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## DIRECTOR AND OFFICER INDEMNIFICATION

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## I. INTRODUCTION

- A. Historically, there was considerable doubt whether a corporation could financially protect its directors and officers from personal liability. Some early authority indicated that corporate expenditures for purpose of D&O indemnification and insurance were ultra vires because such payments were not considered to be directly for the benefit of the corporation itself. See, e.g., New York Drydock v. McCollum, 173 Misc. 106, 16 N.Y.S.2d 844 (S.Ct., 1939); Bailey v. Bush Terminal Co., 293 N.Y. 735, 56 N.E.2d 739 (1944), Aff'g 267 App. Div. 899, 48 N.Y.S.2d 324 (1st Dept., 1944), aff'g 46 N.Y.S.2d 877 (S.Ct., 1943).
1. Other courts recognized that indemnification and reimbursement was permissible and consistent with public policy because such protection encourages sound corporate management, which was viewed as a prerequisite to responsible corporate activity. See, e.g., In re E.C. Warner Co., 232 Minn. 207, 45 N.W.2d 388 (1950). Cf. Solimine v. Hollander, 129 N.J. Eq. 264, 19 A.2d 344 (1941).
- B. These early decisions resulted in enactment of statutes permitting or requiring indemnification in all states and, in most instances, authorizing corporations to purchase D&O insurance.
1. When enacting these indemnification statutes, the state legislatures sought to balance two conflicting interests. On the one hand, they recognized the need to punish unfaithful fiduciaries, thereby creating a deterrence to improper conduct. On the other, they wished to provide protection for aggressive corporate managers willing to undertake good faith risks in the search for profits.
  2. Most states accomplished this balancing of interest by crafting indemnification statutes which permit financial protection if the director's or officer's actions satisfied stated standards of conduct.
- C. Because these indemnification statutes were enacted many years ago and virtually all corporations mandate indemnification consistent with those statutes in their internal corporate documents, most corporations and their risk managers today largely ignore indemnification issues when evaluating and structuring a risk management program for directors and officers. This apparently is based upon the naive assumption that the indemnification protection is adequate notwithstanding recent statutory amendments and case law and new state-of-the-art indemnification concepts.
1. When evaluating the adequacy of a company's current indemnification protection, one must identify the criteria to be used in that evaluation. The broader and more protective the provision, the greater the

corporation's potential liability to its directors and officers for indemnification reimbursement. Although most corporate managers wish to afford the maximum protection available to the directors and officers (thereby creating the maximum potential corporate liability), even that decision should be periodically re-evaluated.

## II. INDEMNIFICATION STATUTES

A. Each state has designed its own unique indemnification statute, which is typically contained within the state's corporation laws. Although the discussion below primarily summarizes the Delaware indemnification statute (Section 145, Delaware General Corporation Law), we have also included information regarding the Ohio indemnification statute. (O.R.C. Ann. § 1701.13)

### B. Scope of Indemnification

1. Permissive/Mandatory. Except as noted below, the Delaware and Ohio indemnification statutes merely permit a corporation to indemnify certain protected persons for certain loss or expenses actually and reasonably incurred in connection with a claim. The corporation is obligated by statute to indemnify for expenses incurred if the person has been successful on the merits or otherwise in defense of the claims against the person. (Section 145(c), Delaware; § 1701.13(E)(3), Ohio).
  - a. Because the statutes are primarily permissive only, a director and officer is not entitled to indemnification unless the corporation's certificate of incorporation, by-laws or other internal document mandates the indemnification.
  - b. The relatively limited mandatory indemnification created by Section 145(c) of the Delaware statute can be triggered while the underlying lawsuit against the D&O is still pending if the complaint alleges facts sufficient to permit a court to presume no D&O liability. Dunham v. Brick, 1993 Conn. Super. LEXIS 80 (Conn. Sup. Ct., Middlesex, Jan. 11, 1993) (complaint alleged reliance by the defendant D&Os upon the advice of accountants and therefore court presumed for purposes of indemnification that the D&O had no liability.) However, the statutory mandatory indemnification is not available simply because the corporation rather than the D&Os pay the settlement amount. Waltuch v. Conticommodity Services, Inc., 88 F. 3d 87 (2d Cir. 1996).
  - c. The mandatory defense cost indemnification under the statute may be triggered when the underlying action is settled and the settlement agreement contains a denial of liability by the director

defendants. Safeway Stores, Inc. v. National Union Fire Ins. Co., 1995 WL 497645 (9th Cir. Aug. 23, 1995).

- d. Similarly, if a case is settled with the company paying the settlement amount and the defendant D&O being released, the defendant D&O may be entitled to mandatory indemnification for his defense costs because he was “successful” in resolving the lawsuit without paying anything personally. Waltuch v. Conticommodity Services, 88 F.3d 87 (2d Cir. 1996); Mollfulleda v. A1 Phillips, 1996 WL 89215 (N.D. Ill. Feb. 27, 1996). Other cases have held a settlement does not trigger the mandatory indemnification provision. Dalany v. American Pacific Holding Corp., 50 Cal. Rptr. 2d 13 (Calif. App., Feb. 14, 1996); In re Landmark Land Co. of California, 76 F.3d 553 (4th Cir. 1996); Raychem, Inc. v. Federal Insurance Co., 853 F. Supp. 1170 (C.D. Cal. 1995).

2. Protected Persons. The statutes permit indemnification of 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, by reason of the fact that he is or was a director, officer, employee or agent of the corporation. (Section 145(a) and (b), Delaware; § 1701.13(E)(1), Ohio).

- a. Because the statute applies to a D&O who is made a “party” to a proceeding, the Delaware Supreme Court has ruled that indemnification is not limited to defendants. Rather, indemnification is available regardless of the D&O’s role in the litigation, including as a plaintiff, intervenor or amicus curiae. Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983). However, in Shearin v. E.F. Hutton Group, Inc., 1994 Del. Ch. LEXIS 69 (Del. Ch. June 7, 1994), the court ruled that an officer who initiates a lawsuit is entitled to indemnification only if the lawsuit is brought as part of the officer’s duties to the corporation or its shareholders. Thus, the officer was not entitled to indemnification for costs incurred in prosecuting a wrongful termination suit against the company. Accord, Augat, Inc. v. Collier, 1996 WL 110076 (D. Mass. Feb. 8, 1996).
- b. Courts have similarly interpreted broadly the requisite capacity in which an individual must participate in the proceeding in order to trigger the indemnification statute. In Heffernan v. Pacific Dunlop GNB Corp., 1992 U.S. App. LEXIS 12595 (7th Cir., June 5, 1992), the court ruled that the Delaware indemnification statute applies

to suits against directors and officers both in their official capacity or if the suit arises more tangentially from his role, position or status as a director. In that case, a former director and shareholder of a company was sued for failure to disclose material information when he sold his stock in the company to another corporation. Although he was sued in his capacity as a shareholder (which would not alone trigger indemnification), the court permitted an indemnification claim against the corporation to proceed since his status as a director put him in a position where, in performance of his duties as a director, he either learned or should have learned of the material information which he did not disclose to the purchaser when he sold his stock. See also, Barry v. Barry, 824 F.Supp. 178 (D.Minn. 1973) aff'd., 28 F. 3d 848 (8th Cir. 1994); U.S. v. Lowe, 29 F. 3d 1005 (5th Cir. 1994), Kapoor v. Fujisawa Pharmaceutical Co., 1994 Del. Super. LEXIS 233 (May 10, 1994); Augat, Inc. v. Collier, 1996 WL 110076 (D. Mass. Feb. 8, 1996).

- c. For purposes of the indemnification statute, a company's independent accounting firm may be an "agent" of the company. APSB Bancorp v. Thornton Grant, 26 Cal. App. 4th 926 (Cal.App. 1994).

3. Standard of Conduct. The Delaware and Ohio statutes permit indemnification only if the person acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interest of the corporation. With respect to any criminal proceeding, the person must also have had no reasonable cause to believe his conduct was unlawful. The termination of any proceeding by judgment, order, settlement, conviction or upon a plea of nolo contendere does not alone create a presumption that the person's conduct did not satisfy this standard. (Section 145(a) and (b), Delaware; § 1701.13(E)(1), Ohio).

- a. A corporation may be required to indemnify an officer who pleads guilty a criminal charge. Maiss v. Bally Gaming International, 1996 WL 732530 (E.D. La. Dec. 12, 1996).
- b. The "best interest of corporation" standard is not met if the D&O conduct is only for personal benefit. Bensen v. American Ultramar Ltd., 1996 WL 435039 (SDNY, Aug. 2, 1996); Boston Children's Heart Foundation, Inc. v. Nodal-Ginard, 73 F.3d 429 (1st Cir. 1996).
- c. The "good faith" standard may be satisfied even if the defendant D&O pays a civil penalty assessed by a regulator if the payment

was pursuant to a settlement and therefore no finding of bad faith occurred. Commodity Futures Trading Commission v. Richards, 1996 WL 199729 (N.D. Ill. April 23, 1996).

4. Indemnifiable Loss. In any proceeding other than one by or in the right of the corporation, the corporation is permitted to indemnify expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the indemnified person in connection with the proceeding. (Section 145(a), Delaware; § 1701.13(E)(2), Ohio).
  - a. However, in order to avoid a circular and meaningless result, the Delaware and Ohio statutes permit indemnification of only expenses (not judgments or amounts paid in settlements) in proceedings brought by or in the right of the corporation, including most notably shareholder derivative suits. Even as to the expenses, no indemnification is permitted if the indemnified person is adjudged to be liable to the corporation unless and only to the extent that a court determines that despite the adjudication but in view of all the circumstances, such person is fairly and reasonably entitled to indemnity for the expenses. (Section 145(b), Delaware; § 1701.13(E)(2)(a), Ohio).
  - b. Indemnification in any type of proceeding is available only if and to the extent the person is obligated to pay the amount for which indemnification is sought. If the person has no personal liability, there is nothing to indemnify. See, In the Matter of Liquidation of WMBIC Indemnity Corp., 1993 Wisc. App. LEXIS 318 (Mar. 18, 1993). But see, Chamison v. Healthtrust, Inc., No. 15904 (Del. Ch. Ct. Jan. 12, 1999.) (Even though D&O suffered no loss because defense costs were paid, action could be brought for contribution by indemnitor against alleged co-indemnitor). If a corporation simply agrees to forego money it is otherwise entitled to receive in exchange for release of claims against D&O's or if a corporation simply agrees to release its claim against D&O's, the corporation incurs a direct loss but not an indemnified D&O loss. First State Underwriters Agency of New England Reinsurance Corporation v. Public Utility District, 1994 U.S. App. LEXIS 31307 (9th Cir. 1994).
- C. Indemnification Procedures. Permissive indemnification must be authorized on a case-by-case basis, upon a determination that indemnification is proper in the circumstances because the person has met the applicable standard of conduct. The determination must be made by one of the following:

1. By the Board of Directors by a majority vote of a quorum consisting of directors who are not parties to the proceedings;
2. If such a quorum of the Board is not obtainable or even if obtainable a quorum of disinterested directors so directs, by independent legal counsel in a written opinion; or
3. By a majority vote of all stockholders.

If corporations do not conform to the proper procedure in approving indemnification by failing to make the necessary determination as to whether the standard of conduct was satisfied, no indemnification is permitted. In re P.J. Keating Company, 180 B.R. 18 (Bankr. D.Mass. 1995). In that situation, coverage under the corporate reimbursement insuring clause of the D&O insurance policy may be jeopardized. See, e.g., MacMillan, Inc. v. Federal Ins. Co., 741 F. Supp. 1079 (S.D.N.Y. 1990); Atlantic Permanent Federal Savings & Loan Assoc. v. American Casualty Co., 839 F.2d 212 (4th Cir. 1988); Waldoboro Bank v. American Casualty Co., 775 F. Supp. 432 (D. Maine 1991).

- a. A court can make its own independent determination whether the standard of conduct was met, regardless of the determination by the directors or stockholders. Heffernan v. Pacific Dunlop GNB Corp., 1993 U.S. Dist. LEXIS 5 (N.D. Ill., Jan. 5, 1993); Waltuch v. Conticommodity Services, Inc., 833 F. Supp. 302 (S.D.N.Y. 1993).

If the disinterested directors deny indemnification, the person seeking the indemnification may seek to judicially enforce the indemnification rights by asserting a claim against the corporation, but may not assert a claim against the disinterested directors. The indemnification claim is based in contract, not tort, and therefore may be made only against the corporation. Pope v. American Airlines, Inc., 1993 U.S. Dist. LEXIS 8896 (N.D. Ill. June 30, 1993), 1994 U.S. Dist. LEXIS 1849 (N.D. Ill. Feb. 22, 1994).

- a. In determining the indemnification rights of a defendant D&O, the court's analysis is not limited to the allegations in the four-corners of the complaint against the D&O's. Grove v. Daniel Valve Company, 1994 Tex. App. LEXIS 484 (Tx. App. Mar. 10, 1994); U.S. v. Lowe, 29 F.3d 1005 (5th Cir. 1994).
- b. If a court determines that indemnification or advancement was improperly denied, the claimant may be able to recover reasonable fees and expenses incurred by the claimant in enforcing his or her indemnification rights. Lipson v. Supercuts, Inc., Civil Action No. 15074 (Del. Ch. Ct., Dec. 10, 1996); Mitrano v.

Total Pharmaceutical Care, Inc., 1996 WL 44703 (Mass. 1st Cir., Feb. 9, 1996).

- D. Advancement. Because the requisite determination as to whether the applicable standard of conduct was satisfied typically cannot be made until the end of the proceeding against the indemnified person, the Delaware and Ohio statutes permit a corporation to pay in advance of the final disposition of a proceeding expenses incurred by an officer or director in defending the proceeding. Such advancement is authorized only if the indemnified person submits to the corporation a written undertaking to repay the amounts advanced if it should ultimately be determined that he is not entitled to be indemnified by the corporation. (Section 145(e), Delaware; § 1701.13(E)(5), Ohio).

Further, under § 1701.13(E)(5)(a), an Ohio corporation is in most cases required to advance expenses to a director so long as that director agrees (i) to repay such advancements if it is proved by clear and convincing evidence that his or her actions or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or was undertaken with reckless disregard for the best interests of the corporation; and (ii) to cooperate with the corporation concerning the action, suit, or proceeding. This provision is self-effectuating and does not require shareholder approval. (Shareholders may vote to “opt-out” of this statute by including a provision in the corporation’s articles of incorporation or code of regulations that specifically states that the provisions of § 1701.13(E)(5)(a) do not apply to the corporation.)

1. “Advancement” is legally distinct from “indemnification”. Neal v. Neumann Medical Center, 1995 WL 680917 (Pa. Cmwlth. 1995). If an internal indemnification provision mandates only “indemnification”, no advancement is required. Advanced Mining Systems v. Frickle, 1992 W.L. 187615 (Del. Ch., July 4, 1992).
2. The right to advancement of expenses can be much broader than the right to indemnification. In Citadel Holding Corporation v. Roven, 603 A.2d 811 (Del. 1992), the Delaware Supreme Court interpreted an indemnification agreement as requiring the corporation to advance expenses incurred by a director who was sued by his corporation for violations of Section 16(b) of the Securities Exchange Act of 1934 (i.e. short-swing profit prohibition) even though that indemnification agreement clearly prohibited indemnification of any liability or expense relating to a Section 16(b) claim, whether or not successful. The Court required the corporation to advance the defense costs even though ultimate indemnification was clearly not permitted and to seek repayment from the director of those advanced costs at the conclusion of the litigation. The Court further ruled that the corporation was obligated

to advance not only the expenses incurred in defending the Section 16(b) claim, but also the expenses incurred in prosecuting a counterclaim against the corporation arising from the same matters as alleged in the original complaint by the corporation. The Court considered this counterclaim as an affirmative defense which triggers the advancement obligation. See also, Megeath v. PLM International, Inc., Case No. 930369 (Cal. Sup. Ct. San Fran., Mar. 18, 1992); Lipson v. Supercuts, Inc., Civil Action No. 15074 (Del. Ch. Ct., Dec. 10, 1996); Neal v. Neumann Medical Center, 667 A.2d 479 (Pa. 1995).

3. In other respects, the right of advancement may be narrower than the right of indemnification. For example, unlike indemnification provisions (which require satisfaction of a standard of conduct), a mandatory by-law advancement provision is subject to the directors' duty of care. Therefore, in one case the court denied advancement of legal expenses to bank officials charged with racketeering activities and securities law violations notwithstanding a mandatory by-law advancement provision. Fidelity Federal Savings & Loan v. Felicetti, Case No. 92-0643 (E.D.Pa., Aug. 5, 1993);
  - a. The directors' duty of loyalty, though, typically does not impair approval of defense costs advancement if the statutory advancement procedures are followed. Therefore, the decision to advance need not be made by disinterested directors. Sevico Corporation International v. H.M. Patterson & Son, Inc., 434 S.E.2d 455 (Ga. 1993).
4. A by-law advancement provision is not invalid because it permits advancement with respect to federal securities law claims or because it does not include a "good faith" or "best interest" standard. Heffernan v. Pacific Dunlop GNB Corp., 1993 U.S. Dist. LEXIS 5 (Jan. 5, 1993).
5. In order to qualify for advancement of expenses, a defendant D&O need not show a probability of success on the merits. Ridder v. Cityfed Financial Corp., 47 F.3d 85 (3d Cir. 1995) (right to receive advancement not dependent upon merits of claims against D&O); Neal v. Neumann Medical Center, 1995 WL 680917 (Pa. Cmwlth. 1995); Sequa Corporation v. Gelmin, 1993 U.S. Dist. LEXIS 10005 (S.D.N.Y., July 21, 1993).
6. A defendant D&O need not post a bond or otherwise secure his undertaking to repay the advanced expenses if he is ultimately not entitled to indemnification. Sequa Corporation v. Gelmin, *supra*; Fidelity Federal Savings & Loan v. Felicetti, Case No. 92-0643 (E.D.Pa., Aug. 5, 1993).

- E. Nonexclusivity. The indemnification and advancement of expenses recognized by the Delaware and Ohio statutes are not deemed exclusive of any other rights that may be available to a person under a by-law, agreement, vote of stockholders or disinterested directors or otherwise. (Section 145(f), Delaware; § 1701.13(E)(6), Ohio). For this reason, corporations can craft ultra protection for its directors and officers through carefully drafted by-laws or other internal corporate documents.
1. The courts have not yet resolved the issue whether this non-exclusivity clause in the statute permits indemnification otherwise prohibited by the indemnification statute. For example, can an internal corporate indemnification provision authorize or require a corporation to indemnify settlements by or judgments against its directors and officers in derivative suits? At least one court has held that the nonexclusivity clause permits that type of expansion of the indemnification statute. Heffernan v. Pacific Dunlop GNB Corp., 1993 U.S. Dist. LEXIS 5 (N.D. Ill., Jan. 5, 1993). Another recent case held the opposite, finding that the nonexclusivity clause does not authorize indemnification otherwise prohibited by the indemnification statute. Waltuch v. Conticommodity Services, Inc., 88 F.3d 87 (2d Cir. 1996).
  2. Most commentators agree that the non-exclusivity clause is subject to public policy constraints. See, e.g., R. Balotti & J. Finkelstein, The Delaware Law of Corporations and Business Organizations, Section 4.16, at 4-319 (2d ed. 1990). To determine the appropriate public policy constraints, courts may look to the constraints adopted by the legislature when it drafted the indemnification statutes. Thus, courts may be reluctant to permit corporations to indemnify for settlements or judgments in derivative suits pursuant to an internal indemnification provision.
  3. At least one court has rejected the argument that public policy bars indemnification pursuant to a non-exclusivity clause. PepsiCo, Inc. v. Continental Casualty Co., 640 F. Supp. 656, 660 (S.D.N.Y. 1986). The court also held that the non-exclusivity clause permits a corporation to indemnify without following the procedural requirements of the Delaware statutes. It is questionable, though, whether a Delaware court would be as willing to permit the non-exclusivity clause to circumvent these statutory provisions.

In Ohio, in an attempt to address the uncertainty regarding the scope of the nonexclusivity provision of the Ohio statute, the legislature amended the statute in 1986 to clarify that a grant of indemnification pursuant to the nonexclusivity clause is not limited by the restrictions, standards of

conduct and procedural requirements contained in the first two divisions of the indemnification statute, which address permissive indemnification for third-party actions and actions brought by or in the right of the corporation. § 1701.13(E)(8). Thus, although there may be public policy constraints on indemnification under Ohio law that will be addressed by courts on a case-by-case basis, indemnification that goes beyond the Ohio statute is not per se unenforceable.

- F. Partnership Indemnification. Unlike corporation statutes, state partnership statutes vary significantly with respect to indemnification rights and powers. Some states have partnership statutes which closely parallel the detailed indemnification rights and procedures applicable to corporations. Other states have extremely broad provisions. For example, the Delaware Revised Uniform Limited Partnership Act provides:

Subject to such standards and restrictions, if any, as are set forth in its partnership agreement, a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever. [Section 17-108]

1. The Delaware Chancery Court has recognized that this statute is broader than the statutory indemnification provisions applicable to corporations and defers completely to the contracting parties to create and delimit rights and obligations with respect to indemnification and advancement of expenses. Delphi Easter Partners Limited Partnership v. Spectacular Partners, Inc., 1993 Del. Ch. LEXIS 318 (Del.Ch.Ct., Aug. 6, 1993).

### III. INTERNAL INDEMNIFICATION PROVISION

- A. If the corporation wishes to assure maximum financial protection to its directors and officers, the company's internal indemnification provision in its certificate of incorporation, by-laws or indemnification agreement is crucial. The primary goal of such a provision is to mandate the indemnification and advancement which is otherwise permitted by the Delaware and Ohio statutes. However, numerous other "whistles and bells" can be included within such a provision to assure maximum protection. Attached as Exhibit B is a sample Delaware indemnification provision containing many provisions intended to maximize protection to the directors and officers. Some of those provisions include:
1. The provisions provide for indemnification "to the full extent permitted by law".
  2. The provisions require indemnification, rather than merely permit the corporation to indemnify.

3. The provisions require the advancement of defense expenses, subject only to an unsecured obligation to repay the expenses if a court subsequently determines the indemnification was not permitted.
  4. The provisions shift the burden of proof to the corporation to prove that the director or officer is not entitled to the requested indemnification.
  5. The provisions require the corporation to reimburse the director or officer for any expenses incurred in a claim against the corporation for such indemnification if the director or officer is successful in whole or in part.
  6. The provisions provide that the director or officer has a right to an appeal or an independent de novo determination as to indemnification entitlement.
  7. The provisions expressly state that the indemnification rights constitute a contract, is intended to be retroactive to events occurring prior to its adoption and shall continue to exist after the rescission or restrictive modification of the provision with respect to events occurring prior to that rescission or modification. Alternatively, a separate indemnification contract could be executed by the corporation and the director or officer.<sup>1</sup>
  8. The provisions state that any director or officer who serves a subsidiary of the corporation or any employee benefit plan of the corporation or such subsidiary is deemed to be providing such service at the request of the corporation. Thus, a D&O of a subsidiary will be entitled to indemnification from the subsidiary and the parent company.
  9. The provisions require indemnification of expenses incurred by a director or officer as a plaintiff in a suit only if the board of directors approves prosecution of the suit by the D&O.
- B. When drafting these broad, ultra protective provisions, the corporation must decide whether only its directors and officers or others will be entitled to the broad protections. Although the Delaware statute permits indemnification of employees and agents, most corporations do not include such persons in the internal indemnification provision, instead relying upon the Board of Directors' ability to indemnify such persons as appropriate under the circumstances. A few companies deem it appropriate to include employees within the broad indemnification provisions, although it is highly questionable whether it is

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<sup>1</sup> If the by-law indemnification rights differ from rights created by an indemnification statute, the broad rights will likely apply. See, Slottow v. American Casualty Co. of Reading, 1993 U.S. App. LEXIS 19872 (9th Cir., August 4, 1993).

appropriate to include agents, which include among others outside legal, accounting and investment banker professionals.

- C. Because directors and officers face uninsured exposures in pollution and regulatory claims or claims by other insured directors and officers (among others), the scope of indemnification protection can be crucial. Therefore, periodic, competent review and revision of a corporation's internal indemnification provision should be an essential element of any D&O risk management program.

#### IV. OUTSIDE DIRECTORSHIP LIABILITY

- A. Virtually every state indemnification statute permits corporations to indemnify persons serving at the request of the corporation as directors, officers, employees or agents of an outside entity. The Delaware and Ohio statutes are typical and state in part as follows:

A corporation may indemnify any person who was or is a party...to any threatened, pending or completed action, suit or proceeding...by reason of the fact that he...is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise....

(Section 145(a), Delaware; § 1701(E)(1), Ohio)

The following summarizes some of the important aspects of these statutes.

#### B. Protected Persons

1. The statute applies to any person (not just directors and officers of the requesting corporation) serving in an outside directorship at the request of the corporation.
2. The statutes apply to any position with an outside entity. Although the term "outside directorship" is frequently used, it is somewhat of a misnomer since a person serving at the request of the corporation as a director, officer, employee or agent of the outside entity is eligible for protection. For example, if a person provides consultation or other assistance to an outside entity such that the person is deemed to be an agent of that outside entity, ODL indemnification protection may apply.
3. The statutes apply to service with any enterprise, including a corporation, partnership, joint venture, trust and employee benefit plans.
  - ODL indemnification can be afforded by a parent corporation to all directors and officers of all subsidiaries or affiliates, thereby

providing backstop indemnification protection to the subsidiary D&Os in the event the subsidiary is legally or financially unable to provide indemnification. To implement such a concept, a provision similar to the following could be inserted in the parent corporation's mandatory by-law indemnification provision:

Any person serving (i) as a director or officer of another corporation of which a majority of the shares entitled to vote in the election of its directors is held directly or indirectly by the Corporation, or (ii) in any capacity any employee benefit plan of the Corporation or of any corporation referred to in clause (i), shall be deemed to be doing so at the request of the Corporation.

- Absent such a provision, the parent corporation is not required to indemnify directors and officers of a subsidiary. Stoddard v. Michigan National Corp., Case No. 125552 (Mich. App., April 8, 1992).

### C. Request

1. The statutes do not require a written request by the corporation for service in the outside directorship. Presumably, an oral request, if sufficiently proven, can trigger the indemnification authorization. Further, the Delaware Supreme Court has ruled that the election of a director to the board of a wholly-owned subsidiary by the 100% stockholder parent constituted a "request" that the director serve the subsidiary, and therefore, the director was entitled to indemnification for costs incurred in defending a third party action pursuant to Delaware statute and the parent's corporate bylaws. VonFeldt v. Stifel Financial Corp., 714 A. 2d 79 (Del. Sup. Ct. 1998)
2. The statutes do not require the request for service to be by the corporation's board of directors, officers or any particular person. Presumably, any person with actual or apparent authority to make the request on behalf of the corporation can bind the corporation.
3. In light of the foregoing, anyone with an expectation of ODL indemnification protection may have a basis for seeking indemnification since the statutes alone contain virtually no controls or limitations. For example, comments by an employee's superior or written policy statements encouraging employees to be active in civic or community organizations or suggesting to employees that they "support" or "help

out” another entity may be sufficient to invoke ODL indemnification protection.

- Even if an employee serves at the request of his employer in an outside position, the ODL indemnification does not extend to acts in that outside position which occurred prior to the person’s employment with the requesting corporation. National Union Fire Ins. Co. v. Emhart Corp., 1993 U.S. App. LEXIS 32226 (10th Cir., Dec. 13, 1993).

D. Indemnified Claim

The statutes apply to any claim against a person serving in an outside directorship. When evaluating this indemnification exposure, one should consider not only the breach of duty and statutory claims typically covered under a D&O insurance policy, but also claims typically excluded by D&O insurance. Most notably, bodily injury and property damage claims against the outside directorship can create potentially enormous indemnification liability to the requesting corporation, particularly if the outside entity maintains no or inadequate general liability insurance coverage.

- The requesting corporation’s general liability insurance may not cover this exposure because such insurance typically does not include ODL coverage.

E. Mandatory Protection

1. The Delaware and Ohio statutes as quoted above, like all other state indemnification statutes in this regard, merely permit, but do not require corporations to indemnify ODL loss. However, many corporations restate verbatim the state indemnification statute in their by-laws and simply change the word “may” to “shall” in order to mandate the statutorily authorized indemnification. Under that type of corporate indemnification provision, this extremely broad, largely uncontrolled ODL exposure becomes a legal obligation of the corporation. The corporation may incur such a legal obligation, which may or may not be covered by insurance, as a result of conduct at any level within the corporate structure, including conduct by virtually any employee of the parent corporation or any subsidiary.
2. To control this unintended and potentially large exposure, corporations can implement an outside directorship program pursuant to which only those positions specifically approved by a defined corporate procedure will qualify for ODL indemnification protection.

V. NEED FOR D&O INSURANCE

- A. The perceived need for D&O insurance is based upon the premise that financial protection through an applicable state indemnification statute may be inadequate. Historically, the primary areas in which indemnification has been deemed inadequate to provide sufficient protection are as follows:
1. The ability to indemnify for derivative suit judgments or settlements is severely limited or prohibited by most state indemnification statutes. The Delaware and Ohio statutes do not authorize indemnification of settlements or judgments in suits brought by or on behalf of the corporation (including derivative suits). This limitation is intended to avoid the circularity which would result if funds received by the corporation were simply returned to the person who paid them.
    - a. D&O insurance policies typically provide coverage for derivative suit settlements or judgments, subject to various “conduct” exclusions.
    - b. A few states have recently amended their indemnification statutes to limit or eliminate this indemnification restriction, at least under certain circumstances. See, e.g., Indiana Code § 23-1-37; New York Bus. Corp. Law § 722.
  2. Indemnification against claims under the registration and anti-fraud provisions of the federal securities laws may be precluded by public policy or by pre-emption. The SEC’s long-standing view is that such indemnification is against public policy and unenforceable. See 17 C.F.R. §§ 229.510 and 229.512(i). That position has received some judicial support. See, e.g., Globus v. Law Research Service, Inc., 418 F.2d 1276 (2nd Cir. 1969), cert. denied, 397 U.S. 913 (1970); Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101 (4th Cir. 1989); First Golden Bancorporation v. Weiszman, 942 F.2d 726 (10th Cir. 1991); Eichenhotlz v. Brennan, 1995 U.S. App. LEXIS 6134 (3d Cir. 1995); Odette v. Shearson, Hammill & Co., 394 F. Supp. 946 (S.D.N.Y. 1975); Ades v. Deloitte & Touche, 1993 U.S. Dist. LEXIS 12901 (S.D.N.Y., Sept. 17, 1993). However, a settlement of federal securities law claims may be indemnified. Raychem Corp. v. Federal Insurance Co., 853 F.Supp. 1170 (N.D. Cal. 1994).
    - a. The SEC does not regard the maintenance of D&O insurance to be contrary to public policy, even where the corporation pays the premium for such insurance. See 17 C.F.R. § 230.461(c).

- b. Public policy may limit indemnification under other federal statutes (e.g., RICO anti-trust laws) where Congress intended personal liability as a deterrent. See, Sequa Corporation v. Gelmin, 851 F.Supp. 106 (S.D.N.Y., 1993) (indemnification for RICO liability prohibited as against public policy). Also, Congress expressly prohibited indemnification of individuals adjudged liable under the Foreign Corrupt Practices Act of 1977. 15 U.S.C. § 78ff(c)(4) and § 78dd-2(b)(4). However, neither Congress nor public policy prohibits indemnification for liability under CERCLA. See, 42 U.S.C. § 9607(e); Witco Corp. v. Beekhus, 38 F.3d 682 (3d Cir. 1994); U.S. v. Lowe, 29 F.3d 1005 (5th Cir. 1994). Public policy may also prohibit indemnification for liability based on failure to pay payroll taxes. Plato v. State Bank of Alcester, No. 19580 (S.D., Nov. 6, 1996).
  - c. Some D&O insurance policies provide coverage for certain securities and other federal law claims, subject to various “conduct” exclusions.
- 3. No indemnification is permitted unless certain standards set forth in the applicable indemnification statute are satisfied and a determination thereof is made by the designated person or body. The Delaware and Ohio statutes require the director or officer to have acted in good faith and in the reasonable belief that his actions were in, or at least not opposed to, the best interests of the corporation. A determination whether indemnification is proper in a given circumstance is to be made by the disinterested members of the board, by special counsel appointed by the board, by shareholders, or by a court.
  - a. D&O insurance may provide protection for acts which do not satisfy the “good faith” and “reasonable belief” standards, so long as the insurance coverage does not otherwise violate public policy.
  - b. D&O insurance may provide protection for a director or officer when the incumbent board chooses, for whatever reason, not to make the required determination and further refuses to submit the question to special counsel or the shareholders. This circumstance is apt to arise, for example, in the aftermath of a hostile takeover.
- 4. The corporation may be financially unable to fund the indemnification, either because it is insolvent or because of cash flow restraints. The 1997 Directors and Officers Liability Survey conducted by The Wyatt Company concluded that the average reported defense costs per case by U.S.

business corporations for all reported closed D&O claims was approximately \$1 million and that the average reported payment to claimants was \$4.19 million. The average indemnity payment in shareholder litigation was \$7.51 million. In some cases, the payment of such large defense costs and settlements could impair a corporation's other business activities and thus this potential deficiency in indemnification protection can be equally applicable to both insolvent and solvent companies.

- a. Subject to the coverage limitations and exclusions, a D&O insurance policy ensures that adequate resources will be available to fund the defense of the corporate managers and any settlement or judgment incurred by them.
  - b. Establishing a trust fund to pay the company's indemnification obligations is not an adequate substitute for D&O insurance since creditors or a receiver may be able to repudiate the establishment of the fund or otherwise attach fund assets. Gibson v. RTC, 1995 U.S. App. LEXIS 10469 (11th Cir. 1995).
5. Either the applicable law or the corporation's articles of incorporation or code of regulations may be modified to reduce or eliminate indemnification for directors or officers. Because protection is probably determined by the indemnification provision in effect at the time the indemnification is sought, rather than when the act giving rise to the claim occurred, such subsequent modification may reduce or eliminate protection otherwise expected by directors or officers.
6. Unique regulations applicable to certain types of financial institutions also limit the ability to indemnify directors and officers.
- a. The Office of the Comptroller of the Currency ("OCC") has promulgated regulations regarding the indemnification of bank directors, officers and employees.
    - (1) Under 12 CFR § 7.5217, a national bank may provide in its articles of association for the indemnification of directors, officers and employees in accordance with the law of the state in which the bank's holding company is incorporated, or the Model Business Corporation Act.
    - (2) 12 CFR § 7.5217 prohibits indemnification of expenses, penalties or other payments incurred in an administrative proceeding or action by a bank regulatory agency which results in a final order assessing civil money penalties or

requiring payments to the bank. 12 CFR § 7.5217 also prohibits insurance coverage in respect of an order assessing penalties.

- b. The Federal Home Loan Bank Board (“FHLBB”) promulgated regulations regarding indemnification of S&L D&O’s. See 12 CFR 545.121. FHLBB regulations continue to apply to formerly FSLIC-insured institutions, unless they are superseded by new regulations of the Office of Thrift Supervision (“OTS”). Among other things, those regulations require the institution to give FHLBB (now OTS) at least 60 days notice of the intended indemnification. No indemnification is permitted if OTS objects to the indemnification within the 60 day period. In addition, no indemnification is permitted if the RTC sues D&O’s for wrongful conduct. See, Adams v. RTC, 1993 U.S. Dist. LEXIS 12003 (D.Minn. Aug. 24, 1993); Musselman v. RTC, 1994 U.S. Dist. LEXIS 8642 (N.D. Ill., June 27, 1994). These regulations define the exclusive indemnification rights of D&Os of federal savings and loans unless by-law indemnification provisions adopted by the savings and loan and approved by the FHLBB create different rights. Gallagher v. RTC, 1993 U.S. Dist. LEXIS 15301 (N.D.Ill., Oct. 29, 1993).
- (1) (1) When the RTC assumes control of a failed savings and loan, the corporation’s indemnification obligations are not acquired by the RTC and indemnification for the D&Os in a suit by the RTC “is simply unavailable.” RTC v. Greenwood, Case No. 92-CV-002 (D.Minn., Aug. 23, 1993).
  - (2) Indemnification pursuant to this regulation is mandatory only if the defendant D&O attains a favorable judgment in the enforcement action. Villarreal v. Metropolitan Bank and Trust Co., 213 Ill. Dec. 812, 660 N.E.2d 69 (Ill. App. 1995).
  - (3) Indemnification pursuant to this regulation is not authorized when the financial institution is insolvent. RTC v. Baker, 1994 U.S. LEXIS 16218 (E.D. Pa. 1994).
- c. The Crime Control Act of 1990, enacted by Congress in October 1990, authorizes the FDIC to prohibit or limit an insured depository institution or holding company from indemnifying D&O’s against certain loss and from purchasing D&O insurance coverage for that loss.

- (1) Loss potentially subject to this prohibition or limitation includes any liability or legal expense incurred by a director, officer or employee with regard to any administrative proceeding or civil action by a federal banking agency that results in a final order under which the person is (i) assessed a civil money penalty; (ii) removed or prohibited from participating in conduct of the affairs of the depository institution; or (iii) required to take certain affirmative action pursuant to a cease-and-desist order.
- (2) Proposed regulations have been issued by the FDIC to implement the statute. Both the statute and the proposed regulations do not appear to prohibit the D&Os from directly purchasing their own insurance to cover these losses. Thus, D&Os may choose to personally pay a small portion of the bank's D&O insurance premium in order to maintain coverage for these losses.

7. From the corporation's standpoint, D&O insurance also shifts the risk of liability for indemnification claims to a third party. Thus, in addition to assuring the directors and officers of financial protection, D&O insurance also serves as a risk management tool to address potentially large corporate exposure.

## VI. CONCLUSION

- A. The area of D&O indemnification is complex and raises difficult corporate, management, legal and financial issues. Because the law and legal creativity relating to indemnification are constantly evolving, a corporation's indemnification program should similarly evolve. Absent thoughtful analysis and state-of-the-art implementation of indemnification planning, directors and officers may forego financial protection which is otherwise available for uninsured exposures, thereby subjecting their personal assets to risk unnecessarily.
- B. This analysis also is important as corporations maintain higher D&O insurance retentions for the corporate reimbursement coverage and as corporations consider alternative D&O insurance products such as those offered by CODA and Aetna which provide only D&O but not corporate reimbursement coverage.

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