

Indemnification: Who Pays the Bill When a Director or Officer is Sued?

When a director or officer is sued in connection with his or her involvement with the corporation, the responsibility for payment of litigation expenses (including attorneys' fees), judgments, fines and amounts paid in settlement of the matter depends on many factors. The responsibility varies depending on the state of incorporation and the extent to which the corporation has permissibly modified state law provisions by contract with the director or officer, or by provisions included in the corporation's organizational documents (i.e., certificate of incorporation or bylaws). ■ This Update will discuss the typical statutory framework and the most common provisions included in corporations' organizational documents. Because Delaware law dominates this arena, it is the logical example for analysis and is the focus of this Update. The rights of directors and officers of a corporation formed under the law of another state will be determined by the law of its state of incorporation; however, the principles discussed in this Update are generally applicable to most corporations.

Statutory Framework

Generally, the purpose of indemnification is to encourage capable people to serve as directors or officers by eliminating the fear that they will be personally liable for costs incurred to defend their honesty and integrity while serving as a director or officer of the corporation. State law may not mandate, however, that directors and officers (or other employees or agents of the corporation) be indemnified. Where state law does not mandate indemnification, the corporation's organizational documents may establish the right to indemnification. For example, it is common for the bylaws of a corporation to provide that directors and officers will be indemnified to the fullest extent permitted by law.

Delaware law empowers, but does not require, a corporation to indemnify any person who was or is a party, or is threatened to be made a party, to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, including derivative actions asserted on behalf of the corporation. In the case of a derivative action, this permissive indemnification is limited to the expenses actually and reasonably incurred in connection with the matter. For non-derivative actions, a corporation may indemnify an individual against any judgment, fine or amount paid in settlement of the matter. In all cases, in order to be indemnified, a person must have acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interests of the corporation. Additionally, in order to be indemnified in a criminal matter, the person must have had no reasonable cause to believe his or her conduct was unlawful. The board of directors of the corporation must make a determination that indemnification is proper because the person to be indemnified has met the applicable standard of conduct.

In addition, indemnification under Delaware law is mandatory when a former or present director or officer of a corporation has been successful on the merits or otherwise in defense of any matter. To illustrate the importance of this distinction, imagine a situation where a corporation is considering legal action against a former director. The corporation needs to be aware that if the action is unsuccessful, the corporation must pay the litigation costs for both sides. The following table provides a general summary of the foregoing distinctions:

PLAINTIFF	TYPE OF COST	SUCCESSFUL DEFENSE	JUDGMENT OR SETTLEMENT AWARDED TO PLAINTIFF
Third-Party	Expenses	Mandatory	Permissive
Third-Party	Liability	N/A	Permissive
Corporation	Expenses	Mandatory	Permissive
Corporation	Liability	N/A	Generally Not Allowed

Success on the Merits: The definition of the “successful on the merits or otherwise” standard has been the subject of much litigation and must be considered on a case-by-case basis. Success in a civil action includes a dismissal with prejudice and without any payment being made, as well as certain types of settlements. Delaware courts are reluctant, however, to consider a settlement that requires payment a success.

Advancement of Costs: The Delaware statute permits the advancement of costs prior to the final disposition of the case as long as the indemnified person promises to repay the amounts advanced if they are later found not to be entitled to such payments. Under the statute, the decision to advance expenses is at the discretion of the board of directors of the corporation.

Modifications to the Statutory Framework

A Delaware corporation may modify the statutory indemnification requirements through its certificate of incorporation, its bylaws or by an express contract. The most common modifications are to make mandatory certain provisions that the statute merely establishes as being permissible. Two key examples are (i) to specify that the corporation will indemnify its directors and officers to the maximum extent permitted by law, and (ii) to require the advancement of costs for directors and officers upon receiving a promise to repay the amounts advanced if they are later found not to be entitled to such payments.

The power of a corporation to indemnify a director or officer, however, is not unlimited and remains subject to certain underlying public policies. For example, despite what a corporation's bylaws may provide, a person who does not act in good faith and in a manner the person reasonably believed to be in, or not opposed to, the best interests of the corporation may not be indemnified.

Other Considerations

Fees on Fees: Until recently, a director or officer would not be reimbursed for fees and expenses incurred in seeking indemnification absent an express provision in either the bylaws or a separate agreement. However, the Delaware Supreme Court recently determined that reimbursement for reasonable costs necessary to prosecute a successful suit for indemnification is permissible. The Court reasoned that the recovery is remedial in nature because the action is to enforce a benefit provided by law that was inappropriately withheld.

Solvency and Bankruptcy: The solvency of the corporation obligated to indemnify has become a topic of recent discussion following the demise of Enron. A corporation's obligation to indemnify a director or officer is only as strong as the financial strength of the corporation. Many corporations obtain D&O insurance that will supplement and protect a corporation's resources if a claim is made against its directors or officers. The adequacy of D&O insurance, however, is a function of many factors, including the scope of coverage, amount of deductible and co-insurance, exclusions and the strength of the insurance carrier, but these factors are not the only considerations that can leave a director or officer without protection (see our recent Update on D&O Insurance). For

example, the protections offered by a D&O policy are uncertain when the corporation that purchased the policy files for bankruptcy. In that case, there is a question as to whether the D&O policy is an asset of the bankruptcy estate and to what extent the insurer is required to pay competing claims.

This question has received inconsistent treatment in the bankruptcy courts. Some courts have held that the entity entitled to receive the insurance proceeds (i.e., the director or officer), rather than the owner or purchaser of the policy, has the stronger claim to the benefits of the policy. Other courts have considered whether the existence of the policy in some way enhances the overall value of the estate. Others apply some form of a balancing test that weighs the public policy purpose of indemnification against the competing goals of bankruptcy law. Such inconsistent decisions make it even more difficult to assess the protection afforded by a corporation's D&O insurance.

Elimination of Liability: Delaware law provides that a corporation's certificate of incorporation may include a provision limiting or eliminating the liability of directors to the corporation or stockholders under certain circumstances not involving a breach of the director's duty of loyalty. This nuance of Delaware law should be carefully considered when drafting a corporation's indemnification provisions as well as when purchasing D&O insurance.

Recent Changes: Whether the Sarbanes-Oxley Act of 2002 will change indemnification law is not yet known. For instance, Sarbanes-Oxley prohibits publicly traded companies from providing certain types of personal loans to directors and officers. The question arises as to whether the advancement of expenses against a promise of repayment will be considered a forbidden personal loan. No court has yet addressed this question.

The information and statements contained in this Update should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult with an attorney regarding your own circumstances and any specific legal questions you may have.

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