Legal and Practical Limits on Indemnification and Advancement in Delaware Corporate Entities

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Directors and officers of Delaware corporations generally expect that the company will provide them with indemnification and advancement in corporate lawsuits.

Indemnification is where the company reimburses the director or officer for the attorneys' fees and costs, and potentially judgments, incurred in connection with claims arising out of the director's or officer's service to the company. Advancement is where the company pays the director's or officer's attorneys' fees and costs prior to the final disposition of the litigation, and is sometimes subject to an undertaking to repay the company if it is ultimately determined that indemnification is unwarranted.

There are, however, several potential exceptions to advancement and indemnification that could potentially leave directors and officers bearing these costs and losses themselves:

- Delaware corporation law provides mandatory "boundaries" for indemnification: a successful defense is always indemnified while persons who were determined to have acted in bad faith cannot be indemnified. Between those extremes, a company has wide discretion to establish its own rules for indemnification.
- Delaware alternative entity law (e.g., LLCs) does not make indemnification mandatory under any circumstances.
- There is no right to advancement under Delaware law. It is left to the entity.
- Indemnification can be restricted by law in certain circumstances.
- Practical considerations regarding D&O policies include risks related to insolvent companies and strategic litigation stresses on shared coverage limits.

Entitlement to Indemnification and Advancement[1]

In general, directors have rights to indemnification under Delaware law and as provided in the corporation's governing documents.

Directors and officers who win their cases are indemnified. Under Delaware law, directors and officers "shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person" if they are "successful on the merits or otherwise in defense of any claim, issue or matter."[2]

In contrast, Delaware law does not allow corporations to indemnify directors and officers if they are found to have acted in bad faith.

Thus, Delaware courts have stated that the "boundaries for indemnification" are "'success' and 'bad faith.'"[3] Within those boundaries, indemnification of directors and officers is permissive.[4] Directors and officers should look to the governing documents (the charter or bylaws) of the corporation for language describing any supplemental indemnification by the corporation. If not supplied in the governing documents (or in addition to such provisions), directors and officers may also secure indemnification rights through contract.

Delaware also allows companies to advance expenses to directors and officers pending the outcome of the litigation. The company can choose to make advancement mandatory or permissive in its governing documents or through a contract with the director, officer or employee. The company can also require a director or officer receiving advancement to execute "an undertaking . . . to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified."[5] Such an agreement to repay sums advanced can be unsecured if the corporation chooses.[6]

For LLCs and other alternative entities, the discretion to provide or withhold indemnification is even broader. Delaware law "gives [alternative entities] wider freedom of contract to craft their own indemnification scheme.[7] Thus, directors, officers, managers and similarly situated people need to closely examine the governing documents of the entity to determine what protection, if any, is conferred.

Notable Exclusions Under Delaware Law

While Delaware law gives corporations the option to confer broad indemnification and advancement rights, those rights are not limitless. As described above, directors and officers can never be indemnified for "bad faith" actions. Two other limits are also notable: the derivative settlement exclusion and the "by reason of" limitation.

Directors and officers cannot be indemnified for payments made to the company in settlements of stockholder derivative suits or other suits brought on behalf of the corporation.[8] Delaware does not "'allow indemnification of judgments or amounts paid in settlement in derivative suits'" because such payments would be "'circular since the corporation would simply be paying itself.'"[9]

Companies have also refused to advance expenses on the grounds that the action did not arise "by reason of" that person's service to the company, especially when the suit was filed after the director or officer left the company.[10] The outcomes of these cases have been mixed; however, even if the director or officer is ultimately successful in pursuing indemnification, the delay in advancing expenses could harm the director's or officer's ability to mount a vigorous legal defense in the underlying litigation.

Trends in Derivative Litigation

Over the last five to ten years, the number of eight- and nine-figure derivative settlements has increased. Where once it was rare to see a derivative settlement for $50 million, in just the last five years, there has been a rapidly increasing number of high-profile derivative settlements in the hundreds of millions. Just one example would be the $137.5 million settlement in the Freeport-McMoran derivative litigation, a case which arose from allegations that conflicts of interest drove Freeport-McMoran to overpay to acquire both a minority-owned affiliate, McMoran Exploration Co., and a rival company that owned 30% of McMoran Exploration, Plains Exploration & Production Co. One commenter described the derivative settlement as "massive" and noted that the structure was "unusual" because the proceeds of the settlement were not delivered to the company, but were paid directly to Freeport stockholders as a special dividend.

1 This article discusses indemnification and advancement under Delaware law. Many states look to Delaware law on principles corporate law and corporate governance, but coverage and limitations can vary by state. Directors and officers of non-Delaware entities should confirm the exact entitlements and exceptions under the applicable laws of their respective states. Outside of the United States, legal rights and obligations with respect to corporate indemnification vary widely, requiring expert legal and insurance advice to avoid potential minefields.

2 8 Del. C. § 145(c).

3 Hermelin v. K-V Pharm. Co., 54 A.3d 1093, 1094 (Del. Ch. 2012).

4 Id.

5 8 Del. C.§ 145(e).

6 See Mariano v. Patriot Rail Co., 131 A.3d 325, 332-37 (Del. Ch. 2016) (analyzing history of Section 145(e) and evolution of undertaking requirement).

7 Weil v. VEREIT Operating P'ship, L.P., C.A. No. 2017-0613-JTL (Del. Ch. Feb. 13, 2018) (citation omitted).

8 8 Del. C. § 145(b); see also Mariano, 131 A.3d at 339.

9 Arnold v. Society for Sav. Bancorp., 678 A.2d 533, 540 n.18 (Del. 1996) (citation omitted).

10 E.g., Meyers v. Quiz-Dia LLC, C.A. No. 9878-VCL (Del. Ch. June 6, 2017); Davis v. EMSI Holding Co., C.A. No. 12854-VCS (Del. Ch. May 3, 2017); Mariano, 131 A.3d at 344-45; Charney v. Am. Apparel, Inc., C.A. No. 11098-CB (Del. Ch. Sept. 11, 2015) (denying advancement of founder, former Chairman and CEO).

Just ten years ago, derivative litigation was dominated by securities class action tag-along suits and run-of-the-mill corporate waste and mismanagement claims. While those cases still permeate state and federal courts, large event-driven litigation has become much more common than it was. Events driving derivative litigation include: sexual harassment; data breaches; privacy violations; M&A transactions; public, workplace and product safety; and antitrust, FDA, FCPA, FCA and other regulatory issues. In these cases, the plaintiffs seek to hold the directors and officers personally liable to make good to the company for legal expenses, settlements, fines and other costs that allegedly resulted from the mismanagement. High profile rulings against directors and officers in derivative suits can also attract the attention of prosecutors and regulators. Every front-page headline can carry the risk of event-driven litigation, and these suits are getting harder to dismiss, more costly to defend and, in many cases, much more costly to settle.

Practical Considerations for D&O Policies

Delaware entities typically purchase D&O policies to cover the costs of indemnification or advancement or to provide coverage where indemnification is unavailable. These policies come with their own considerations. For example, the D&O policies that provide entity coverage may be considered property of the estate for an insolvent company.[11] On the other hand, if a policy "covers directors and officers exclusively" (such as a so-called "Side-A" policy), it is generally considered "not property of the estate."[12] Furthermore, to release proceeds under either type of policy in an insolvency situation, directors and officers may need to petition the bankruptcy court for a "comfort" order authorizing a limited lift of the automatic stay to allow insurance carriers to pay amounts accrued since the petition date and any amounts incurred going forward.

Directors and officers of solvent companies are not immune to risk. For example, many D&O policies have shared coverage limits. Enterprising plaintiffs' attorneys can strategically exclude some or all directors and officers from earlier portions of litigation, only to bring them in as defendants later to exert settlement leverage. Such tactical maneuvers could result in directors and officers finding themselves exposed because they were not a party to the litigation until shared policy limits are at or near exhaustion.

As a result of these risks, directors and officers should carefully consider the benefits of dedicated Side-A coverage, which can help address the increased risks of high-dollar derivative settlements seen over the last decade, the limitations on indemnification rights in bankruptcy and any gaps in indemnification under Delaware law. While policy provisions can vary, Side-A policies generally allow for broader coverage and fewer exclusions, thus providing directors and officers coverage where the company and/or its primary insurance policy fails to.

Prospective, current and past directors and officers of Delaware entities (all generally insureds under D&O policies) can put themselves in the best position to minimize exposure by knowing their rights under Delaware law and knowing the coverage applicable to them under the D&O policies carried by the company. Only then can directors or officers confirm that their expectation of protection from out-of-pocket costs will meet with the reality of future corporate litigation.

[11] In re MF Glob. Holdings Ltd., 515 B.R. 193, 203 (Bankr. S.D.N.Y. 2014).

[12] Id. at 203.

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This article reflects the views of the authors and not the firm or its clients.