "defend" refers to Centerstone's obligation to pay Phillip's attorney's fees and costs. Although Centerstone plausibly could argue that the word "defend" precludes Phillip from seeking advancement for affirmative claims he asserts against Centerstone, the company cannot rely on that language to argue that it is not obligated to pay advancement related to the fees that Phillip specifically was forced to incur to defend against Centerstone's affirmative defenses that it concedes directly challenge the propriety of Phillip's conduct as an officer.

In support of its argument, Centerstone relies mistakenly on cases interpreting 8 *Del. C.* § 145(e), particularly this Court's decision in *Baker v. Impact Holding, Inc.*<sup>26</sup>

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<sup>24</sup> *Phillip v. Centerstone Linen Servs., LLC*, 2013 WL 6671663, at \*11-12 (Del. Ch. Dec. 3, 2013).

<sup>25</sup> Ltr. to the Court from John P. DiTomo dated Apr. 14, 2014, at 6.

<sup>26</sup> 2010 WL 2979050 (Del. Ch. July 30, 2010).

Section 145(e) gives a corporation the authority to advance to a director or officer expenses incurred “in defending” a covered proceeding. In *Baker*, this Court held that a former officer could not receive advancement for a series of affirmative claims he filed against the company to “offensively counter” an investigation the company purportedly had initiated against him. The Court reasoned that “[t]o hold otherwise effectively would read the ‘in defending’ language out of the [a]dvancement [p]rovision ... .”<sup>27</sup>

*Baker* and similar cases are inapposite for at least two reasons. First, unlike Section 145(e), the LLC Act does not preclude a company from providing advancement rights beyond fees and expenses incurred “in defending” a covered proceeding. Section 18-108 permits a limited liability company to “indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever.” *Baker* rested on the “in defense of” language in Section 145 and the defendant company’s charter – a limitation not present in this case. This Court has held that the LLC Act gives contracting parties complete discretion in establishing the scope of indemnification and advancement rights,<sup>28</sup> and Article 3.7 of the LLC Agreement requires Centerstone to “defend” Phillip for “all costs, losses, liabilities, and damages whatsoever paid or incurred ... in the performance of his duties [as a Manager or Officer],” without regard to whether those costs are incurred “in defense of” a covered proceeding or claim. Second, even if the reference to “defend” in Article 3.7 were read

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<sup>27</sup> *Id.* at \*4.

<sup>28</sup> See *Delphi Easter P’rs Ltd. P’ship v. Spectacular P’rs, Inc.*, 1993 WL 328079, at \*2 (Del. Ch. Aug. 6, 1993).

as equivalent to the “in defense of” language in Section 145, *Baker* did not address the scenario raised here, where an official brought a limited breach of contract action against the company, the company then raised both affirmative defenses and counterclaims challenging the official’s conduct in his capacity as an officer, and the official then sought attorneys’ fees relating only to the Company’s counterclaims and affirmative defenses and not to the claims the official himself filed.<sup>29</sup>

Finally, Centerstone argues in a footnote that its unclean hands defense is not subject to advancement because it relates only to Phillip’s claim regarding the enforceability of the restrictive covenants in the Employment Agreement.<sup>30</sup> As an aside, it is difficult to place much weight in this argument, given that (1) Centerstone previously conceded that its affirmative defenses directly implicated Phillip’s performance of his duties as an officer and manager, without arguing that the defenses were limited only to particular claims,<sup>31</sup> and (2) the parties to the Georgia Action stipulated that Phillip’s claims regarding the restrictive covenants are moot, that claim therefore will not be tried in the Georgia Action, but Centerstone nevertheless continues to assert an unclean hands defense in its recently filed Third Amended Counterclaims.<sup>32</sup> In any event, Centerstone’s argument misses the point; the question is not whether Phillip’s claims against the company are subject to advancement, but only whether a defense the company asserted in

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<sup>29</sup> See *Baker*, 2010 WL 2979050, at \*6 & n.32.

<sup>30</sup> See Ltr. to Court from John P. DiTomo, dated April 14, 2014, at 7 n.3.

<sup>31</sup> See, e.g., *Phillip v. Centerstone Linen Servs., LLC*, 2013 WL 6671663, at \*11 n.53 (Del. Ch. Dec. 3, 2013).

<sup>32</sup> See Georgia Summ. J. Order at 14; Third Am. Countercl. at 2, Fourth Defense.

response to those claims requires Phillip to incur costs to defend his performance of his duties as an officer.

For reasons I explained in my December 2013 Report, both the text of Article 3.7 and the policy underlying advancement support a conclusion that Centerstone is required to advance Phillip's attorneys' fees and expenses incurred in responding to Centerstone's affirmative defenses accusing Phillip of misconduct in the performance of his duties as a CEO and manager.

#### **4. Phillip's Efforts to Enforce the Settlement Agreement**

In the December 2013 Report, I recommended that the Court find that Centerstone was obligated to advance Phillip's litigation expenses for his motion to enforce the alleged settlement agreement to the extent those fees related to Centerstone's argument that any agreement was unenforceable because Phillip breached his fiduciary duties to Centerstone and fraudulently induced Centerstone to settle the Georgia Action before Centerstone discovered Phillip's alleged manipulation of the company's revenue and profitability.<sup>33</sup> Because the Georgia court denied Phillip's motion to enforce on the basis that a jury needed to resolve factual issues surrounding the alleged fraudulent inducement, Phillip later amended his complaint to assert an additional count to enforce the Term Sheet. Centerstone continues to resist that count on the basis that any agreement is unenforceable because the company was fraudulently induced by Phillip's failure to disclose his alleged wrongdoing. Centerstone also separately argues that the Term Sheet

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<sup>33</sup> See *Phillip*, 2013 WL 6671663, at \*12.

is unenforceable because there was no meeting of the minds with respect to certain material terms of the agreement.

In its recent order resolving the parties' cross motions for summary judgment, the Georgia court denied Phillip's motion as to his claim to enforce the Term Sheet, reasoning that summary judgment was precluded because "jury questions exist[] ... [concerning] Phillip's culpability for [o]verbilling and any resulting inflated revenues."<sup>34</sup> The Georgia Order therefore confirms that at least a portion of the fees associated with Centerstone's defense of this count were incurred to resolve questions directly relating to Phillip's conduct in his capacity as an officer of Centerstone.

Centerstone here reprises its argument that advancement nonetheless is not required because its position regarding Phillip's alleged fraudulent inducement is "merely in defense of Phillip's claim and thus not subject to advancement." For the reasons set forth in Section (3) above, that argument rests on a contrived reading of the word "defend" in Article 3.7. As a result of Centerstone's defense to this claim, Phillip's conduct as an officer of Centerstone has become a central issue, and Phillip has incurred fees and expenses by reason of his position as an officer. I therefore recommend that the Court order Centerstone to advance Phillip's fees and expenses for the motion to enforce – and the separate claim to enforce – the Term Sheet, but only to the extent those fees and

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<sup>34</sup> Georgia Summ. J. Order at 15.

expenses are related to Centerstone's defense that the purported agreement was fraudulently induced.<sup>35</sup>

## **5. Phillip's Repayment Obligation**

The parties also dispute whether Article 3.7 confers on Phillip an obligation to repay advances in the event of a final decision that he did not meet a particular standard of conduct. Centerstone argues that, as in the corporate context, Phillip must repay any advancement if a court finds he is not entitled to indemnification, regardless of the type of claims that were asserted against him. Phillip, on the other hand, takes the position that Article 3.7 limits his repayment obligation to cases in which he is "finally determined to have committed ... fraud or bad faith acts." Phillip also argues that this Court need not and should not resolve this issue at this time, both because the dispute threatens to further extend these proceedings and delay Phillip's advancement, and because it would be speculative to resolve the issue before a final, non-appealable order is entered in the Georgia Action.

Although I harbor skepticism as to Phillip's position that his repayment obligation is limited to claims of fraud or bad faith, I agree that this Court need not and should not decide this issue at this point. First, although these proceedings are intended to be summary, this action has been pending for several months and Phillip has yet to be paid any of the advancement or indemnification to which he is entitled. The parties have not fully briefed and presented this new repayment dispute, which was not raised until Vice

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<sup>35</sup> Given this limitation, I expect these fees largely are duplicative of the fees incurred in response to the Eighth and Ninth Affirmative Defenses.

Chancellor Glasscock remanded the case, and I do not believe additional delay associated with briefing, argument, and a decision would serve the interests of justice. Second, although it may be possible for the Court to interpret Phillip's repayment obligation based on the terms of the LLC Agreement, it is not necessary at this stage in the proceedings, and may never be necessary depending on the outcome of the Georgia Action. To delay these proceedings to resolve an issue that may never become ripe would not be efficient and arguably would amount to the issuance of an advisory opinion. Centerstone can point to no reason why this issue must be decided at this time.<sup>36</sup>

## **6. Fees on Fees**

Finally, Phillip argues that he is entitled to indemnification for the attorneys' fees and costs he has incurred in connection with this advancement proceeding. In the December 2013 Report, I concluded that Phillip was entitled to reimbursement of 90% of his expenses, a figure that was based on his relative success to that point.<sup>37</sup> I did not award Phillip 100% of his "fees on fees" because he was not successful on his claim for advancement for Count III of the Amended Counterclaims and was not entirely successful on his claim for advancement relating to the motion to enforce the settlement agreement.<sup>38</sup> Phillip did not take exception to that recommendation and did not continue to press for advancement of Count III or for any portion of the motion to enforce other

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<sup>36</sup> My conclusion might be different if, for example, the LLC Agreement permitted Centerstone to insist on an undertaking or surety before advancing Phillip's fees and costs, and the parties were disputing the terms of the undertaking.

<sup>37</sup> See *Phillip v. Centerstone Linen Servs., LLC*, 2013 WL 6671663, at \*13.

<sup>38</sup> See *id.* at \*13 n.62.

than the fraudulent inducement issue, and he therefore argues he is entitled to indemnification for all the fees he incurred in this action after the December 2013 Report, aside from any minimal fees associated with clarifying the basis of Count III of the Amended Counterclaims.<sup>39</sup>

Because Phillip was successful on the portion of Centerstone's exceptions considered by Vice Chancellor Glasscock, and was successful on all the issues presented to me on remand, I recommend that the Court award Phillip 100% of his "fees on fees" incurred after the December 2013 Report was issued, less any fees associated with Count III of the Amended Counterclaims.

## **CONCLUSION**

For the foregoing reasons, I recommend that the Court find that Phillip is entitled to advancement for (1) the Dismissed Counterclaims, (2) Counts I and II of the Amended Counterclaims, the Second Amended Counterclaims, and the Third Amended Counterclaims, (3) the Second and Fourth Affirmative Defenses asserted in the Amended Counterclaims, and the Second, Fourth, Fifth, Eighth, and Ninth Affirmative Defenses asserted in the Third Amended Counterclaims, and (4) Centerstone's defense of the motion to enforce the Term Sheet and the claim relating to the same, but only to the extent Centerstone argues the Term Sheet is unenforceable because of fraudulent inducement. I also recommend that the Court order Centerstone to indemnify Phillip for 90% of the attorneys' fees reasonably incurred in this action until the December 2013

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<sup>39</sup> See Letter to the Court from Marie Degnan, dated Apr. 11, 2014, at 10 & n.6.

Report was issued, and all the attorneys' fees reasonably incurred after that date, except as provided above. Finally, I recommend that the Court defer resolving the parties' dispute regarding Phillip's repayment obligation until such dispute becomes ripe. This is my final report and exceptions may be taken in accordance with Rule 144.

Sincerely,

*/s/ Abigail M. LeGrow*  
Master in Chancery