Corporate Indemnification Agreements: Selected Issues to Consider
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The Sarbanes-Oxley Act, corporate governance reforms and increased public scrutiny focused on the responsibilities of corporate directors and officers have led many corporations and their advisers to consider whether a corporation’s directors, officers and other representatives (collectively, “corporate representatives”) are adequately protected against the personal liability that can arise from their service on behalf of the corporation. Corporate representatives can potentially derive protection against personal liability from various sources, including state indemnification and exculpation statutes, indemnification provisions of a corporation’s charter or bylaws and coverage under directors’ and officers’ liability insurance policies. These protections must be considered together and individually as part of a comprehensive corporate indemnification package.

In addition, depending upon a corporation’s philosophy concerning indemnification of its corporate representatives and the relative bargaining power between the parties, a corporation might also enter into an indemnification agreement with selected corporate representatives. An indemnification agreement typically provides protection for a corporate representative against personal liability that is broader in certain respects than the protection provided under applicable state law or a corporation’s charter or bylaws. Additionally, an indemnification agreement provides contractual protection of a corporate representative’s indemnification rights which ordinarily requires his or her consent to alter or void such rights.

The particular facts and circumstances involved in any situation must be considered in determining whether contractual indemnification arrangements are advisable or necessary. In evaluating whether the selective use of indemnification agreements is appropriate for a corporation, consideration should be given to the extent to which these contracts are perceived to be beneficial in attracting and retaining qualified corporate representatives, as well as the scope of the protection from personal liability afforded to these persons from the other potential sources of protection mentioned above.

In addition, state laws may vary with respect to a corporation’s authority to enter into indemnification agreements with its corporate representatives and as to the potential enforceability of particular contractual indemnification provisions that deviate from the applicable state indemnification statute. Many state indemnification statutes include a “nonexclusivity” clause declaring that statutory indemnification is not deemed exclusive of any other indemnification rights that may be available to a person, including any rights to indemnification under an agreement. Corporations and their advisers should, however, examine applicable law, both statutory and common, for potential limits on the extent to which a corporation can deviate from the applicable statutory indemnification scheme in providing contractual indemnification to corporate representatives. Additionally, interested director transaction and similar statutory provisions should also be considered where applicable with respect to a corporation’s approval of indemnification agreements with selected corporate representatives.

The following list highlights critical indemnification issues that should be considered in the context of negotiating a comprehensive indemnification agreement.
Mandatory Indemnification

A corporate representative is usually entitled to indemnification by the corporation, under state indemnification statutes, for expenses incurred in defense of a proceeding as a result of serving the corporation only to the extent he or she is successful in such a defense. Corporations are frequently also permitted, but not required, to indemnify a corporate representative under permissive state indemnification statutes. Consideration may be given to including a provision in an indemnification agreement providing for mandatory indemnification of the corporate representative against personal liabilities incurred as a result of serving the corporation. Such a contractual provision might, for example, obligate the corporation to indemnify the corporate representative “to the fullest extent permitted by law.” A contractual right to indemnification is sometimes predicated on a determination by the board or other reviewing party that a corporate representative possessed a particular state of mind or met a particular standard of conduct with respect to his or her actions that form the basis for an indemnification claim.

When contractual indemnification depends on a determination concerning the corporate representative’s conduct, such a provision frequently mirrors the requirements set forth in the applicable permissive statutory indemnification provision. For example, the agreement might require a determination that a person seeking indemnification has acted in good faith and in a manner he or she believed to be in or not opposed to the best interests of the corporation, and with respect to criminal actions or proceedings, had no reasonable cause to believe his or her conduct was unlawful. Once a favorable determination is made, the corporate representative will be contractually entitled to be indemnified by the corporation rather than being subject to the corporation’s discretion to indemnify pursuant to statutory indemnification. As discussed below, an indemnification agreement might also contain certain procedural rights in favor of the corporate representative where such a determination is adverse or is not timely made following a claim for indemnification. Additionally, even where the corporation’s charter or bylaws include a provision having the effect of making the corporation’s indemnification obligation mandatory in circumstances where it would be permissive by statute, a contractual confirmation of such an obligation can provide assurance to a corporate representative that his or her right to indemnification will not be altered or voided without such person’s consent.

Mandatory Advancement of Expenses

Corporations are authorized under virtually all indemnification statutes to pay the expenses incurred by a corporate representative in defending a proceeding in advance of the final disposition of the proceeding. A contractual right to the mandatory advancement of expenses prior to the disposition of any proceeding can ensure that a corporate representative has the financial resources necessary to undertake a vigorous defense in any proceeding arising from actions taken on behalf of a corporation. Applicable state law might require a corporate representative to furnish an undertaking to repay amounts advanced by a corporation if it is ultimately determined that he or she is not entitled to be indemnified. Whether an undertaking by a corporate representative to repay advanced expenses could be deemed to be a company loan in violation of the Sarbanes-Oxley Act has not been resolved definitively, but the predominant view among corporate lawyers is that these arrangements should not be likely to violate the Sarbanes-Oxley Act.
Procedural Matters

A corporate representative may seek certain procedures in an indemnification agreement applicable to certain determinations regarding the rights and obligations of the parties under the agreement. These procedures might include placing the burden on the corporation to prove that the corporate representative is not entitled to payments or advances that he or she claims under the agreement; implementing a litigation “appeal” right to a judicial de novo determination of indemnification rights where there has been a determination adverse to the corporate representative; providing for a deemed favorable determination where there is a failure to act upon a request for indemnification within a certain period of time; and providing for the right to have an independent “reviewing party” make determinations concerning the right to indemnification in particular circumstances. In addition, the parties might consider providing in the agreement that the termination of any proceeding by judgment, order, settlement or conviction, or a plea of nolo contendere or its equivalent, does not create a presumption or inference that the representative did not have any particular belief or did not meet any particular standard of conduct, or that a court has determined that the corporation is not obligated to the corporate representative under the agreement.

Directors’ and Officers’ Liability Insurance

The parties may wish to include a provision that sets forth the obligations, if any, of the corporation to maintain D&O insurance covering the corporate representative. Such a provision might establish certain minimum amounts of coverage or specified policy coverage amounts dedicated solely to coverage of directors and officers, which may be beneficial in the context of corporate bankruptcy. A provision requiring maintenance of D&O insurance might also include specified circumstances in which the corporation’s obligation to maintain D&O insurance is limited, or eliminated, for example, due to adverse market conditions for D&O products. The issues that might be considered in evaluating the terms of a D&O policy are beyond the scope of this publication.1

Selection of Counsel

The corporation and the corporate representative may want to agree in advance on the circumstances in which the corporation will advance expenses or indemnify a corporate representative in connection with his or her retention of separate counsel in any proceeding for which the corporate representative seeks advancement of expenses or indemnification under the agreement. In particular, the parties might consider specifying their respective rights and obligations with respect to retention of separate counsel in circumstances where there may be a conflict between the corporation and the corporate representative in a covered proceeding.

Fees on Fees

The parties may wish to consider the circumstances, if any, in which the corporate representative is entitled to reimbursement of expenses incurred in enforcing indemnification rights. The statutory right to recovery of these amounts, sometimes referred to as “fees on fees,” is unsettled in many jurisdictions and

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1 A representative list of issues that a corporation might consider in procuring D&O insurance appeared in an earlier K&L publication entitled “Checklist of Selected D&O Insurance Issues.” To obtain a copy of this publication, contact Tom Reiter, an attorney in our firm’s insurance coverage group, at treiter@kl.com.
under the law of certain states, such as New York, fees on fees will not be recoverable except as contractually
agreed or as otherwise provided by a corporation’s charter or bylaws.\(^2\) Consideration may also be given to
agreeing whether or not the corporate representative is entitled to advancement of amounts incurred in
seeking to enforce an indemnification claim against the corporation in advance of the disposition of any such
proceeding.

**Covered Proceedings and Expenses**

The parties may consider agreeing on the scope of proceedings covered by the indemnification
agreement. For example, the corporate representative may seek assurance that contractual indemnification
rights extend to a wide variety of civil and criminal actions, suits and proceedings, both formal and informal,
including pending, threatened or completed judicial proceedings as well as administrative, investigative and
arbitration and alternative dispute resolution proceedings. In addition, the parties might consider the
circumstances, if any, in which the corporate representative will be entitled to indemnification rights in any
proceeding brought by the corporate representative. The parties may also want to clarify whether the
corporate representative is covered under the indemnification agreement with respect to services rendered
to corporate subsidiaries, benefit plans and other affiliated entities, as well as service on behalf of another
corporation or entity at the request of the corporation.

Consideration may also be given to specifying the expenses and other amounts covered by the
agreement. For example, the parties may want to consider whether the corporate representative is entitled
to be indemnified for judgments and amounts paid in settlement of actions brought by or on behalf of the
corporation, as well as any limitation on indemnification in such circumstances under applicable law. The
parties may also consider clarifying whether expenses incurred preparing for and being a witness are
indemnifiable under the agreement.

**Partial Indemnification**

Under some circumstances, a corporate representative may be entitled to contractual indemnification
for some but not all expenses incurred in a covered proceeding. The agreement may include a clause that
confirms the corporation’s obligation to indemnify the corporate representative for the portion of expenses
for which he or she is entitled to be indemnified. Partial indemnification may arise, for example, where a
court interpreting an indemnification agreement has determined that certain amounts incurred by a
corporate representative are not appropriate for indemnification, or where it is otherwise determined that a
representative is entitled to be indemnified for amounts incurred with respect to some but not all of the
claims arising in a proceeding for which a representative seeks indemnification.

**Changes in Law or the Corporation’s Charter or Bylaws**

The right to indemnification and advancement of expenses may be affected by legislation, decisional law
and changes to a corporation’s charter or bylaws. A corporate representative, therefore, may seek to include a

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\(^2\) Two recent court decisions that highlight the potential importance to corporations and their representatives of whether or not
“fees on fees” will be recoverable in the absence of express language providing for such recovery were discussed in the
November 2002 K&L Alert entitled “Can Directors And Officers Recover From Their Corporation Fees They Incur To Obtain Indemnity
From The Corporation Under Applicable Indemnification Agreements and Bylaws? New York and Delaware Courts Take Different
provision in an indemnification agreement which provides that any change in law or in the corporation’s charter or bylaws which narrows the right to receive payments under the agreement will have no effect on the parties’ rights or obligations under the agreement, except as required by applicable law.

Severability

Many jurisdictions have little decisional law determining the validity or enforceability of provisions that may be included in an indemnification agreement. Accordingly, the parties should consider including a severability clause that protects the validity and enforceability of the agreement to the greatest extent possible in the event that any provision is determined, in whole or in part, to be invalid or unenforceable under applicable law. Enforceability of particular contractual indemnification provisions might be limited where, for example, a court determines that indemnification under the particular circumstances is contrary to public policy or where provisions of an agreement are inconsistent with applicable substantive statutory indemnification provisions and in other circumstances.

Nonexclusivity of Rights

As discussed above, there are potentially many sources of protection for a corporate representative against personal liability arising from their service in such capacity. For example, corporate representatives may have indemnification rights under a corporation’s charter or bylaws, statutory indemnification provisions and D&O insurance. An indemnification agreement may include a provision that makes the right to indemnification under the agreement nonexclusive of any other rights that the corporate representative may have from other sources to protect against personal liability.

Change in Control

Corporate representatives may face considerable uncertainties concerning the availability of corporate indemnification following a change in control of the corporation. For this reason, corporate representatives may seek a broad successor-in-interest clause providing for continued contractual indemnification rights following a change in control of the corporation, including a merger or sale of all or substantially all of the corporation’s assets. A change in control provision may also trigger other rights under the agreement, including establishment of a “reviewing party” to make determinations of the corporate representative’s entitlement to indemnification under the agreement upon the occurrence of a change in control.