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Boardroom Briefing

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Can and Should You Indemnify Your In-House Counsel?

Exclusive new research on boards and their attorneys

Can and Should You Indemnify Your In-House Counsel?

By Priya Cherian Huskins

There is clear public policy in favor of allowing organizations to indemnify employees, but does this include in-house counsel?

Priya Cherian Huskins

Given the ethical duties of attorneys, an interesting question arises when it comes to indemnification agreements for in-house counsel. In particular, under relevant state codes of ethics for attorneys, is it proper for an in-house attorney to enter into an indemnification agreement with his or her employer? The answer is likely yes, although this position might be considered aggressive by some.

While requirements and interpretations of professional codes of conduct will vary from state to state, a particular state's existing regulatory climate and prevailing legal framework should be taken into account wherever and whenever the question of indemnification agreements for in-house counsel arises.

This article uses California law as an example to illustrate the issues. The question under California law is tricky because of the conflict that may exist between prohibitions on indemnification found in California Rule of Professional Conduct 3-400 and the indemnification provided by both California Labor Code Section 2802 and general corporate law.

On the one hand, Professional Conduct Rule 3-400 prohibits a member of the California Bar from contracting with a client prospectively to limit the member's liability to a client for professional malpractice. There is nothing in the text of the rule that exempts in-house counsel from the application of this prohibition. Thus, Rule 3-400 might seem to prohibit in-house counsel from entering into an indemnification agreement with his or her employer.

On the other hand, there is clear public policy in favor of allowing a corporation to indemnify its employees. This public policy is formally expressed in California Labor Code Section 2802, which requires employers in California to indemnify employees for expenditures and losses incurred in direct consequence of the discharge of their duties of employment. There is no exception in the statute that removes in-house counsel from this general protection.

Indemnification of agents

In addition, corporations organized under the laws of Delaware—which includes a majority of corporations in the United States—are allowed to provide for the indemnification of their agents pursuant to Delaware General Corporations Code Section 145. A similar framework for indemnification exists for California corporations through California Corporations Code Section 317. Finally, experience indicates that in-house counsel who are also officers typically benefit from the mandatory indemnification provided to all officers pursuant to the corporate bylaws of the vast majority of corporations.

Given the clear public policy in favor of allowing a corporation to indemnify its agents, is it improper for in-house counsel to request that his or her employer sign an indemnification agreement in favor of in-house counsel?

There seems to be no California case law that directly addresses this potential conflict. Here are, however, a few observations that support the argument that in-house counsel may properly enter into indemnification agreements:

1. The right to the advancement of legal fees—one of the most important features of a good indemnification agreement—may not be implicated by California Rule of Professional Conduct 3-400 at all. An employer's advancement of legal fees does not limit a lawyer's ultimate liability to the employer, the subject of 3-400. Indeed, the advancement of legal fees provided for in an indemnification agreement is usually predicated upon the indemnitee's executing an undertaking to pay back any legal fees that have been advanced if the indemnitee is ultimately adjudicated not to be entitled to such advancement. See, for example, Delaware General Corporation Code Section 145(e).

2. Suits brought by third parties against in-house counsel do not necessarily indicate that the in-house counsel has committed an act of malpractice against the counsel's sole client, namely his or her employer. As a result, there should be no controversy about indemnifying

an in-house counsel against suits brought by third parties, at least to the extent that the counsel's liability to the third party was not also the result of malpractice to the employer. Concerned in-house counsel might consider explicitly exempting from his or her indemnification agreement indemnification for legal malpractice claims.

3. California Labor Code Section 2802 requires employers to indemnify employees for losses incurred in direct consequence of the discharge of their duties. If an employer were to bring suit against its in-house counsel for malpractice, the employer would likely be suing its in-house counsel for activities that were performed within the course and scope of the in-house counsel's job. Because the activities were performed within the course of the in-house counsel's job, California Labor Code Section 2802 might force the employer to indemnify the very in-house counsel whom the employer was suing. Thus, indemnification agreements for an in-house counsel arguably do nothing more than give contractual expression to a pre-existing, statutory limitation of liability.

Given that there is no clear authority on the question of in-house counsel and indemnification agreements, some corporations may consider providing additional protection for their in-house counsel by also purchasing Employed Lawyer's insurance policies. A discussion of this type of insurance falls outside the scope of this Boardroom Briefing, other than to note that this insurance may be helpful in some cases.

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boards could not insulate themselves through "willful blindness."

Implications for Directors

In light of the Stone ruling, what do directors need to know about meeting this standard?

First, stay informed. Boards need to have a thorough understanding of the company's compliance program. Directors should ask questions to assess management's ability to identify relevant risks and determine how effective the compliance program is in addressing those risks. One way to keep directors informed is for board meetings to include presentations on all high-risk issues facing the company and how the compliance program is addressing these risks. All of the risks detailed and how the directors dealt with each item should be documented in board meeting minutes.

Although management has a critical role in assessing risks, as well as developing appropriate controls and compliance programs to address them, the board must make its own objective and independent assessment to determine that the company's compliance programs are effective.

To help the board fulfill this responsibility, directors will often have to seek the assistance of outside advisers to carry out an independent assessment of the institution's compliance programs. Such an assessment may be performed by reputable independent third parties that understand leading industry standards or "practices" for the particular area being reviewed. It is crucial, however, that once the assessment is performed, the board require detailed action plans by management to rectify deficiencies noted by the assessment in an efficient and sustainable manner and also require management to provide regular progress updates. Failure to follow through in this manner may create liability based upon the articulated standard contained in Stone.

Finally, directors—and management and shareholders—should understand that pursuing such an assessment and appropriate remediation will not only create evidentiary support documentation of board oversight, as it did in Stone, but also enhance the company's overall compliance program, providing greater protection to both company investors and board members alike.

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