

For your more robust personal protection

Yes, you need a personal indemnification agreement ... and here is what should be in it and what it should cover. **BY PRIYA CHERIAN HUSKINS**

DIRECTORS AND OFFICERS of corporations face the risk of personal liability for actions performed and decisions made on behalf of the corporation. Perhaps unknowingly, many directors and officers unnecessarily accept an enhanced risk of personal liability by failing to insist on a personal indemnification agreement — a relatively common agreement that obligates the corporation to indemnify a director or officer for his or her actions.

Directors and officers likely fail to insist on indemnification agreements because of their:

- misplaced trust in the effectiveness of protections found in corporate bylaws,
- belief that the coverage provided by director and officer liability insurance is sufficient, and
- failure to appreciate that, in the face of a governmental investigation, indemnification agreements can reduce the risk that corporate management will “serve up” directors and officers to avoid indictment of the corporation.

The payoff is significant for the shareholders of corporations that provide their directors and officers with robust personal indemnification agreements. All else being equal, well-qualified directors and officers will prefer to serve corporations that provide them with the best possible personal protection. Such protection enables them to put aside concerns of personal liability and focus on the job of increasing shareholder value.

Of course indemnification is available to directors and officers from sources

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other than indemnification agreements. State corporate law allows a corporation to indemnify its directors and officers, and state labor law often provides protection for officers in their capacity as employees of the corporation. Corporations usually implement these protections by adopting bylaws that both promise indemnification to the “fullest extent permitted by law” and provide for the advancement of legal defense costs prior to the resolution of any litigation. Many directors and officers of corporations mistakenly believe that these bylaw provisions provide them with the maximum protection possible. After all, how could a corporation enter into a contract that is more expansive than the “fullest extent permitted by law”?

Misplaced trust in corporate bylaws

This logic is flawed, however. Although these other sources of protection are useful, none offers the level of certainty that a personal indemnification agreement can provide.

Directors and officers should not rely solely on corporate bylaws for two primary reasons:

- Corporate bylaws, unlike personal indemnification agreements, can be unilaterally amended by the corporation to the detriment of directors and officers.
- Only personal indemnification agreements provide an adequate level of process detail.

Bylaws can be amended. The corporate laws of most states allow the board of directors to amend a corporation’s bylaws, even if the amendment diminishes protections previously afforded to and relied upon by a director or officer. A board can therefore unilaterally reduce the protections afforded by a corporation’s bylaws, including with respect to indemnification or the advancement of legal fees. In particular, the board has this right under Delaware law, the applicable corporate law for the



majority of corporations in the United States. In addition, most states, including Delaware, allow shareholders to amend bylaws without the consent of the board.

More than a theoretical risk, one of these scenarios played out in the Delaware Chancery Court case of *Schoon v. Troy*. In the *Schoon* case, William Bohnen had been a board member of Troy Corp. At the time that Mr. Bohnen stepped down, Troy's bylaws provided for the right to the advancement of legal fees to *current and former* directors of the corporation. Subsequently, the Troy board amended the bylaws so as to provide for the advancement of legal fees only to *current* directors of the corporation.

Some time later, Troy sued Mr. Bohnen, accusing him of breaching his fiduciary duties. Because of the changes that had been made to the bylaws, Mr. Bohnen was not entitled to have his legal defense fees paid by Troy. If Mr. Bohnen had instead entered into a personal indemnification agreement with Troy, the board could not have unilaterally diminished or eliminated his rights.

Only agreements provide adequate process detail. Bylaws almost never adequately specify the procedural details for such matters as the advancement of legal fees, notification protocols, or the undertaking to reimburse the corporation for losses in the event that a claim proves to be nonindemnifiable. Negotiating such provisions in advance has significant benefits for directors and officers.

In particular, directors and officers should negotiate ahead of time the details of the procedure that will be followed when they apply for the advancement of legal fees. Once again, this scenario is more than a theoretical risk. In *Homestore, Inc. v. Tafeen*, Peter Tafeen, a former officer of this publicly traded corporation, had to sue for the advancement of legal fees. Homestore's bylaws afforded to Mr. Tafeen the right the advancement of legal fees, but the parties had failed to specify the details of the procedure. The result was an almost four-year delay in obtaining the advancement of his legal fees, a delay that could have been avoided if he had had a detailed personal indemnification agreement.

Insufficiency of D&O insurance

Many believe that obtaining director and officer liability insurance eliminates the need for a personal indemnification agreement. However, even the best D&O policies may leave significant gaps

in coverage that should be addressed by a personal indemnification agreement. These gaps in coverage result from:

- Limitations inherent to D&O insurance policies generally.
- Decisions made by the corporation that prove to be detrimental to the directors and officers.

Limitations inherent to D&O insurance policies.

Although indemnification agreements are generally designed to respond "to the fullest extent permitted by law," D&O policies make no such promise.

Instead, D&O policies — like all insurance policies — are subject to numerous limitations on their scope of coverage. For example, while a personal indemnification agreement can guarantee that a corporation will pay the legal defense costs of the target of an internal investigation self-initiated by a corporation, most D&O policies will not. Moreover, although it happens infrequently, D&O insurance carriers can go out of business. Thus, it is much better for directors and officers to have the "belt and suspenders" of having *both* a D&O insurance policy and a personal indemnification agreement.

Detrimental decisions. Consider the fact that most D&O insurance policies are negotiated on an annual basis. The terms and conditions of these

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What should be in your indemnification agreement?

With this understanding of the importance of personal indemnification agreements, the next question is: what provisions should be included in a personal indemnification agreement? Here are a few of the key questions to ask — with only affirmative "yes" answers being acceptable:

- Is the corporation's obligation to advance legal fees nondiscretionary?
- Does the obligation to advance legal fees last until the final resolution of all litigation?
- Has the actual process and procedure for

the advancement of legal fees been specified in detail?

- Does the agreement set forth the procedure for choosing defense counsel for the directors and officers?

- Is there a clearly stated presumption in favor of the right to indemnification?

- Is the agreement designed to remain in effect so long as there may be any liability resulting from having been an officer or director of the corporation?

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policies change over time, sometimes for the worse. By contrast, personal indemnification agreements are not renegotiated annually, and corporations cannot amend these agreements to the detriment of directors or officers without their consent.

Also consider what would happen if a corporation simply refused to advance legal fees.

Normally if a claim is made against the direc-

tors or officers of a corporation, they can expect the corporation to advance their legal fees immediately. The corporation then in turn seeks reimbursement or advancement of costs from the insurance carrier when the amounts paid exceed the D&O policy's stated "self-insured retention" — roughly the equivalent of a deductible. For large public corporations, the amount of the retention can run into

What is a personal indemnification agreement?

A **personal** indemnification agreement is a written contract between a company and an individual director, officer or other person — known, in the typical language of such agreements, as the "indemnitee." The agreement obligates the company to indemnify the indemnitee for legal actions brought against him or her.

A properly constructed indemnification agreement contains myriad provisions designed to protect the indemnitee as long as the indemnitee acted in good faith and a manner reasonably believed to be in, and not opposed to, the best interests of the company. With respect to criminal matters, the indemnitee must have had no reason to believe that the conduct in question was unlawful. Collectively, these provisions ensure that, when an indemnitee is sued, the indemnitee will be entitled to a vigorous defense at the company's expense as well as reimbursement for any losses suffered.

Experience tells us that within the United States these agreements can cause a company to pay for nearly everything — defense costs, expert witness fees, settlements, and even judgments — except for civil and criminal fines and penalties. Civil and criminal fines and penalties are generally not indemnifiable (or insurable) as a matter of public policy.

A good indemnification agreement provides not only for indemnification but also for the advancement of legal fees. By granting an indemnitee the right to the advancement of legal fees, the company becomes obligated to pay for an indemnitee's defense from the moment the indemnitee is summoned as a witness or accused of wrongdoing. These advances can be unsecured, interest free, and made without regard to the indemnitee's ability to repay the loan or even whether the indemnitee has met any applicable standard of conduct.

Typically, to qualify for the advancement of legal fees, the indemnitee need only sign an "undertaking" promising to return the money if it is ultimately determined that the indemnitee was not entitled to indemnification. By contrast, the right to indemnification is an "after-the-fact" reimbursement for an indemnitee who has suffered a loss, and can be paid only after a determination has been made that the indemnitee met the applicable standard of conduct.

United States must file their indemnification agreements with the Securities and Exchange Commission. When first adopting or later amending a company's form of indemnification agreement, companies do not normally ask for shareholder approval before putting a new form of indemnification agreement into place. The potential exception to this custom and practice is when there is already a controversy pending against a board of directors, such as a lawsuit. If the board has already



Having the right to the advancement of legal fees is critical for directors and officers. When it comes to suits against directors and officers, getting to the "after-the-fact" moment can take years. During this time, the indemnitee's defense attorneys will expect prompt payment of their monthly bills. If an individual indemnitee has to wait until after the litigation is resolved for reimbursement of legal fees, he or she may face several long and expensive years. Thus, although indemnification is important, for most indemnitees the right to the advancement of legal fees is the more immediate need when they are first accused of wrongdoing and need to defend themselves.

Companies that are publicly listed in the

been sued, the adoption of a personal indemnification agreement could be regarded as self-interested. To avoid this risk, companies should consider the issue of personal indemnification agreements as part of their normal review of risk management for the directors and officers of the company.

In the absence of a pending controversy, personal indemnification agreements fall within the scope of authority for the board of directors. The approval of personal indemnification agreements is much like the purchase of D&O insurance and other housekeeping decisions designed to recruit and retain good directors and officers for the benefit of a company's shareholders.

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the tens of millions of dollars.

If a corporation refuses to indemnify and advance legal fees even though it could as a matter of law — perhaps there is a dispute or perhaps the timing is fiscally inopportune for the corporation — the insurance carrier will not start paying policy proceeds until the contractual obligation to pay the retention is honored. Therefore, if the corporation refuses to pay the retention, then individual directors and officers will have to pay the retention to access the insurance policy. The risk of having to make a personal payment like this is greatly mitigated by having a personal indemnification agreement that mandates the advancement of legal fees.

In addition to having a personal indemnification agreement, there is another insurance solution that can protect a director or officer from having to pay the retention. This type of insurance is known as a Side A Difference in Condition (or DIC) policy and would typically be purchased in addition to a corporation's regular D&O policies. DIC policies can be tricky, so caution should be used when buying a DIC policy as a substitute for a personal indemnification agreement.

Protection against governmental pressure

Personal indemnification agreements may also be a good idea because their existence discourages a corporation from “serving up” its directors or officers in the face of pressure from government. Mandatory contractual obligations set forth in an indemnification agreement may greatly relieve this pressure.

Typically when the Securities and Exchange Commission or the United States Department of Justice investigates the actions of directors and officers, these agencies seek cooperation from the corporation that the directors and officers served. If the corporation fails to cooperate, the SEC or DOJ is more likely to bring legal action against the corporation itself. In light of these stakes, the corpora-

tion's management and the board of directors will want to cooperate — as they should to promote the interests of their shareholders.

What is cooperation? As of August 2008, the official position of the DOJ is that a corporation's decision to advance legal fees on a voluntary basis will *not* be a consideration in determining whether to indict the corporation. The SEC is also on record as saying that it does not consider the advancement of legal fees as evidence of non-cooperation. This is good news.

However, since the policy has been different in the past, it could certainly be different again.

Rather than leave it to chance, directors and officers can better ensure that their corporation will advance their legal fees by making the advancement mandatory in their personal indemnification agreements. The SEC and the DOJ are unlikely to take the position that “cooperation” requires the breach of a corporation's binding legal agreements, including agreements with a corporation's directors and officers.

When it comes to crafting an excellent indemnification agreement, directors and officers are well served by going to a specialist in director and officer protection issues. Where possible, this specialist should also be able to advise directors and officers on the manner in which their personal indemnification agreements will interact with their corporation's D&O insurance policies. This is the best way to ensure that directors and officers have the most complete, robust personal protections possible. ■

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