

# Difficult Issues: Indemnification and Fee-Advancement

By **Scott M. Himes and Marjorie J. Pearce**

The scenario is familiar: A company comes under investigation for a business practice or a particular deal, or it is sued for securities fraud or for wrongdoing involving a complicated transaction. The company's personnel who are implicated look to the company for financial support and protection.

Most companies, at least where the employee acted in good faith and reasonably, typically want to give some measure of support to their employees in these circumstances. This would include both indemnification for actual liability, and payment of legal fees that the employee incurs in defending himself. State law typically provides a statutory regime for these matters, and most companies have provisions for indemnification and advancement in their bylaws.

But in scenarios like these, important issues may present themselves. Precisely who is entitled to be indemnified and receive advancement of fees? Is advancement of fees a discretionary or mandatory obligation? How does an undertaking — a promise from the individual to repay fees paid by the company if it turns out that advancement was not warranted — come into play? How do these issues fit into the governing statutory

scheme? And are they (or should they be) covered in the company's bylaws?

## Scope of Coverage

Suppose you learn that the Department of Justice (DOJ) has started a broad antitrust investigation involving your corporate client, which will implicate several divisions and numerous personnel. It is often assumed that all employees have at least the right to request advancement and to seek to be indemnified. But this is not necessarily so. What do the state corporate law provisions and the company's bylaws say, and do the bylaws incorporate or go beyond the state law?

For example, New York's Business Corporation Law provides for indemnification and advancement for "officers and directors." Other company personnel — such as those not formally designated with an "officer" title — are not within the scope of the statutory provisions. Indeed, the New York law authorizing indemnification/advancement states that it does not affect "any rights to indemnification to which corporate personnel other than directors and officers may be entitled by contract or otherwise under law." N.Y. Bus. Corp. L. § 721. The very limited legislative history available on this statute confirms that it applies only to officers and directors and that indemnification of other corporate personnel is left to the common law. However, there is very sparse case law addressing this distinction; general principles of agency law give the most guidance, absent a governing bylaw provision or other corporate-governance instrument. This statutory limitation where a New York corporation is involved may be an often overlooked limitation on who, as an initial matter, comes within indemnification/advancement.

For a company incorporated in Delaware, the law is different. Delaware law includes an "employee or agent" of the corporation among those who can be indemnified. Del. Code Ann. tit. 8, § 145(a). The Delaware statute also provides for advance payment of legal fees for officers and directors and for payment for legal fees for directors, officers or "other employees and agents" of the corporation "upon such terms and conditions ... as the corporation deems appropriate." *Id.*

§ 145(e). In short, the scope of covered personnel, by virtue of corporate law itself, is broader and more flexible for a Delaware company than for a New York one. (Other than this coverage expansion, the New York and Delaware statutes are basically the same.) While these are two common jurisdictions, the law for a specific company's jurisdiction must always be consulted.

Corporate law, however, is basically the "default provision." Most companies have bylaw provisions that authorize and prescribe indemnification and advancement. Bylaws can, obviously, address the scope of coverage, limiting indemnification/advancement rights to officers and directors; including "employees" and "agents" or the like; covering former as well as current personnel; or otherwise stating a "hybrid" regime where certain rights apply to certain personnel, or on certain conditions, in a more nuanced approach.

On the other hand, many companies take a plain-vanilla approach in their bylaws, authorizing and prescribing indemnification/advancement "to the full extent provided by" the applicable corporate law. That kind of provision (which, particularly for a smaller business, might exist as an historical matter without ever having received much attention) will merely permit and prescribe indemnification and advancement in

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accordance with whatever the statute says, providing neither more nor less. Every company should make sure that the provision in its bylaws involving indemnification/advancement is consistent with the current policy, goals and intentions of management and the board.

#### **A Discretionary vs. Mandatory Approach**

State statutes typically provide that a company "may" indemnify its personnel and advance fees for them — that is, they generally authorize a permissive approach, allowing, but not requiring, indemnification and advancement. Typically, a mandatory obligation for indemnification does not arise until a proceeding has run its course and a person has defended it successfully. However, a company can consider adopting a mandatory policy for advancement, so that covered company personnel are entitled automatically to receive payment of defense costs from the get-go. Indeed, advancement is important as soon as a person is sued, charged, or comes under investigation, so that the person can retain and pay counsel without having to wait to be indemnified until a favorable outcome is achieved down the road. Having a mandatory policy in place lets personnel know they will have a right to advancement in the event the need arises, as opposed to leaving the decision to a case-specific approach once a claim or potential liability surfaces.

Providing mandatory advancement promotes the main policy rationale for indemnification/advancement: Every business wants to attract and retain capable employees, and providing indemnification/advancement helps recruit able employees and encourages them to perform their duties conscientiously, secure in the knowledge that they will be protected from legal liability and expenses for actions done honestly and in good faith. Furthermore, an allegation, claim, accusation or charge against an employee is far different from an actual determination that the employee acted wrongfully or unlawfully; a business can therefore consider it sound management to "stand behind" its employee by providing advancement, at least until (and unless) improper conduct is proven. Finally, a company's financial support for an employee's defense may enable the employee to present a more effective defense than if left to his or her own resources. Since the company might be liable for an employee's actions, assisting the employee to defend effectively also serves the company's interests.

While personnel are afforded greater protection under a mandatory advancement policy, the flip side is that the company has

limited flexibility or discretion. Being "locked into" advancing fees could pose a major financial commitment, involve the company extensively in the defense of an individual when it does not want to make that kind of commitment, and generally eliminate a case-specific evaluation of whether to provide advancement. Decision-making might be informed by historical information about the number and magnitude of matters a business has faced in the past where indemnification and advancement have been implicated.

Furthermore, a company might consider whether to provide mandatory advancement for certain personnel and discretionary advancement for others. For example, mandatory advancement might be prescribed for directors and officers, and discretionary advancement could be established for employees and agents based on board determination in a specific case. By this approach, the issues and policy considerations of mandatory-or-discretionary advancement combine with the determination of whether advancement rights are afforded to "employees" rather than only officers and directors.

Of course, there is no right answer to discretionary vs. mandatory advancement. The decision is mainly a policy-related, business decision that a company and its counsel should evaluate carefully, based on all of these relevant factors.

#### **Use of the Undertaking**

The statutory provisions permitting advancement typically require that the person receiving the advancement provide an undertaking promising to repay the legal fees if, at the end of the day, it is determined that the person failed to meet the applicable standard of conduct (evinced lack of good faith, lack of reasonableness and the like). A criminal conviction involving deliberate dishonesty, for example, might be the most obvious instance where repayment of advanced fees is required.

Because it is a contract between the employee receiving the advancement and the company, specific terms can be included in the undertaking to further protect the company's interests (these can, conversely, pose issues for the employee); in particular, terms can be used to ameliorate to an extent the company's lack of flexibility if mandatory advancement is adopted. For example, the undertaking can provide that advancement is conditioned upon the employee providing a sworn statement that she believes she acted in good faith, without dishonesty, and not for personal gain. This obviously gives the

company greater comfort that the employee acted properly and is therefore entitled to advancement — and that obtaining recovery down the road from the employee, which frequently poses real uncertainty, might be unnecessary. And if the employee declines to sign such an undertaking (presumably on advice of counsel), the company has additional information that might prove useful in assessing the employment relationship and in defending itself, if necessary, in the matter.

The undertaking can also require the employee to cooperate with the company in connection with the lawsuit, proceeding or investigation. Cooperation has real benefits for the company. Since the company might be liable for the employee's actions, and might be a party itself in the proceeding, the employee's affirmative obligation to cooperate with the company (which often takes the form of counsel collaborating) helps the company. The details of cooperation can also be spelled out, such as a requirement to share documents, submit to interviews by company counsel, and the like.

After-the-fact recovery from an employee who received advancement for legal fees is always a concern. Indeed, the company might have a very difficult time recouping from the employee the amount advanced in the event that the employee is adjudged to have engaged in misconduct. One approach, again through the undertaking, is to require the employee to tender a bond from a third party (such as a surety) to secure the advancement. This typically will be financially onerous, at least for rank-and-file employees. However, a company can consider it in appropriate cases to minimize the exposure from advancement, particularly if a mandatory advancement policy is adopted for any personnel.

#### **Conclusion**

Once an investigation or major lawsuit starts up, corporate personnel are sure to be involved and, consequently, the difficult issues surrounding indemnification and advancement will undoubtedly arise. A company should examine its policies carefully before that happens, to be sure it is prepared for the inevitable issues.