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The Importance of Personal Indemnification Agreements

A WS&Co. Article By Priya Cherian Huskins, Esq.[1], Partner

Directors and officers of corporations know that their companies can spend thousands if not millions of dollars on Director and Officer liability insurance ("D&O Insurance"). These sums are spent to protect the directors and officers from potentially bankrupting litigation. D&O insurance alone, however, is an inadequate defense for directors and officers; they also need state-of-the-art personal indemnification agreements.

What is an Indemnification Agreement?

An 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 in a manner reasonably believed to be in, and not opposed to, the best interests of the company.[2] With respect to criminal matters, the Indemnitee must have had no reason to believe that the conduct in question was unlawful.[3] 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.

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.

Why Don't All Directors & Officers Insist on Having Indemnification Agreements?

Too often, directors and officers go without an indemnification agreement. Perhaps this is because they have been told that their company bylaws provide for indemnification "to the fullest extent permitted by law" and consequently do not need anything else. Or perhaps they have been told that D&O insurance fully covers them. In both cases, these directors and officers have been misinformed.

First, only an indemnification agreement provides adequate process detail. Bylaws almost never fully specify all necessary procedural details. Waiting to negotiate these details until after a problem has emerged is a mistake. Consider what happed in Homestore, Inc. v. Tafeen.[4]

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[2] *Delaware General Corporation Law Section 145(a) and (b).*

[3] *Delaware General Corporation Law Section 145(a).*

[4] *Homestore, Inc. v. Tafeen, 2005 WL 3091887 (Del.Supr. 2005).*

Mr. Tafeen, a former officer of this publicly traded corporation, had to sue for the advancement of legal fees. Homestore's bylaws afforded Mr. Tafeen the right to 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.

The idea that D&O Insurance eliminates the need for an indemnification agreement is also wrong. Here's the problem: 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 an internal, self-initiated investigation 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.

Finally, consider the fact that most D&O insurance policies are negotiated on an annual basis. The terms and conditions of these policies change over time, sometimes for the worse. By contrast, personal indemnification agreements are not renegotiated annually, and corporations cannot unilaterally amend these agreements to the detriment of directors or officers without their consent.

What Next Steps Should Directors & Officers Take?

Directors and officers who are operating under a form of indemnification agreement that has not been reviewed for many years, or without an indemnification agreement at all, should engage the help of an attorney specializing in director and officer protection issues. Indemnification agreements—often 15+ pages of single space text—are complex documents. A cursory, checklist–type approach to reviewing them is inappropriate. Instead, the board should engage someone to represent the Indemnitees and review specific contractual language on behalf of the Indemnitees. 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. Anything short of this means that the directors and officers do not have the most complete, robust personal protections possible.

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Indemnifcation Agreement Checklist

When it comes to indemnification agreements, the devil is in the 15+ pages of details these agreements can and should provide to a company's directors and officers. Reviewing these agreements can be daunting . . . and the pay-off can potentially be calculated in the millions of dollars if someone one day needs to access funds through an indemnification agreement.

Companies offer indemnification agreements to help recruit and retain excellent directors and officers for the benefit of the shareholders. It is the responsibility of the board of directors to make an appropriate business judgment about the scope and robustness of the indemnification agreement it wants to put into place.

Whether it is putting a form of indemnification agreement in place for the first time or updating an existing form, the board will want to make sure it is working with someone who can show it the range of provisions that are available to address the myriad items that should be in an indemnification agreement, including:

- Advancement of legal fees
- Change of control
- Contribution
- D&O insurance
- ERISA coverage
- Foreign law accomodations
- Good faith
- Internal and informal investigations
- Levy-specific language
- Selection of defense and monitoring counsel
- Settlement dynamics
- Severability
- Specific performance
- Undertakings

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