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Indemnification: Forgotten D&O Protection

In the current post-Enron environment, directors and officers increasingly realize, perhaps more than ever before, that absent strong financial protection, their personal assets are at risk if they are alleged to have committed wrongdoing in their capacity as a director or officer. This heightened sensitivity to one's personal risk exposures arises not only because the magnitude of settlements has increased dramatically, but also because it is now almost commonplace for plaintiffs and regulators to more aggressively pursue individual director and officer defendants. The public seems to endorse if not demand that mentality, at least in the more publicized cases.

Predictably, the response by senior management and outside directors to this situation is newfound interest in the terms and amount of their D&O insurance program. Many boards are retaining counsel or other advisors (in addition to their insurance broker) to assist in evaluating and negotiating protective D&O insurance coverage. More limits are being purchased and ancillary coverages for the company are being deleted from many D&O policies. Those responses are certainly appropriate and will likely result in a higher quality and more predictable insurance program for the directors and officers.

Unfortunately, most companies end their analysis there, and fail to recognize that the financial protection program for directors and officers includes not just quality D&O insurance coverage, but also quality D&O indemnification from the company. Virtually all companies include within their certificate of incorporation, bylaws or similar document an indemnification provision which requires the company to indemnify its directors and officers in certain circumstances. Typically, that provision was drafted long ago and has not been critically evaluated since.

Most companies and their risk managers largely ignore indemnification issues when evaluating and structuring a risk management program for directors and officers. This apparently is based upon the naïve assumption that their sometimes antiquated indemnification provision is adequate notwithstanding subsequent statutory amendments and case law, as well as new state-of-the-art indemnification concepts. If directors and officers want maximum financial protection, a current analysis by qualified counsel of the company's indemnification provisions should be performed.

Such an evaluation necessarily raises an inherent conflict issue. The broader and more protective the indemnification provision, the greater the company's potential liability to its directors and officers for indemnification reimbursement. Most company executives wish to afford the maximum protection available to the directors and officers, thereby creating the

maximum potential company indemnification liability. Although that conclusion is a legitimate business decision on behalf of the company, the critique of a company's indemnification provision should include this consideration.

The evaluation process should also be performed in light of the applicable state indemnification statute and case law. The law of the state in which the company is incorporated applies for this purpose. Although there are many common features among the various state indemnification statutes, there are also important differences which could affect a company's internal indemnification provision.

A sample broad-form internal indemnification provision under Delaware law is attached as Exhibit A. That sample provision seeks to afford maximum indemnification protection for directors and officers without creating unnecessary or unintended liability for the company. The following summarizes some of the many important features of that sample provision. If a company's current internal indemnification provision does not adequately address each of the following issues, that provision likely is either affording less than complete protection for directors and officers, or creating greater liability exposure for the company than necessary.

A. Mandatory. The sample provision requires the company to indemnify its directors and officers, rather than merely permit indemnification. This is one of the primary purposes of an internal indemnification provision. The state indemnification statutes generally permit, but do not require indemnification. Since directors and officers want the assurance that they will be indemnified if at all possible, it is critical that the provision mandate indemnification.

B. Protected Persons. State indemnification statutes typically permit a company to indemnify its current and former directors, officers, employees and agents. The sample provision mandates indemnification only for directors and officers. Thus indemnification for non-officer employees and agents is discretionary, based on the unique circumstances of each case. This is frequently viewed as appropriate since employees and agents typically do not decide to serve the company based upon the existence of indemnification protection. If a company's current indemnification provision extends the mandatory protection to employees and agents, the company should evaluate whether such an extension creates an unnecessary liability exposure of the company, particularly with respect to "agents" (which could include outside attorneys, accountants and other third parties).

C. Standard of Conduct. State indemnification statutes typically permit a company to indemnify its directors and officers if the director or officer acted in good faith and in the reasonable belief that his or her conduct was in the best interest of the company. However, most indemnification statutes also authorize the company to provide even broader indemnification pursuant to an internal indemnification provision or agreement. See, e.g., Section 145(f), Delaware General Corporation Law. Although courts are divided as to how far beyond the

statutory authorization a company can go when affording indemnification pursuant to this so-called non-exclusive provision, it is clear that at least somewhat broader indemnification is available. In order to maximize the benefit from this non-exclusive statute, the internal indemnification provision should require indemnification "to the fullest extent authorized by law," and not limit indemnification to only those circumstances where the director or officer acts in good faith and in the reasonable belief his or her conduct is in the best interests of the company. Likewise, the indemnification provision should not prohibit indemnification if the director or officer was grossly negligent, reckless, etc.

D. Advancement. By statute, indemnification can occur only if disinterested directors, independent legal counsel or a court determines that a particular director or officer's conduct qualifies for indemnification. Because that determination frequently cannot occur until the claim is fully investigated or resolved, state statutes also authorize companies to advance defense costs for a director and officer prior to that determination being made. However, courts consistently recognize that "indemnification" and "advancement" are separate and distinct concepts. If an indemnification provision only requires a company to "indemnify" and does not also require "advancement" of defense costs, directors and officers would not be entitled to advancement, and thus would have the right to payments from the company only after all the relevant facts have been investigated or adjudicated. Therefore, the internal indemnification provision should require not only indemnification, but also advancement of defense costs, subject to an unsecured undertaking by the defendant director and officer to repay the advanced amounts if a court subsequently determines the indemnification is not permitted.

E. Discourage Wrongful Refusal. Even under a mandatory indemnification provision, there is some subjectivity to the indemnification process since the incumbent board of directors must determine that the defendant director or officer qualifies for indemnification. If the defendant and the incumbent directors are antagonistic, the indemnification protection may be wrongly withheld. The attached sample provision contains in paragraph (b) several features which disincentivize the company from wrongfully refusing to indemnify a director or officer. For example, a director or officer who is denied indemnification and who is successful in whole or in part in a lawsuit against the company to enforce his or her indemnification rights, is entitled to reimbursement from the company of costs incurred in enforcing his or her indemnification rights. In addition, the provision states that in any such suit to enforce one's indemnification rights, the company bears the burden of proof to establish that the claimant is not entitled to indemnification. Also, the provision states that any determination by the board of directors with respect to the claimant's right to indemnification is not a defense for the company in such a suit, and does not create a presumption against the claimant. All of these

provisions minimize the chance the company will wrongly withhold indemnification, and maximize the chance the director or officer will prevail in any suit to enforce his or her indemnification rights.

F. Contractual Rights. The sample provision in paragraph (c) expressly creates a contractual right in favor of the directors and officers to the broad indemnification protection described in the provision. As a result, the company cannot unilaterally and retroactively amend or eliminate those indemnification rights. This provision affords protection equivalent to that available under a separate indemnification contract between the company and its directors and officers.

G. Subsidiaries. By statute, a company is authorized to indemnify its directors, officers, employees and agents, as well as any person serving at the request of the company as a director or officer of another organization. As a result, a parent company is probably not permitted or required to indemnify the directors and officers of its direct and indirect subsidiaries unless those subsidiary directors and officers are serving in that capacity at the request of the parent company. The sample provision in paragraph (d) states that a director or officer of a direct or indirect subsidiary of the company or any employee benefit plan of the company or such subsidiary, is deemed to be serving in that capacity at the request of the company. This provision requires a parent company to indemnify all of the directors and officers of all of its subsidiaries as well as fiduciaries of their employee benefit plans. Although ultra-protective for the directors and officers of the subsidiaries, this provision obviously creates new liability exposures for the parent company that should be considered before adopting such a provision. An alternative approach would be to afford this indemnification protection only to directors and officers of the parent company who serve a subsidiary in any capacity.

H. Outside Positions. Indemnification statutes typically permit companies to indemnify any person serving at the request of the company as a director, officer, employee or agent of another organization. If that statutory language is included within the internal mandatory indemnification provision, the company may be creating unintended liability for itself because the statutory authorization simply requires the outside service to be "at the request of the company." For example, an oral statement by anyone with apparent authority to act on behalf of the company could create this outside position indemnification liability. In order to manage and control that exposure, the sample provision extends the mandatory indemnification for outside positions only to directors or officers of the company who serve "at the written request of the company's board of directors or its designee" in the outside position.

I. Prosecution Costs. Indemnification statutes typically authorize indemnification of expenses incurred by a director and officer who is a "party" in a legal proceeding. Several courts have held that the reference to being a "party" to a proceeding includes not only directors and officers as defendants, but also directors and officers as plaintiffs. As a result, in some instances, a director or officer who sues the company, other directors and officers or third parties may be entitled under a poorly drafted indemnification provision to indemnification of legal fees incurred in prosecuting that claim. The sample provision in paragraph (a) does not obligate the company to indemnify those prosecution costs unless the director or officer who is bringing the claim was authorized to do so by the company's board of directors.

Because in many instances indemnification from the company is the ultimate "back-stop" protection for directors and officers, companies should assure themselves they are providing the broadest possible indemnification protection for their directors and officers. For many companies, their current indemnification provision does not accomplish that goal. If a provision has not been thoroughly evaluated by qualified counsel in the last five to eight years, there is a good chance it is less than ideal.

Exhibit A

SAMPLE DELAWARE INDEMNIFICATION PROVISION

(a) Right to Indemnification. Each person who was or is a party or is threatened to be made a party to or is involved in any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative ("Proceeding"), by reason of the fact that he or she, or a person of whom he or she is the legal representative, is or was a director or officer of the Corporation or, as a director or officer of the Corporation, is or was serving at the written request of the Corporation's Board of Directors or its designee as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, whether the basis of such Proceeding is alleged action in an official capacity as a director, officer, trustee, employee or agent or in any other capacity, shall be indemnified and held harmless by the Corporation to the fullest extent authorized by law, including but not limited to the Delaware General Corporation Law, as the same exists or may hereafter be amended (but, in the case of any such amendment, only to the extent that such amendment permits the Corporation to provide broader indemnification rights than said Law permitted the Corporation to provide prior to such amendment), against all expenses, liability and loss (including attorney's fees, judgments, fines, ERISA excise taxes or penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered by such person in connection therewith; provided, however, that the Corporation shall indemnify any such person seeking indemnity in connection with an action, suit or proceeding (or part thereof) initiated by such person only if such action, suit or proceeding (or part thereof) initiated by such person was authorized by the board of directors of the Corporation. Such right shall include the right to be paid by the Corporation expenses, including attorney's fees, incurred in defending any such Proceeding in advance of its final disposition; provided, however, that the payment of such expenses in advance of the final disposition of such Proceeding shall be made only upon delivery to the Corporation of an undertaking, by or on behalf of such director or officer, in which such director or officer agrees to repay all amounts so advanced if it should be ultimately determined by a court or other tribunal that such person is not entitled to be indemnified under this Section or otherwise.

(b) Right of Claimant to Bring Suit.

(i) If a claim under paragraph (a) is not paid in full by the Corporation within thirty days after a written claim therefor has been received by the Corporation, the claimant may any time thereafter bring suit against the Corporation to recover the unpaid amount of the claim and, if successful in whole or in part, the claimant shall be entitled to be paid also the expense of prosecuting such claim. In any such action, the burden of proof shall be on the Corporation to prove the claimant is not entitled to such payment.

(ii) Neither the failure of the Corporation (including its Board of Directors, independent legal counsel, or its shareholders) to have made a determination prior to the commencement of such action that the claimant is entitled to indemnification or advancement under the

circumstances, nor an actual determination by the Corporation (including its Board of Directors, independent legal counsel, or its shareholders) that the claimant is not entitled to indemnification or advancement, shall be a defense to the action or create a presumption that the claimant is not entitled to indemnification or advancement.

(c) Contractual Rights; Applicability. The right to be indemnified or to the reimbursement or advancement of expenses pursuant hereto (i) is a contract right based upon good and valuable consideration, pursuant to which the person entitled thereto may bring suit as if the provisions hereof were set forth in a separate written contract between the Corporation and the director or officer, (ii) is intended to be retroactive and shall be available with respect to events occurring prior to the adoption hereof, and (iii) shall continue to exist after the rescission or restrictive modification hereof with respect to events occurring prior thereto.

(d) Requested Service. Any director or officer of the Corporation serving, in any capacity, and any other person serving as director or officer of, (i) another organization of which a majority of the outstanding voting securities representing the present right to vote for the election of its directors or equivalent executives is owned directly or indirectly by the Corporation, or (ii) any employee benefit plan of the Corporation or of any organization referred to in clause (i), shall be deemed to be doing so at the written request of the Corporation's Board of Directors.

(e) Non-Exclusivity of Rights. The rights conferred on any person by paragraphs (a) through (d) above shall not be exclusive of and shall be in addition to any other right which such person may have or may hereafter acquire under any statute, provision of the Certificate of Incorporation, Code of Regulations, bylaws, agreement, vote of shareholders or disinterested directors or otherwise.

(f) Insurance. The Corporation may maintain insurance, at its expense, to protect itself and any such director, officer, employee or agent of the Corporation or another corporation, partnership, joint venture, trust or other enterprise against such expense, liability or loss, whether or not the Corporation would have the power to indemnify such person against such expense, liability or loss under the Delaware General Corporation Law.

About the Author:

Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

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