

Indemnification Considerations for Directors and Officers of Delaware Entities

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Directors and officers (Ds&Os)¹ face exposure to potential personal liability for claims made against them in their capacity as directors and officers of the companies that they serve. This article is Part One in a two-part series that will consider the principal protections that may be utilized to protect Ds&Os against personal liability in connection with such claims: Part One provides a “nuts and bolts” overview of key indemnification and advancement provisions for Ds&Os of Delaware entities, and Part Two will provide an overview of the interplay between D&O liability insurance and the protection afforded by indemnification provisions in organizational documents and separate indemnification agreements.

Delaware law is well-settled that the rights to indemnification and advancement are distinct. Indemnification is, generally speaking, a reimbursement by a company of its Ds&Os for expenses or losses they have incurred in connection with litigation or other proceedings relating to their service to the company. Advancement provides for the payment of legal expenses as incurred, in advance of the final disposition of the litigation or other proceeding, and is often conditioned upon receipt of an undertaking from the individual D&O to repay amounts advanced if it is ultimately determined that he or she is not entitled to indemnification for failure to meet the required standard of conduct.

Delaware Corporations

By statute, Delaware has established a minimum “standard of conduct” that, if met by a director or officer, permits a corporation to indemnify such director or officer pursuant to a charter or bylaw provision, an indemnification agreement with such D&O, or a resolution of the board or stockholders. For third-party actions, he or she must act (1) in good faith and (2) in a manner reasonably believed to be in or not opposed to the best interests of the company, and (3) with respect to any criminal action or proceeding, he or she must have no reasonable cause to believe that his or her conduct is unlawful.² For actions brought by the corporation against a D&O, including any derivative actions brought by stockholders in the right of the corporation, the director or officer must meet the requirements described in clauses (1) and (2) above, plus an additional requirement that, if he or she is found liable to the corporation, there must be a determination by the Court of Chancery (or the court in which the action was brought) that, despite such adjudication of liability, the individual is “fairly and reasonably” entitled to indemnity for expenses in view of all the circumstances.³

In either case, if the director or officer of a Delaware corporation is ultimately determined to have acted in bad faith, indemnification is not available. Further, even in the absence of a charter provision, a bylaw provision or an indemnification agreement providing Ds&Os with the right to indemnification, a corporation is required by statute to indemnify directors and certain senior officers for expenses actually and reasonably incurred in the defense of any action or proceeding relating to the service as a D&O

¹ All references herein to Ds&Os also are intended to include, where applicable, individuals serving as managers of a Delaware limited liability company.

² See 8 Del. C. § 145(a).

³ See 8 Del. C. § 145(b).

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if he or she has been successful on the merits or otherwise.⁴ Other than such required indemnification, however, Delaware corporations are not required to provide Ds&Os with the right to indemnification, and advancement of expenses to Ds&Os is never required. It is purely permissive.⁵ Within these parameters, Delaware corporations have broad leeway to set the parameters for indemnification of Ds&Os.

Delaware LLCs

For Delaware limited liability companies (LLCs), there is greater flexibility to provide indemnification and the right to advancement.⁶ The standards described above for Delaware corporations do not apply to LLCs, which are authorized by statute to indemnify managers, members or other persons for “any and all claims and demands whatsoever,” subject to the standards and restrictions, if any, as set forth in the LLC agreement and subject to public policy considerations. Thus, Delaware LLCs and their managers, members, officers and similarly situated individuals should closely examine the entity’s governing documents to determine what protection, if any, is conferred. Importantly, if the underlying operating agreement contains no provision regarding indemnification and the individual is not party to a separate indemnification agreement with the company, indemnification will not be available (absent resolution of the managers or members) even if it would have been required if the individual were a director of a Delaware corporation.⁷ Similarly, advancement rights are established either in the operating agreement or in a standalone indemnification agreement.

Indemnification Agreements

While Delaware entities typically set forth indemnification and advancement rights in their certificate of incorporation, bylaws or LLC agreement, a standalone indemnification agreement can provide Ds&Os of both Delaware corporations and Dela-

ware LLCs with a greater degree of certainty that they will be protected in the event of an indemnifiable event.⁸ Setting forth indemnification rights in a separate agreement ensures they cannot be unilaterally amended by the entity without the D&O’s consent. Further, in light of the recent amendments to Section 145, only certain officers are entitled to mandatory indemnification of expenses as a matter of law when they are successful on the merits; an indemnification agreement allows a director or officer to secure such rights in the absence of express statutory coverage. Indemnification agreements also allow the indemnitee and the company to clarify the requirements for indemnification (subject to applicable law) and advancement rights and the manner in which they will be administered. Although such rights may not be independently sufficient if, for example, the company is insolvent, they are nonetheless critical for Ds&Os. Below are certain key provisions that should be considered by both the company and the individual D&O when negotiating such an agreement:

- **Scope of Indemnification:** Indemnification agreements may provide for indemnification to the fullest extent permitted by Delaware law. Thus, if the agreement relates to a Delaware corporation, both parties should be familiar with the outer legal limits of indemnification, as outlined above. In the case of a Delaware LLC, careful attention should be given to any indemnification or advancement provisions in the operating agreement.
- **Key Defined Terms:** Terms used to define the scope of indemnification (e.g., “claims,” “proceedings,” “expenses” and “losses”) can be defined to cover any and all types of legal claims and proceedings (including alternative dispute resolution proceedings and investigations) and all manner of expenses (including legal costs) and potential monetary awards, judgments or amounts paid in settlement that an individual may incur. Special attention should be paid to the scope of conduct (potentially captured by a term such as “indemnifiable event”) that is covered by the agreement, including, for example, whether the indemnitee’s service for other entities (including any subsidiaries) at the request of the company is covered.
- **Changes in Law:** The agreement may provide that subsequent changes in the law will not reduce the benefits available to the indemnitee but that the indemnitee is entitled to the benefit of any changes that broaden those rights.

⁴ See 8 Del. C. § 145(c). On July 16, 2020, certain amendments to Section 145 of the Delaware General Corporation Law (the DGCL) became effective that, among other things, limit the universe of “officers” that are entitled to mandatory indemnification under Section 145(c) to: (1) the president, (2) the CEO, (3) the COO, (4) the CFO, (5) the CLO, (6) the controller, (7) the treasurer and (8) the CAO. These amendments apply to any acts or omissions after December 31, 2020, and are discussed in greater detail in the June 25, 2020, Skadden client alert by Allison L. Land and Edward B. Micheletti, *Delaware Corporate Law Amendments Address Emergency Powers, Public Benefit Corporations and Other Matters*.

⁵ See 8 Del. C. § 145(e).

⁶ See 6 Del. C. § 18-108.

⁷ *In re AHL Holdings LLC*, 675 F. Supp. 2d 462, 484 (D. Del. 2009) (declining to order indemnification of managers in connection with successful defense of counterclaim alleging breach of fiduciary duty where the operating agreement contained no indemnification provision).

⁸ Section 145(f) of the DGCL specifically provides that indemnification and advancement rights in a company’s charter or bylaws are not exclusive of other such rights that a director or officer is entitled to by agreement. See 8 Del. C. § 145(f).

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- **'Fees on Fees':** The agreement also may specifically provide for, or preclude, expenses incurred in successfully asserting a claim for indemnification or advancement under the agreement or the company's governing documents.⁹
- **Advancement:** Because advancement is not mandatory (unless required by the entity's organizational documents), the agreement may provide that the company "shall" provide advancement. Attention also should be given to whether the advancement language (including relevant defined terms) captures expenses incurred by the individual both as a current and former director or officer.¹⁰ The agreement also may outline the scope of any undertaking required of the indemnitee and identify a period of time in which the company must make advance payments.
- **Determination of Entitlement:** The agreement can establish a framework for determining whether the director or officer has met the requisite standard of care required by statute. The determination can be made, for example, by a majority of disinterested directors or by shareholder vote or, upon a change of control, by a legal opinion from independent counsel. The agreement also may set forth a time frame in which this determination should be made and establish a means by which the indemnitee may appeal or contest the determination, including by separate legal action.
- **Presumptions:** The agreement may provide for a presumption that the indemnitee is entitled to indemnification, which would apply to any determination of whether he or she has met the requisite standard, and establish a specific (*e.g.*, clear and convincing) burden that must be met by the company to rebut that presumption. It also may clarify, in accordance with Delaware law,¹¹ that any judgment, order or settlement will not create a presumption that the director or officer did not meet the requisite standard. The indemnitee also may obtain a presumption that he or she met the standard if he or she relied in good faith upon the company's records or professional advisers.
- **Joint Indemnification Obligations:** Often, a director or officer may have indemnification rights separate from those offered by the company, including from a private equity fund or other sponsor. In this case, it is important for both parties to specify the relative priority of each indemnitor source in the event multiple parties are liable to the director or officer for indemnification.¹² For example, the agreement can make clear that the portfolio company is the primary obligor, effectively triggering liability for the private equity sponsor only if the portfolio company is unable to fully indemnify the director or officer, in which case the sponsor should be subrogated to the rights of recovery of the indemnitee vis-à-vis the company.
- **Insurance:** The agreement also may require the company to maintain director and officer insurance for the indemnitee in an amount not less than that available to any other director or officer, and clarify that any such insurance would respond prior to any indemnification obligations of the company, as well as any insurance policies held by a sponsor.
- **Company Participation:** The agreement may contain a provision requiring the indemnitee to notify the company of potentially indemnifiable proceedings, and allowing the company to participate in the defense of any such action. However, these provisions also can allow the director or officer some measure of control over these participation rights, including by requiring their consent to any counsel proposed by the company and permitting the indemnitee to retain separate counsel in certain circumstances (*e.g.*, conflicts). Further, the agreement can limit the company's ability to unilaterally settle, including by mandating the consent of the director or officer before the company can execute a settlement that does not contain a release in his or her favor.
- **Modification:** As opposed to indemnification and advancement rights created by the company's organizational documents, which may be amended by the board or shareholders, indemnification agreements allow the director or officer to prevent the company from unilaterally terminating or reducing the indemnitee's rights. Although a provision allowing for such unilateral amendment would be highly unusual, attention should be given to ensure that the agreement provides that the company's obligations thereunder may only be amended with the written consent of the director or officer.

⁹ The general rule is that an officer or director is entitled to reasonable expenses incurred in prosecuting a claim for indemnification unless the governing document or indemnification agreement expressly provides otherwise. See *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561-62 (Del. 2002).

¹⁰ In contrast to indemnification provisions that incorporate Section 145 of the DGCL, the Court of Chancery has narrowly construed advancement provisions, requiring express language covering former officers. See, *e.g.*, *Charney v. Am. Apparel, Inc.*, No. CV 11098-CB, 2015 WL 5313769, at *7-8 (Del. Ch. Sept. 11, 2015).

¹¹ See 8 Del. C. § 145(a).

¹² Otherwise, a director's sponsor may be jointly liable and left with only an action for contribution against the company in the event it fully indemnifies a director. See *Levy v. HLI Operating Co.*, 924 A.2d 210, 224 (Del. Ch. 2007).