

Am I Covered? Understanding the Scope and Availability of Directors' and Officers' Indemnification and Advancement Rights

By Oderah C. Nwaeze and Jaclyn C. Marasco

Every so often, a news story breaks involving corporate greed or wrongdoing. It might be an oil spill allegedly caused by a pattern of ignoring internal risk memoranda in order to chase profits or a public company that fabricated its financials to hide years of underperformance. Regardless of the storyline, the company accused of unlawful conduct often becomes synonymous with scandal. By way of example, it is difficult to hear the name Theranos without being reminded of the controversies that plagued the company.

But corporations are not self-governing. Instead, they are controlled by directors and officers, whose decisions, strategies, acts, and omissions are what lead to civil lawsuits, government investigations, and criminal complaints, including:

- Administrative and civil proceedings concerning violations of securities laws.
- Civil liability stemming from breach of fiduciary duty allegations.
- Criminal proceedings and investigations under the Foreign Corrupt Practices Act.
- Civil or criminal exposure for fraud, financial misstatements and other financial crimes.
- Civil or criminal litigation stemming from mass tort liability.

When dealing with challenges to or investigations regarding their corporate conduct, directors and officers face significant financial exposure in the form of attorneys' fees, fines and personal judgments. Even for wealthy directors and officers, the personal liability associated with their roles could lead to bankruptcy — a significant disincentive for otherwise ideal executive candidates.

To address this concern, directors and officers are entitled to some form of indemnification and advancement to limit financial exposure associated with their roles. Often, corporations rely on their own coffers to satisfy indemnification obligations. But since companies cannot control when or how frequently they will be investigated or sued, self-funding advancement and indemnification are extremely costly and could interfere with a company's ability to operate its business and accomplish strategic initiatives. For that reason, among others, many corporations satisfy their indemnification obligations through insurance policies.

As a starting point for anyone considering or starting a role as a corporate director or officer, this article explores (1) the basics of indemnification and advancement rights under Delaware law; (2) the impact of corporate insolvency on indemnification and advancement rights; and (3) how directors' and officers' insurance policies ("D&O insurance") are used to mitigate liability exposure, including a discussion of cost and best policies. This article will focus primarily on Delaware law because approximately 66% of the Fortune 500 and more than half of all public companies are incorporated in Delaware, and Delaware has the most developed body of corporate law decisions.

The Definition and Scope of Indemnification and Advancement Rights Under Delaware Law

Delaware law provides directors and officers with two primary mechanisms for protecting against any personal financial liability that might stem from the proper discharge of their duties. Those are indemnification and advancement, and both emanate from Section 145 of the Delaware General Corporation Law (“DGCL”). 8 *Del. C.* § 145. Indemnification refers to the right to have a company reimburse current or former directors or officers for all losses, including legal fees, incurred in connection with litigation arising from actions taken in service to the company or at the company’s direction. It is a final reimbursement that occurs after the underlying proceeding has concluded.

Advancement rights, on the other hand, require the company to pay a current or former director’s or officer’s legal fees as they are incurred, and before a final resolution. It is, in other words, an “advance” or credit toward future indemnification. Under 8 *Del. C.* § 145(e), advancement is statutorily conditioned upon the director or officer’s *undertaking* to repay the advanced fees if indemnification is ultimately found to be inappropriate. Both indemnification and advancement rights apply to threatened, pending, or completed lawsuits or proceedings, where, by virtue of an individual’s role as a director or officer, the director or officer faces legal exposure or costs. The scope of these operative rights is governed first by the company’s bylaws, charter, or indemnification agreement, and if silent, the DGCL.

To be entitled to indemnification or advancement under the DGCL, a director or officer must have acted in a manner he or she reasonably believed to be in the best interest of the corporation. Generally, directors and officers are not entitled to indemnification for any claim, issue or matter where he or she has been found liable or to have acted unlawfully. If a director or officer received advancement before being found liable for having acted unlawfully, he or she must reimburse the corporation the amounts advanced.

With respect to criminal proceedings, a director or officer is entitled to indemnification or advancement only if he or she had no reasonable basis to believe that his or her conduct was unlawful. Under DGCL Section 145(a), the termination of a criminal action by settlement, conviction, or plea of *nolo contendere* “shall not, of itself, create a presumption” that the person did not act in accordance with the requisite standard of conduct. 8 *Del. C.* § 145(a). Thus, a director or officer may be entitled to indemnification or advancement for anything short of being found guilty of all criminal charges.

Mandatory or Permissive: Not All Indemnification and Advancement Rights Are Created Equal

Indemnification rights are either permissive or mandatory. Mandatory indemnification provisions require a corporation to indemnify the director or officer — typically where *the director or officer has been successful on the merits* of either a third-party claim or a claim brought by or on behalf of the corporation.

In most other situations, indemnification is permissive, meaning that the director or officer has not been successful on the merits but may be entitled to some form of indemnification based on

the company's bylaws, charter, or indemnification agreement. With respect to the indemnification rights of current directors or officers, it is common for governing documents to task the following with the authority to determine the scope of indemnification rights: (1) directors who are not a party to the proceeding giving rise to the indemnification demand; (2) a committee of directors who are uninvolved in the underlying litigation and selected by a majority of the board; (3) independent counsel in a written opinion; or (4) stockholders. The decision whether to indemnify former directors and officers is typically made by any person with the corporate authority to make that decision.

Under Delaware law, advancement always is treated as permissive. Thus, directors and officers must look to the scope of the advancement provisions in their corporation's bylaws, charter or other governing agreement. That said, to entice quality candidates, many corporations have adopted bylaw provisions permitting mandatory advancement, subject only to the director's or officer's undertaking. Even where the director or officer does not sign an undertaking, there is case law indicating that the receipt of advancements carries with it an implicit obligation to repay them if the recipient ultimately is not entitled to indemnification. Advancement need not be authorized by the board — only the person or people with authority to act on behalf of the corporation with respect to such matters.

The Impact of Insolvency on Advancement and Indemnification Rights

When considering directors' and officers' indemnification and advancement rights, it often is tempting to end the analysis at the scope of those rights under the governing documents or relevant statutes. Routinely overlooked is how the company plans to fund those obligations. Since many companies deploy their own capital to advance attorneys' fees or to reimburse legal costs and judgments, directors and officers should be aware of what happens to their indemnification or advancement rights when their company becomes insolvent or lacks sufficient capital. The answer may be unsettling for many directors and officers. Indeed, when a corporation is insolvent or bankrupt, its directors' and officers' indemnification and advancement rights could be worthless.

Andrikopoulos v. Silicon Valley Innovation Co., LLC, 120 A.3d 19 (Del. Ch. 2015), *aff'd*, 142 A.3d 504 (Del. 2016), is an example of that reality in the insolvency context. In that case, the plaintiffs sought advancement from the defendant-company, an insolvent entity whose only assets were contingent claims against its former directors and officers. During the litigation, the defendant-company conceded that the plaintiffs were entitled to advancement, but since the company had become insolvent, there was a question of whether the plaintiffs' advancement claims would take priority over any other claims. Ultimately, the Court of Chancery held that the plaintiffs' advancement claims must receive the same treatment as claims by unsecured creditors and would be paid pro rata from the assets, if any, remaining after higher priority debts had been satisfied.

In *In re Mid-American Waste Systems, Inc.*, 228 B.R. 816 (Bankr. D. Del. 1999), the bankruptcy court reached an even harsher result. In that case, the debtor-company's equity holders commenced a post-petition class action against the debtor-company's former directors and officers for securities law violations. The former directors and officers then asserted their indemnification claims against the debtor-company and sought administrative priority treatment

for those claims. The bankruptcy court opined that “an indemnification claim by an officer or director based on that officer’s or director’s prepetition services is not a claim ... that is entitled to administrative expense priority.” *Id.* at 821; *see* 11 U.S.C. § 503(b)(1)(A).

The bankruptcy court further explained that “indemnification claims are merely claims for prepetition compensation for services rendered, not unlike salary or other benefits” and thus, constitute general unsecured claims. 228 B.R. at 821. Broadly construing 11 U.S.C. § 510(b), the *Mid-American Waste Systems* court subordinated the directors’ and officers’ indemnification claims attaching lower priority equal to that of the debtor-company’s equity holders. *Id.* at 826 (“because Congress intended the holders of securities law claims to be subordinated, why not also subordinate claims of ... officers and directors ... who play a role in the purchase and sale transactions which give rise to the securities law claims?”).

In some instances, indemnification claims filed against a debtor-company may be disallowed in their entirety. In *In re Touch America Holdings, Inc.*, 409 B.R. 712 (Bankr. D. Del. 2009), for example, the debtor-company, along with its directors and officers, were named defendants in various civil actions. As the civil matters lumbered on, the directors and officers filed proofs of claim in the bankruptcy case for indemnification, reimbursement and contribution for costs incurred and for any judgment of liability entered against them in the civil actions.

The bankruptcy court ultimately disallowed the directors’ and officers’ claims under 11 U.S.C. § 502(e)(1)(B) because the claims were (i) for reimbursement, (ii) contingent on the resolution of the underlying litigation, and (iii) claims in which the debtor and its directors and officers were co-liable. *Id.* at 716; *see also* 11 U.S.C. § 502(e)(1)(B); *but see In re RNI Wind Down Corp.*, 369 B.R. 174, 181 (Bankr. D. Del. 2007) (allowing a standalone claim for advancement (i.e., not as a component of an overall indemnification claim), notwithstanding 11 U.S.C. § 502(e)(1)(B), because the debtor and its officer could only be co-liable on the underlying claims, and *not* the defense costs associated with such claims).

Thus, directors and officers who have negotiated robust indemnification or advancement rights for themselves and have not acted unlawfully or breached their fiduciary duties could still be exposed to the financial liability they sought to avoid. One way to mitigate that risk is through D&O insurance policies. *See* Personal liability of employees — Corporate employees who directly commit criminal violations, 1 *White Collar Crime* § 3:23 (3d ed.) (“[o]nce a corporation becomes insolvent, outside directors often lose the protection of indemnification and must look to insurance coverage as an exclusive protection against lawsuits.”). Depending on the type of coverage, directors and officers may be able to mitigate the risk of personal liability that could arise during their time in service to the company, including in the context of bankruptcy.

Mitigating Liability Exposure Through D&O Insurance Policies

When a company files for bankruptcy, certain factors affect how D&O insurance proceeds may be used to cover claims against the company’s directors and officers, including the type of insurance agreement contained in the D&O policy (i.e., Side A, B, or C). Side-A agreements provide coverage for individuals, covering both loss (meaning damages, settlements and judgments) and defense costs (meaning reasonable and necessary costs, charges, and expenses

incurred by the insureds in the defense of a covered claim) that are incurred by the directors and officers of the insured company that are *not* indemnified by the company.

In some D&O insurance policies, the Side-A coverage may specify that the lack of indemnification can result from either a legal prohibition on indemnification for the particular costs in question, or the company's inability to indemnify certain costs by reason of insolvency. Side-B agreements, on the other hand, provide coverage for loss *to the company*, including defense costs incurred by the insured directors and officers that are indemnified by the company. Finally, Side-C agreements provide coverage for loss *incurred by the company*, including defense costs, as a result of a securities claim made directly against the company.

While courts generally agree that a D&O insurance policy itself is property of the bankruptcy estate (and thus, subject to the automatic stay), the determination of whether the *proceeds* of the policy are property of the estate is controlled by the language and scope of the policy at issue. See *In re Downey Fin. Corp.*, 428 B.R. 595, 603 (Bankr. D. Del. 2010); *In re Allied Digital Techs. Corp.*, 306 B.R. 505, 509 (Bankr. D. Del. 2004). The most predictable outcome is where a standalone Side-A insurance agreement is at issue because the proceeds of Side-A coverage are generally not considered property of a bankruptcy estate and, therefore, not subject to the automatic stay.

When a policy provides direct coverage to multiple parties (i.e., both the company and its directors and officers), “the proceeds will be property of the estate if the depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate’s other assets from diminution.” *Downey Fin. Corp.*, 428 B.R. at 603 (quoting *Allied Digital*, 306 B.R. at 512). Thus, with respect to policies that include Side-A, Side-B, and Side-C coverage, courts often find that depletion of the policy proceeds to indemnify individual directors and officers harms the debtor-company by decreasing the funds available to settle outstanding claims against the debtor-company.

This outcome may differ, however, in the absence of any showing that (i) there are additional claims outstanding under the policy or (ii) “the Debtor . . . made or committed [itself] to payments using [its] entity coverage” — as required to demonstrate that the policy “actually protects the estate’s other assets from diminution.” *Id.* at 604; *Allied Digital*, 306 B.R. at 512. The outcome also would differ if the policy contains a priority of payments provision, prioritizing the payment of indemnification claims against the company’s directors and officers over other claims against the company.

Given these complexities, insurance companies may require — and it is generally advisable for — the debtor’s directors and officers to obtain a comfort order from the bankruptcy court, lifting the automatic stay to the extent it applies, to allow for the payment of D&O insurance proceeds toward covered defense costs in that claim.

Directors and officers of a bankrupt company may also consider run-off insurance coverage to mitigate their financial exposure. Run-off insurance often covers claims made against companies that have been acquired, merged, or have ceased operations, including through bankruptcy. Since the actions taken by the officers and directors of a distressed company are usually subject to heightened scrutiny, run-off insurance shields the acquiring company from liability in lawsuits

against the directors and officers of the acquired company. Such policies are designed to protect policyholders for a defined period of time — usually six years, or long enough to cover any relevant statutory limitations periods. The wording and endorsements for run-off coverage are often carefully tailored to the specific risk presented.

Conclusion

At this point, anyone that has made their way to the end of this article knows one thing: not all indemnification or advancement rights are created equal. To ensure that the director or officer has adequate coverage, he or she must:

- Review the language governing the operative rights to understand what types of conduct are covered.
- Determine whether the indemnification or advancement rights are permissive or mandatory.
- Understand what their litigation exposure is and whether their indemnification rights will be covered by the company or insurance.
- Investigate whether the company has adequate capital to cover indemnification and advancement obligations.
- Consider whether and what type of directors' and officers' insurance is necessary, if any.

Since the circumstances giving rise to the need for advancement or indemnification often are complicated and fast-moving, directors and officers should contact counsel as soon as it appears that their work for the company might lead to some liability.

Oderah C. Nwaeze is a business litigation partner at Faegre Drinker and a first-chair trial attorney who helps clients resolve complex corporate and commercial disputes. Contact him at oderah.nwaeze@faegredrinker.com.

Jaclyn C. Marasco is a finance & restructuring associate at Faegre Drinker experienced in high-profile bankruptcy cases and complex commercial litigation. Contact her at jaclyn.marasco@faegredrinker.com.