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Not Just Belt and Suspenders: Indemnification Agreements and State Corporate Law

by

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The possibility of personal liability presents a significant obstacle to recruiting and retaining the most qualified individuals to serve as corporate directors and officers. Although directors of publicly traded companies face this risk most acutely, directors of private, and even non-profit, corporations are not immune from these concerns.

State corporate codes address these concerns in part by permitting a corporation to include provisions in its organizational documents that eliminate monetary liability in many instances, and otherwise provide for indemnification and advancement of expenses in connection with claims against directors and officers. However, even for directors and officers of corporations that have obligated themselves in their organizational documents to indemnify and advance expenses to their directors and officers, the risk of personal liability remains. Organizational documents are subject to later amendment or changes in law and both are often silent regarding important procedural and other questions that arise in connection with claims for indemnification or advancement of expenses. Although some states, such as Delaware, have a well-developed body of case law that addresses the major substantive, procedural and practical issues that arise in connection with the actual enforcement of indemnification and advancement obligations, these states represent a minority.

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Individual indemnification agreements with directors and officers are a common remedy for the potential gaps in the exculpation, indemnification and expense advancement provisions often included in a corporation's organizational documents. These agreements ensure that a corporation's directors and officers are contractually entitled to (1) indemnification, subject to meeting the required standard of conduct, and (2) advancement of expenses for claims and actions arising out of their service as a director or officer, regardless of changes to a corporation's governing documents, changes in control of the corporation (including changes in the composition of the corporation's board of directors) or changes in governing law. In addition, by more fully addressing certain procedural and other matters, indemnification agreements can provide more certainty about many of the issues related to indemnification and advancement of expenses that often arise in connection with such claims.

Exculpation

Both the Delaware General Corporation Law (DGCL) and the Model Business Corporation Act (MBCA)—variations of which have been adopted in over thirty states—provide that a corporation may, through its charter, eliminate or limit the monetary liability of a director to the corporation for acts, or failures to act, as a director, with certain exceptions.[1] These exceptions generally include:

- any breach of the director's duty of loyalty to the corporation or its stockholders;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

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- acts or omissions in connection with unlawful distributions to stockholders; or
- any transaction from which the director received an improper personal benefit.

Although an exculpation provision provides directors with substantial protection, plaintiffs commonly allege violations of a director's fiduciary duty of loyalty, including failures to act in good faith, or an intentional or knowing violation of law on the part of the director. Such allegations, if adequately pleaded, allow the complaint to survive a motion to dismiss, even where the corporation has an exculpatory provision in place. Therefore, even if those allegations are without merit and the director ultimately prevails, he will have incurred significant expenses defending the proceeding in the absence of an agreement with the corporation to advance expenses.

Indemnification

With regard to indemnification, the DGCL generally permits a corporation to indemnify a director against liability incurred in a proceeding,[2] subject to two conditions:

- the director must have conducted himself in good faith; and
- the director must have reasonably believed that
  - his conduct was in or not opposed to the best interests of the corporation; and
  - in the case of a criminal proceeding, he had no reasonable cause to believe that such conduct was unlawful.[3]

Before a corporation may indemnify a director, the DGCL provides that one of the following must determine whether a director's conduct met the applicable standard described above:

- a majority of the disinterested directors or committee thereof (even though less than a quorum);
- independent legal counsel in a written opinion if there are no disinterested directors or the disinterested directors designate; or
- by the stockholders.[4]

It is important to note that to varying degrees state laws generally obligate a corporation to indemnify a director for reasonable expenses incurred by the director if he is successful in his defense of a proceeding. The MBCA requires that a director be wholly successful in his defense of the entire proceeding to be statutorily entitled to indemnification, while the DGCL allows for partial mandatory indemnification for claims for which a director is not adjudged liable.[5]

In Delaware, the Court of Chancery is vested with exclusive jurisdiction with respect to disputes for advancement of expenses or indemnification, which allows for an expedited resolution of these matters. Most other state courts lack a mechanism to resolve indemnification disputes on an expedited basis. In an attempt to reduce this disparity other state courts have attempted to create forums to more quickly resolve these and other complex business matters through the creation of separate business court divisions.[6] However, these courts have various jurisdictional limitations, including amount in controversy limitations, such that not all indemnification/advancement disputes would be subject to such courts' jurisdictions.

Advancement of Expenses

In many cases, it may not be practicable to determine whether a director or officer has met the applicable standard of conduct entitling him to indemnification prior to the final disposition of a proceeding, which in turn could take months or years and involve considerable expenditures by the parties to the proceeding. Needless to say, having to fund protracted litigation out of one's own pocket until its final conclusion is a frightening prospect to many potential directors and officers, regardless of whether they are confident of ultimate victory. To address this concern and further provide directors and officers the appropriate tools to withstand frivolous lawsuits, the DGCL and the MBCA each permit a corporation to advance reasonable expenses incurred by a director or officer who is a party to a proceeding if the individual provides an undertaking to repay advanced funds if it is ultimately determined that he is not entitled to indemnification.[7] The MBCA further requires that the individual providing the undertaking also provide a written affirmation of his good faith belief that he met the relevant standard of conduct, and that advancement of expenses be authorized by (1) the shareholders (not including interested directors), (2) two or more disinterested directors (assuming there are two or

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more disinterested directors) or, if there are fewer than two disinterested directors, (3) a majority of the board of directors.[8]

Because the exculpation, indemnification and advancement of expenses provisions of the DGCL and MBCA are only permissive, the organizational documents of many corporations affirmatively obligate the corporation to indemnify its directors and officers and advance expenses to them to the maximum extent permitted by state law.[9]

Indemnification Agreements

Inadequate procedural protections under state law leave many directors and officers of corporations not incorporated in Delaware at a distinct disadvantage if the need arises to enforce an indemnification or advancement obligation. Moreover, even if a corporation has obligated itself in its organizational documents to provide the maximum available indemnification and advancement rights under state law, those provisions in a corporation's organizational documents are potentially subject to amendment, particularly at a time when the indemnitee no longer sits on the board of directors or the corporation has undergone a change of control.

Although the 2009 amendments to the DGCL provide some comfort to directors and officers in this regard, by adding a new Section 145(f), which states that a right to indemnification or advancement of expenses arising under a corporation's organizational documents shall not be eliminated or impaired by an amendment to such provision after the occurrence of the act or omission that is the subject of the proceeding for which indemnification or advancement of expenses is sought[10] However, the extent to which Section 145(f) would permit a corporation to retroactively change the indemnification and advancement procedures contained in its certificate or bylaws is unclear. Since these procedures can, in many instances, be as important as the substantive right to indemnification or advancement, indemnification agreements can provide significant comfort that the procedures that must be followed in connection with a request for indemnification or advancement are not subject to change.

An indemnification agreement is a common solution to address risks of personal liability and out-of-pocket funding of litigation faced by directors and officers. An agreement creates a contractually enforceable obligation that requires a corporation to indemnify a director or officer whose conduct meets the applicable standard, and/or advance expenses to such individual in advance of a final disposition of a proceeding to the maximum extent permitted by law. Further, in contrast to the corporation's organizational documents, indemnification agreements are contracts that cannot be amended or terminated without the agreement of the director. Moreover, indemnification agreements can clarify the practical operation of the indemnification provisions included in state law, particularly outside of Delaware where courts have not addressed questions related to indemnification of directors and officers as frequently as the Delaware courts have.[11] The absence of well developed case law outside of Delaware often limits the usefulness of the default provisions of state law in avoiding conflicts among the parties in connection with a claim, and provides another reason for parties to consider indemnification agreements.

In this regard, indemnification agreements typically address the following, among other items already discussed: (i) partial indemnification for each matter to which an individual was successful, (ii) indemnification for costs related to serving as a witness, (iii) procedures for notifying the corporation of a claim and its right to control the defense, (iv) procedures for determining the right to indemnification and advancement of expenses, (v) a dispute resolution procedure regarding the entitlement to indemnification or advancement, (vi) provisions for a corporation's obligation to obtain director and officer insurance, and (vii) provisions for spousal indemnification.

When drafting and negotiating these and other provisions of an indemnification agreement, there are a number of details, particularly relevant to change of control transactions that directors, officers and their counsel should consider carefully, including the following:

• *Ability to select counsel:* As with many other types of indemnification arrangements, if the corporation elects to participate in or assume the defense of a proceeding, then the corporation is entitled to select counsel reasonably satisfactory to the director—after all, it is the corporation's money that is ultimately at stake.[12] Ordinarily, this arrangement is perfectly suitable, as the interests of the parties are

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aligned, and the corporation naturally wants to limit the liability of a director who may still be sitting on its board. Directors should be mindful, however, of the many different ways in which such a situation can evolve. For example, indemnification agreements are commonly executed immediately prior to a change of control transaction. In that situation, the interests of a new owner and the corporation's directors and officers could diverge, particularly since, in many cases, the directors will be replaced in connection with the change of control. Accordingly, directors and their counsel should consider whether they should have broader latitude to influence the selection of counsel and to control the defense of litigation following a change of control.

• *Procedures for determining entitlement to indemnification:* Most indemnification agreements track the procedures set forth in state law. This often means that the determination of entitlement to indemnification is generally made by the disinterested members of the board of directors, or in cases where there are no such directors, by independent counsel.[12] As with the selection of counsel, directors should be mindful that the individuals who will determine whether that director is entitled to indemnification may change over time. This could happen suddenly, as in the case of a change in control, or over time, as a board of directors reshuffles in the ordinary course. To that end, some indemnification agreements specifically contemplate that following a change of control, independent counsel exclusively will make the determination of whether or not indemnification is appropriate, and explicitly describe the type of individuals or firms eligible to serve as independent counsel. For example, some agreements exclude any firm that has previously performed services for either the corporation or the director to be indemnified from serving as independent counsel. Others go further and explicitly require firms with specific, verifiable expertise in matters of corporate law.

• *Presumptions of entitlement to indemnification/ advancement:* Many agreements provide that a director or an officer shall be presumed to be entitled to indemnification and advancement of expenses, and that the corporation has the burden of proving that he is not entitled to indemnification or advancement of expenses. The questions of whether or not a director is entitled to indemnification are inherently factual, and the "close calls" are more likely to be the subject of disputes. Accordingly, a presumption gives an indemnitee the added protection of a "tie-breaker" of sorts. In addition, some agreements provide that the director or officer will be deemed to be entitled to indemnification if the determination of the right to indemnification is not made within 30 days of the request for indemnification. Such a provision incentivizes the corporation to avoid undue delay in determining whether or not indemnification is appropriate.

• *Impact on attorney relationships:* Many agreements contain provisions that grant the indemnifying party the right to copies of invoices or other documentation to describe the expenses incurred on behalf of the indemnitee, counsel should remain mindful of the impact that this seemingly innocuous request might have on the existence of the attorney-client privilege. Indemnitees could be faced with a Hobson's Choice—provide detailed invoices and supporting documentation that could reveal litigation strategy to a potentially unfriendly party or forego advancement of expenses in advance of a final disposition of a proceeding. In theory, billing invoices could lead to accidental waivers of the attorney-client privilege that could go far beyond the matters disclosed within the four corners of a monthly invoice. Accordingly, some agreements provide, particularly after the occurrence of a change of control or the commencement of a derivative proceeding, that only summary or redacted statements of expenses are required.

• *Expedited dispute resolution procedure:* Some indemnification agreements give indemnitees the option to commence a binding arbitration proceeding to resolve disputes or controversies arising out of the agreement. Because corporations could use counterclaims or other collateral issues to delay a determination about the core question of whether or not an indemnitee is entitled to indemnification or advancement, some agreements further prohibit asserting any counterclaim against the indemnitee, other than asserting that the indemnitee does not meet the standards for indemnification under applicable law. Expedited arbitration provisions are an attempt to provide directors of corporations from other jurisdictions access to a summary proceeding in which the entitlement to advancement of expenses is expeditiously decided in a manner similar

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to that available to the directors and officers of a Delaware corporation.

• *Indemnification for expenses related to enforcement:* Many agreements explicitly state that indemnification is available for any expenses related to the enforcement of the agreement, even if the indemnitee is ultimately determined not to be entitled to indemnification or advancement of expenses.

Conclusion

Indemnification agreements are often an important supplement to the protections afforded directors and officers through state law and provisions contained in corporate organizational documents. In light of the recent volatility in the financial markets and potential shareholder lawsuits that could arise for a variety of factors related to current economic conditions, directors and officers should consider anew the protections afforded by corporate articles of incorporation and bylaws, and review their current indemnification agreements (or consider requesting indemnification agreements if there is not one in place) to ensure that they have a suitable level of protection from personal liability consistent with the current state of the law, and adequate procedural mechanisms to ensure the fair and prompt performance of the company's obligations to advance expenses and indemnify its directors and officers.

Notes

[1] See DGCL § 102(b)(7); see also MBCA § 2.02(b)(4).

[2] A "proceeding" is "any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative, arbitrative or investigative." DGCL § 145(a); see also MBCA § 8.50(6).

[3] DGCL § 145(a). In the case of a derivative action or suit that is brought by or in the right of the corporation, the indemnitee may only be indemnified for expenses incurred in connection with the defense or settlement of such action or proceeding. If the person is adjudged to be liable to the corporation in respect of any claim, issue or manner, no indemnification may be made in respect of such claim, issue or manner unless a court determines upon application that despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnification for such expenses which the court shall deem proper. DGCL § 145(b). See also MBCA § 8.51.

[4] DGCL § 145(d); see also MBCA § 8.55.

[5] DGCL § 145(c); see also MBCA § 8.52.

[6] Notable examples include the North Carolina Business Court and the Business Case Division of the Superior Court of Fulton County, Georgia (which includes the City of Atlanta and other major business districts in the Atlanta Metropolitan area).

[7] DGCL § 145(e).

[8] MBCA § 8.53.

[9] Although advancement of expenses is related to indemnification, directors should remember that it is a separate and distinct right that should be fully and thoughtfully addressed in the corporation's organizational documents and/or indemnification agreements. Failure to do so can lead to unintended and unwanted results in certain cases. 9 The MBCA permits a corporation to obligate itself in advance of an act or omission to provide indemnification or advance funds, so long as such obligation is consistent with the other MBCA sections relating to indemnification. MBCA § 8.59.

[10] Section 145(f) would, however, permit retroactive changes to indemnification and advancement rights if the provision in effect at the time of the act or omission explicitly authorizes elimination or impairment of these rights after the action or omission has occurred.

[11] Delaware courts regularly consider questions presented related to exculpation, indemnification and advancement of expense matters. For a few recent examples, see, *Sun-Times Media Group, Inc. v. Black*, 954 A.2d 380 (Del. Ch. 2008) (holding that court determination of officers' and directors' entitlement to indemnification could not be made prior to non-appealable final judgment, and determination of whether individuals were required to

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return advanced amounts prematurely, before non-appealable final judgment); *Ryan v. Lyondell Chem. Corp.*, No. 3176-VCN 2008 WL 2923427 (Del. Ch. 2008) (refusing to dismiss a shareholder derivative suit that included claims of breach of duty of loyalty at the summary judgment stage based on exceptions to exculpation provisions of certificate of incorporation), rev'd by WL 1024786 (Del. Supr. 2009); and *Donohue v. Corning*, 949 A.2d 574 (Del. Ch. 2008) (denying managing member's right to advancement under provisions of LLC agreement).

[12] There are a number of common exceptions to this rule, typically involving cases where there is a conflict between the interests of the corporation and those of the director being indemnified.

[13] Although the MBCA contemplates the possibility that shareholders may also make the determination of whether or not indemnification is appropriate, that is, of course, rarely a practical alternative for a public company.

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