

INDEMNIFICATION OF DIRECTORS AND OFFICERS: DELAWARE AND TENNESSEE

MARK W. PIERCE*

Introduction

In the wake of the recent corporate scandals and subsequent enactment of the Sarbanes-Oxley Act of 2002, aimed at effecting extensive corporate reform, director and officer indemnification has become the subject of heightened debate and scrutiny. Following the Delaware Supreme Court's 1985 decision in *Smith v. Van Gorkom*,¹ "indemnification provisions have become one popular method whereby states have limited traditional core fiduciary duties of corporate law"² Since that time, however, and particularly in the last several years, "there has been a significant increase in the volume of lawsuits launched against corporate directors and officers"³

* Mark W. Pierce is a 2003 *cum laude* graduate of The University of Tennessee College of Law and a 1998 *summa cum laude* graduate of Hillsdale College. Mr. Pierce is an attorney with Shumacker Witt Gaither & Whitaker, P.C., in Chattanooga, Tennessee, where his practice areas include securities, general corporate, and real estate law. The author would like to thank John F. Henry, Jr., Esq. and Christopher J. Raybeck, Esq. for their assistance with this article.

¹ 488 A.2d 858 (Del. 1985).

² Jay P. Lechner, *Corporate Misdeeds and Their Impact Upon Enforceability of Executive Employment Agreement Indemnification Provisions*, 77 FLA. B.J. 20, 22 (May 2003). In *Smith v. Van Gorkom*, the court held that directors' objective fiduciary duties include those of loyalty, care, and candor; imposed liability on directors who acted in a grossly negligent manner in approving a sale of a corporation; and established procedures designed to allow boards to evaluate management proposals properly. 488 A.2d at 858. While *Smith v. Van Gorkom* has since been distinguished by subsequent cases and superseded in part by statute, it remains an important illustration of the potential vulnerability of corporate directors to liability for actions taken in their official capacity with the corporation. See *Emerald Partners v. Berlin*, 787 A.2d 85, 96 (Del. 2001) (acknowledging the General Assembly's enactment of title 8, section 102(b)(7) as a "thoughtfully crafted legislative response to [the court's] holding in *Van Gorkom*." Section 102(b)(7) prevents shareholders from exculpating directors for breaches of loyalty or good faith.).

³ While many state indemnification statutes expressly refer only to corporate directors as candidates for indemnification and advancement of expenses, see, e.g., TENN. CODE ANN. § 48-18-502 (2004), other provisions of state corporate codes routinely extend these protections to officers, employees, and agents of the corporation as well. See, e.g., MOD. BUS. CORP. ACT § 8.56 (1997); TENN. CODE

seeking to impose personal liability upon them.”⁴ Accordingly, due in large part to recent corporate misdeeds, “heightened scrutiny of these still-common [indemnification] provisions is foreseeable.”⁵ The policy rationale behind these provisions is basic and forthright: “[I]n order to attract and retain qualified individuals to serve as directors and officers, corporations have been forced to provide an efficient and comprehensive shield against personal liability. Indemnification has [proved] to be an indispensable component of this shield.”⁶

Indemnification provisions are a feature of corporate law in every state.⁷ The following overview of the statutory law governing indemnification and advancement of expenses in for-profit corporations will focus primarily on Delaware and Tennessee law. In addition, because “Nevada is striving on an ongoing basis to challenge Delaware as the state of choice for incorporation,”⁸ for purposes of clarity

ANN. § 48-18-507. Consequently, please note that in this article, references to director and officer indemnification may in certain circumstances be applicable to employees and/or agents of the corporation as well.

⁴ Kurt A. Mayr, II, *Indemnification of Directors and Officers: The “Double Whammy” of Mandatory Indemnification under Delaware Law* in *Waltuch v. Conticommodity Services, Inc.*, 42 VILL. L. REV. 223, 230 (1997). See Allan E. Korpela, Annotation, *Insurance: Construction of Policy or Bond Indemnifying Directors or Officers of Corporation for Expenses Incurred in Defending Actions Brought Against Them in Their Capacity as Such*, 49 A.L.R.3d 1250 (noting “an expanding area of corporate director and officer liability and an apparent concomitant rise in the number of legal actions, both derivative and third-party, which have sought to impose personal liability on such insiders . . .”). See also Jonathan C. Dickey & John D. van Loben Sels, *Indemnification and Insurance for Directors and Officers of Public Companies: What Directors and Officers Need to Know in the Post-Sarbanes-Oxley World* (June 2-3, 2003) 4, at http://media.gibsondunn.com/fstore/documents/pubs/DandO_Ins.pdf (last visited May 10, 2005) (“Corporate officers and directors are subject to potential liability from a number of sources, including suits by shareholders on behalf of the corporation and suits by third parties due to allegations concerning the actions or inaction of company officers and directors.”).

⁵ Lechner, *supra* note 2, at 20 (observing that the indemnification provision is “a common controversial feature of many executive employment agreements . . .”).

⁶ Mayr, *supra* note 4, at 230.

⁷ 13 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6045.10 (Perm. ed. 1995) (observing that “[a]ll jurisdictions now have statutes authorizing some form of indemnification of directors, officers, agents or other employees.”).

⁸ David Mace Roberts & Rob Pivnick, *Tale of the Corporate Tape: Delaware, Nevada, and Texas*, 52 BAYLOR L. REV. 45, 47 (2000). “Nevada has adopted statutes that are more director friendly and anti[-]takeover favorable than Delaware’s. Unfortunately, since only the opinions of the Nevada Supreme Court are published, corporate case law in Nevada is sparse.” *Id.*

and comparison, Nevada law is discussed in several footnotes with regard to specific aspects of director and officer indemnification statutes.

Delaware generally sets the corporate standard for all other jurisdictions, and Delaware's law governing indemnification is no exception.⁹ In accord with the perception that "Delaware is most often thought of as the state with the most director-friendly corporate laws,"¹⁰ the Delaware Code "confers broad, flexible indemnification powers" on corporations.¹¹ Title 8, section 145 of the Delaware Code governs indemnification of officers, directors, employees, and agents as well as advancement of expenses and insurance. The key purpose of section 145 is "to permit corporate executives to be indemnified in situations where the propriety of their actions as corporate officials is brought under attack."¹² Tennessee indemnification law, patterned upon after the indemnification section of the Revised Model Business Corporation Act ("RMBCA") and given an understandably lesser degree of attention than that of Delaware, does not effect a complete deviation from the Delaware standard. There are, however, some key differences in the extent to which a corporation may provide indemnification to its officers and directors.

Mandatory Indemnification and Bars to Indemnification

State corporation statutes generally establish absolute standards for mandatory indemnification as well as prohibitions against indemnification in certain situations.¹³ Under subsection (c) of the Delaware statute, a corporation must

⁹ See Diane H. Mazur, *Indemnification of Directors in Actions Brought Directly by the Corporation: Must the Corporation Finance its Opponent's Defense?*, 19 J. CORP. L. 201, 219 (1994) ("the Delaware [indemnification] statute served as a model for most other state statutes . . ."). See also Sean T. Carnathan, *Will the Company Cover an Ex-Officer's Legal Costs? The New World of Sarbanes-Oxley*, BUS. L. TODAY, Sept.-Oct. 2003, at 33 ("Corporate governance issues, such as whether a corporation can or must indemnify its directors and officers, are generally controlled by the law of the state of incorporation. Because the lion's share of public companies are incorporated in Delaware, that is usually where these issues play out.").

¹⁰ Dickey & van Loben Sels, *supra* note 4, at 5.

¹¹ RODMAN WARD, JR., EDWARD P. WELCH, AND ANDREW J. TUREZYN, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* (4th ed. Supp. 2003) (hereinafter "FOLK") § 145.1.

¹² *Essential Enters. Corp. v. Automatic Steel Prods., Inc.*, 164 A.2d 437, 441 (Del. Ch. 1960) (discussing Delaware's predecessor indemnification statute).

¹³ See 13 FLETCHER, *supra* note 7, at § 6045.10 ("Statutes generally provide for mandatory indemnification of reasonable expenses incurred by a director, officer, employee, or other agent who was successful, on the merits or otherwise, in connection with the defense of any proceeding,

indemnify “a present or former director or officer of a corporation to the extent that [the individual] has been successful on the merits or otherwise in defense of any action, suit or proceeding” covered by section 145 “or in defense of any claim, issue or matter therein”¹⁴ Section 145 provides for indemnification “against expenses (including attorneys’ fees) actually and reasonably incurred by such person in connection therewith.”¹⁵ The Delaware statute also acknowledges the possibility of court-ordered indemnification where appropriate.¹⁶

including derivative proceedings, to which he or she was a party.”); 19 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS: CORPORATE PRACTICE DESKBOOK §3:16 (Perm. ed. 1988 & Supp. 2003) (The argument for mandatory indemnification for directors and officers who successfully defend actions brought against them is “that these individuals were sued for actions taken by them in the course of their employment by the corporation, and they should not have to bear the burden of the substantial legal expenses incurred in their exoneration of any wrongdoing.”).

¹⁴ DEL. CODE ANN. tit. 8, § 145(c)(2004). Further:

Indemnification statutes generally provide for mandatory indemnification if a party “has been successful on the merits or otherwise.” In such a case, [directors and officers] are not required to establish any of the necessary elements for permissive indemnification, which include acting in good faith and in a manner reasonably believed to be in the best interest of the corporation.

Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 904 (1993) (quoting DEL. CODE ANN. tit. 8 § 145(c)). Note, however, that “[w]hether the statute empowers a corporation to indemnify its directors partially, or to indemnify them only if they are ‘wholly successful,’ mandatory indemnification does not apply at all unless a final judgment has been entered in the director’s favor.” *Id.* at 905.

¹⁵ DEL. CODE ANN. tit. 8, § 145(c).

¹⁶ See *Unreported Case*: Cochran v. Stifel Financial Corp., No. 17,350, 26 DEL. J. CORP. L. 311, 334 (2001), available at 2000 WL 286722, at *10, for the proposition that “the text of [section] 145(d) contemplates that a judicial determination that indemnity is due can be made in lieu of a corporate determination.” A related issue is that of “fees on fees” or “fees for fees.” Regardless of the name given, these are fees incurred by an officer, director, or other individual in successfully seeking indemnification from the corporation through the courts. “Under [Delaware] case law, ‘fees for fees’ may be recovered only if such recovery is expressly authorized by the bylaws. “This Court has clearly held that the right to . . . indemnification against fees and expenses incurred in a successful action to obtain indemnification is not found in section 145 and must be based on express provisions found either in corporate bylaws or separate agreements.” *Unreported Case*: Perconti v. Thornton Oil Corp., No. Civ. A. 18, 630-NC, in 28 DEL. J. CORP. L. 389, 404 (2003) (Del. Ch. May 3, 2002), available at 2002 WL 982419, at *9 (quoting Cochran, *supra*, at 350). See also Stephen A. Radin, *Directors Beware: Statutory D & O Indemnification Obligations Do Not Include Fees on Fees*, 16 INSIGHTS 2 (July 2002) (stating

A prominent distinction separating Delaware's indemnification statute from that of many other states is that Delaware does not require a director, officer, or other individual to be "*wholly* successful" in the defense of an action.¹⁷ Instead, a Delaware corporation must indemnify such an individual to the extent that the person has been successful.¹⁸ For purposes of Delaware's indemnification statute, the Delaware Superior Court provided the following succinct explanation: "Success is vindication."¹⁹ Under Delaware case law, "vindication, when used as a synonym for 'success' under [section] 145(c), does not mean moral exoneration. . . . According to *Merritt*, the only question a court may ask is what the result was, not why it was."²⁰

"that New York law, like Delaware law, provides directors and officers no right to indemnification of amounts incurred to obtain indemnification, even where the corporation fails to honor an obligation to indemnify" and recommending that "directors would do well to provide for such indemnification in bylaws, employment contracts, and insurance, if they can." (quoting *Baker v. Health Mgmt. Sys., Inc.*, 772 N.E.2d 1099, 1106 (N.Y. 2002)).

¹⁷ See DEL. CODE ANN. tit. 8, § 145(c) (requiring indemnification "*to the extent* [the] officer or director of a corporation has been successful on the merits." (emphasis added)). According to Fletcher:

The concept of indemnity appears to conflict with the concept of judicial enforcement of directors' and officers' fiduciary obligations, particularly when the person is not *wholly exonerated* in the action. The Revised Model Business Corporation Act [now commonly referred to as simply the "Model Business Corporation Act"] tries to resolve this apparent conflict in two ways. First, it provides standards of conduct for directors and officers, which will presumably provide a separate basis for judicial regulation. Second, the act places a precondition on voluntary indemnification, namely that the corporation make a determination that the director has met the standards of conduct required for indemnification under Section 8.51 of the act. This determination is required to be made by the directors not involved in the lawsuit for which indemnity is sought; if there are not sufficient noninvolved directors, then by special legal counsel appointed by the noninvolved directors, or, if that is not feasible, by a majority of the board of directors, or by shareholders without participation of the shares owned or controlled by any involved party.

¹⁹ FLETCHER, *supra* note 13, at § 3:17 (emphasis added). Nevada, like Delaware, does not require that a party seeking indemnification be "wholly" successful. See NEV. REV. STAT. ANN. 78.7502 (Michie 2004).

¹⁸ DEL. CODE ANN. tit. 8, § 145(c).

¹⁹ *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 141 (Del. Super. Ct. 1974).

²⁰ *Waltuch v. Conticommodity Svcs., Inc.*, 88 F.3d 87, 96 (2nd Cir. 1996) (citing *Merritt-Chapman*, 321 A.2d at 141) (adopting and applying *Merritt's* definition of "successful" for purposes of Delaware's indemnification statute). In *Waltuch*, the Second Circuit observed that "[a]lthough the underlying

It is also noteworthy that Delaware statutory law does not expressly bar the corporation from indemnifying specific individuals in specific instances as other jurisdictions choose to do (although the absence of an express prohibition does not allow for complete discretion on the part of the corporation). An officer, director, or other individual seeking indemnification or advancement of expenses under Delaware law obviously must still qualify for indemnification according to the terms of the statute;²¹ that is, the person seeking indemnification must “hav[e] acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation” to qualify for potential indemnification.²²

Somewhat akin to Delaware’s provisions, Tennessee law establishes standards for mandatory indemnification, permissive indemnification, court-ordered indemnification, and situations where indemnification is prohibited.²³ Tennessee law, however, only mandates indemnification in instances where the director, officer, employee, or agent is “*wholly* successful, on the merits or otherwise, in the defense of any proceeding to which the director [or officer²⁴] was a party” because of the director’s or officer’s role as such in the corporation,²⁵ unless the charter specifically limits director liability.²⁶ Indemnification may also be mandated by court order in

proceeding in *Merritt* was criminal,” it found the *Merritt* analysis instructive in the context of a civil litigation settlement as well. *See id.*

²¹ *See id.* at 90-91, 95 (finding that the Delaware statute does not permit indemnification of an officer who did not act in good faith).

²² FOLK, *supra* note 11, at § 145.3.

²³ *See generally* TENN. CODE ANN. §§ 48-18-501–509 (2004) (governing indemnification and advancement).

²⁴ *Id.* § 48-18-507.

²⁵ *Id.* § 48-18-503 (emphasis added). *See also* 19 FLETCHER, *supra* note 13, at § 3:17 (noting that “if voluntary indemnification is not provided, there can be a dispute as to the meaning of the concept of successful defense on the merits.”).

²⁶ *See* TENN. CODE ANN. § 48-12-102(b)(3) (authorizing corporations to include a provision in their corporate charter eliminating or limiting a director’s liability to the corporation for a breach of the duty of due care if they so choose). Similarly, title 8, section 102(b)(7) of the Delaware Code permits “a corporation to include in its charter, either originally or through an amendment, a provision limiting or completely eliminating a director’s personal liability for a breach of a fiduciary duty. The provision does not take effect unless it is accepted by the shareholders as an amendment to the corporation’s certificate of incorporation.” Moskowitz & Effross, *supra* note 14, at 914-15.

Tennessee. In order to qualify, a director or officer must be entitled to mandatory indemnification under the statute and be fairly and reasonably entitled to indemnification in view of all the relevant circumstances.²⁷

Under Tennessee law, a corporation is expressly *barred* from indemnifying its directors or officers when that individual is either held liable to the corporation or has received an improper personal benefit.²⁸ The Tennessee Code also establishes limitations upon what a corporation is permitted to indemnify—no indemnification may be made on behalf of any director or officer “if a judgment or other final adjudication adverse to the director [or officer] establishes the director’s [or officer’s] liability: (1) For any breach of the duty of loyalty to the corporation or its shareholders; (2) For acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law,” or for unlawful distributions.²⁹

Delaware’s indemnity provisions with regard to mandatory and prohibited indemnification provide relatively broad potential indemnity coverage to an officer or director of the corporation as well as greater freedom to the corporation itself to make determinations as to one’s eligibility for indemnification. Tennessee law, though similar in overall scope, contains somewhat narrower provisions with regard to indemnification, both mandatory and permissive.³⁰

²⁷ TENN. CODE ANN. § 48-18-505. Of course, if a director or officer is adjudged liable to the corporation, the most a court can order is the payment of the “reasonable expenses incurred,” and not the amount of the judgment itself. *Id.* § 48-18-505(2).

²⁸ *Id.* § 48-18-502(d). See also Dickey & van Loben Sels, *supra* note 4, at 4-5 n.9 (stating that

courts have drawn a distinction between derivative suits and third-party suits when considering whether indemnification of an officer or director is appropriate. Derivative suits are brought on behalf of the corporation, and the officer or director is accused of harming the corporation. The purpose of derivative suits would be nullified if the corporation were then permitted to indemnify the officer or director for the amount which the officer or director was held liable to the corporation. However, even with derivative actions, officers and directors should be entitled to indemnification for litigation expenses when successful in defense of the action).

²⁹ TENN. CODE ANN. § 48-18-509(a). See also *id.* § 48-18-304 (providing for liability on the part of directors and shareholders for unlawful distributions).

³⁰ **NEVADA:** Nevada prohibits the corporation from providing indemnification to its officers or directors where the individual is adjudicated liable to the corporation or pays amounts in settlement to the corporation unless a court determines that “in view of all the circumstances of the case, the

Permissive Indemnification

Occupying the vast middle ground between mandatory and prohibited indemnification is the area of permissive indemnification, through which a corporation itself is enabled to determine the extent of indemnification.³¹ Absent explicit statutory guidelines and mandates, the corporation's bylaws or indemnity agreement will determine the extent to which the corporation chooses to indemnify its directors and officers.³² Referring to a corporation's prerogative to determine eligibility for indemnification within the sphere of "permissive indemnification," Fletcher observes that "[a]uthorization and determination of indemnification under this provision is likely to be controversial."³³ Because permissive indemnification vests a great deal of discretion in the corporation, the lack of objective statutory boundaries in this area may beget a lesser degree of confidence and satisfaction with the basis for such indemnification decisions. As Fletcher predicts, "unless some mechanism is used which will provide an objective evaluation of the question on the basis of all available facts, questions of indemnity will end up in litigation."³⁴

person is fairly and reasonably entitled to indemnity for such expenses as the court deems proper." NEV. REV. STAT. ANN. 78.7502(2) (Michie 2004). This language resembles Delaware's statutory framework in this area. Nevada also mandates indemnification "[t]o the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in [the subsections permitting indemnification], or in defense of any claim, issue or matter therein." Under this statute, the corporation must indemnify the individual "against expenses, including attorneys' fees, actually and reasonably incurred by him in connection with the defense." *Id.* 78.7502(3). Again, this provision is very similar to that enacted by Delaware; as in Delaware, an individual need not be "wholly successful" to qualify for indemnification under Nevada law.

³¹ See Carnathan, *supra* note 9, at 34 ("The corporation's undertaking to indemnify its officers and directors and advance them legal expenses is generally found in the corporate bylaws. In some instances, the corporation may also enter into a separate contractual arrangement with a particular officer or director.").

³² See Dickey & van Loben Sels, *supra* note 4, at 6 ("The rights of directors and officers to [indemnification and] advancement are governed by a combination of state law and the bylaws of the corporation. Under state law, corporations typically have broad discretion to set terms and conditions in the company's bylaws on indemnification and advancement of fees, provided that the bylaws are not inconsistent with the statutory scope of the corporation's power to indemnify.").

³³ 19 FLETCHER, *supra* note 13, at § 3:20.

³⁴ *Id.* "Permissive statutory indemnification is a two stage procedure. Initially, a determination must be made as to whether the actions of the corporate agent satisfied the standard of conduct required for indemnification. If the standard has been met, the corporation may then elect to indemnify."

Not surprisingly, Delaware law provides rather wide latitude to corporations in permitting the corporations themselves to grant indemnification. Subsection (a) and (b) of section 145 “clearly establish corporate authority to indemnify directors and officers and effectively remove all questions regarding the existence of such authority at common law.”³⁵ In examining this grant of authority, however, it is important to remember that

[w]hile these subsections convey the power to indemnify upon a corporation, they in no way require the exercise of that power. Rather, exercise of the power to indemnify directors and officers is wholly discretionary, and a director or officer is not entitled to indemnification unless the corporation provides for such protection in its by-laws or certificate of incorporation.³⁶

Nevertheless, “[t]he scope of indemnifiable expenses under [section] 145(a) is extremely generous, authorizing corporations to indemnify directors and officers against expenses incurred, including attorney fees, judgments, fines and amounts paid in settlement. This broad spectrum of expenses is limited only by a vague reasonableness [and good faith] standard.”³⁷

Subsection (a) of the Delaware statute grants this right of permissive indemnification:

A corporation shall have the power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture,

Mazur, *supra* note 9, at 220 (quoting Joseph E. Irenas & Ted Moskowitz, *Indemnification of Corporate Officers, Agents, and Directors: Statutory Mandates and Policy Limitations*, 7 SETON HALL LEGIS. J. 117, 121 (1984)).

³⁵ Mayr, *supra* note 4, at 235.

³⁶ *Id.*

³⁷ *Id.* at 239.

trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was unlawful.³⁸

In a complementary fashion, subsection (b) of the Delaware statute provides for indemnification in situations in which the officer, director, or other party seeking indemnification is adjudged liable to the corporation and is thus ineligible for mandatory or permissive indemnification under the terms of subsection (a).³⁹

³⁸ DEL. CODE ANN. tit. 8, § 145(a) (2004). *See also* *Barry v. Barry*, 824 F. Supp. 178, 183 (D. Minn. 1993) (stating that

[u]nder Delaware law, both indemnification and advances are permissive; that is, Delaware's indemnification statute allows corporations to choose whether to indemnify or advance expenses. . . . The Minnesota statute, like the Delaware statute, allows corporations to alter the statutory presumption; corporations may adopt articles or bylaws that prohibit indemnification or advances or that impose conditions on indemnification or advances beyond those imposed by statute.).

A decision by the corporation to mandate indemnification via a bylaw provision does not mean that the corporation must also advance expenses under that same provision. *Advanced Mining Systems v. Fricke*, 623 A.2d 82, 84-85 (Del. Ch. 1992).

³⁹ *Folk* provides a clear and concise explanation of the structure of the Delaware indemnification statute:

Each of the first two subsections of section 145 contains a test that must be met in order for a person to be eligible for indemnification under that subsection. Subsection (a) applies to a broad variety of third party proceedings, whether threatened, pending, or completed. . . . Subsection (b) authorizes a corporation to indemnify its director, officer, or employee involved in a suit brought by the corporation or in the right of the corporation to procure a judgment in its favor by

Indemnification under 145(b), however, is only available “to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.”⁴⁰ Thus, Delaware courts—and neither the corporation itself nor the express terms of the statute—serve as the ultimate arbiter where the party seeking indemnification is adjudged liable to the corporation. By contrast, remember that Tennessee law bars indemnification in all situations where the individual is adjudged liable to the corporation.

Though Tennessee bars indemnification in certain specific instances, Tennessee law permits corporations to indemnify directors and officers in situations that fall between the explicit statutory standard for mandatory indemnification and that barring indemnification, provided that the director or officer acted in good faith and in doing so reasonably believed that his or her actions were in the corporation’s best interests (and thus did not breach the duty of due care).⁴¹ Note that under this statute, in all instances in which the officer or director’s conduct giving rise to potential liability was performed “in the individual’s *official capacity* with the corporation,” the officer or director must have reasonably believed that the conduct was in the best interests of the corporation.⁴² In all other cases, the belief must still be reasonable, but the threshold is not quite as high; in these situations, the individual’s conduct must at least not be *opposed* to the best interests of the corporation.⁴³ Again, Tennessee does allow corporations to limit the liability of

reason of such relationship against reasonable attorneys’ fees and expenses in connection with the defense or settlement of such suit. Indemnification under subsection (b), like subsection (a), is dependent on the individual having acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation.

FOLK, *supra* note 11, at § 145.3.

⁴⁰ DEL. CODE ANN. tit. 8, § 145(b).

⁴¹ *See* TENN. CODE ANN. § 48-18-502(a)(1), (a)(2)(A) (2004).

⁴² *See id.* § 48-18-502(a)(2)(A) (emphasis added).

⁴³ *Id.* § 48-18-502(a)(2)(B). In the case of a criminal proceeding, however, the individual must have “no reasonable cause to believe the individual’s conduct was unlawful.” *Id.* § 48-18-502(a)(3). *See also* 19 FLETCHER, *supra* note 13, at § 3:17 (“If the corporation provides voluntary indemnification under a statute which follows the provisions of the Model Act, such indemnification is apt to be broader than

directors for breach of the duty of due care in the corporate charter, thus in certain instances avoiding liability and the question of indemnification altogether.^{44 45}

Advancement of Expenses

“Indemnification statutes generally also provide for advance payments of fees and expenses before the final adjudication of the litigation.”⁴⁶ As with indemnification, states provide statutory authorization for the advancement of expenses to directors or officers. While these concepts are closely related, they are

the mandatory indemnification, and any controversy regarding the scope of mandatory coverage may be avoided.”).

⁴⁴ Tennessee recognizes that where no such limitation exists, officers and directors of a for-profit corporation generally owe a fiduciary duty to the corporation and its members or shareholders. *Founders Life Corp. v. Hampton*, 597 S.W.2d 897, 899 (Tenn. 1980). Also, “[d]irectors and officers of corporations are bound to the exercise of the utmost good faith, loyalty, and honesty toward the corporation.” *Summers v. Cherokee Children & Family Svcs.*, 112 S.W.3d 486, 503 (Tenn. Ct. App. 2002) (citing *Knox-Tenn Rental Co. v. Jenkins Ins., Inc.*, 755 S.W.2d 33, 36 (Tenn. 1988)) (although *Summers v. Cherokee Children and Family Services* involved two non-profit public benefit corporations, the Tennessee court discussed the obligations of officers and directors of a for-profit corporation and analogized these duties to those of officers and directors of a non-profit corporation). “[T]he directors of a corporation have to see to it that the corporation have to see to it that the corporation had the benefit of their best judgment and act solely and always with reasonable care in good faith to promote its welfare.” *Neese v. Brown*, 405 S.W.2d 577, 584 (Tenn. 1964).

⁴⁵ **NEVADA:** “Nevada allow[s] corporations to provide broad indemnification to their directors and officers.” *Roberts & Pivnick*, *supra* note 8, at 52. To qualify for indemnification under Nevada law, an officer or director must have “[a]cted in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation” NEV. REV. STAT. ANN. 78.7502(1)(b) (Michie 2004). The individual must also not be liable under section 78.138, the Nevada statute governing directors and officers in the exercise of their powers and performance of their duties and their potential liability to the corporation and stockholders. *Id.* Fees, fines, and settlement amounts (to be paid to those other than the corporation itself) are indemnifiable expenses in all suits (provided the statutory criteria are met), but amounts for judgments and settlement amounts to be paid by the corporation are only indemnifiable in actions other than those by or in the right of the corporation. *Id.* 78.7502(1), (2). In instances where an individual is to pay a settlement to the corporation, a court may allow indemnification of the settlement amounts—and any other expense—if it determines the amount to be a “proper” expense. *Id.* 78.7502(2). Absent court order to the contrary, a corporation is prohibited from indemnifying a director or officer “if a final adjudication establishes that his acts or omissions involved intentional misconduct, fraud or a knowing violation of the law and was material to the cause of action.” *Id.* 78.751(3)(a).

⁴⁶ Moskowitz & Effross, *supra* note 14, at 911.

not identical.⁴⁷ “Advancement often works in concert with indemnification, but advancement provisions may specifically require the repayment of such expenses, in the event the defendant is found not to be entitled to indemnification.”⁴⁸ According to the Delaware Court of Chancery, “[t]he right to be indemnified for expenses will exist (or will not) depending upon factors quite independent of the decision to advance litigation expenses.”⁴⁹ Generally, to qualify for advancement of expenses, a director or officer must first satisfy specific requirements: “Corporations may pay in advance reasonable expenses incurred by a director who is a named target in a proceeding,” but

the director or someone acting on his behalf [] must provide the corporation with a written undertaking to pay the corporation back any amount paid or reimbursed. This undertaking is required “if it is ultimately determined that [the director] has not met that standard or if it is ultimately determined that indemnification of the director against expenses incurred by him in connection with the proceeding is prohibited.”⁵⁰

⁴⁷ See Michael S. Quinn & Andrea D. Levin, *Directors’ and Officers’ Liability Insurance: Probable Directions in Texas Law*, 20 REV. LITIG. 381, 405 (2001) (stating that

[t]echnically, A has a right of indemnification against B when B must reimburse A because A has spent money for a specified purpose. Dissimilarly, A has a right to advancement against B when A has a right that B should make a payment on his behalf; i.e., when A has a right that B should advance money. The rights of directors and officers to indemnification and advancement are slightly different.).

⁴⁸ Joseph L. Lemon, Jr., *Just How Limited is that Liability? The Enforceability of Indemnification, Advancement, and Fiduciary Duty Modification Provisions in LP, LLP, and LLC Agreements in Delaware Law*, 8 STAN. J.L. BUS. & FIN. 289, 297 (2003).

⁴⁹ *Advanced Mining Sys. v. Fricke*, 623 A.2d 82, 84 (Del. Ch. 1992) (because of the corporation’s bylaws included only a provision for indemnification and not advancement, the Delaware court upheld the corporation’s decision not to advance the defendant litigation expenses).

⁵⁰ Quinn & Levin, *supra* note 47, at 409 (quoting TEX. REV. CIV. STAT. ANN. art. 2.02-1 § K (Vernon Supp. 2000)) (although this article addresses indemnification and advancement issues under Texas law, the principle of advancement and contingent repayment is generally consistent regardless of jurisdiction). Some jurisdictions also require that the director “provide to the corporation a written affirmation of his good faith belief that he has met the standard of care necessary for indemnification.” *Id.* See also Charles J. Greaves, *The Unique Issues in Shareholder Derivative Litigation: A Limited Statutory Scheme Has Led Courts to Play a Key Role in Shaping Derivative Lawsuits*, 25 L.A. LAW. 16, 18 (Dec. 2002) (“As a prerequisite to obtaining advancement of litigation expenses, a defendant—whether he or she is a director, officer, employee or other agent of the corporation—must first

Thus, the obligation of the officer or director upon receiving an advancement of expenses is a contingent one.⁵¹ Not only is the obligation contingent, but under advancement statutes in some states, including Tennessee, “[t]he undertaking . . . must be an unlimited general obligation of the director but need not be secured and may be accepted without reference to financial ability to make repayment.”⁵² Under such a standard, a corporation is free to advance sums even where no conceivable possibility exists that the individual would repay the amounts should the corporation later determine that repayment is proper. Under Tennessee law, determinations as to advancements are made in the same manner as those relating to indemnification.⁵³

The Delaware statute governing advancement does not require that the board of directors authorize such advancement, but it does provide that the obligation on the part of the recipient of the advancement is contingent and must be repaid if there is an ultimate determination that this person was not entitled to indemnification.⁵⁴ Tennessee likewise permits “[a] corporation [to] pay for or reimburse the reasonable expenses incurred by a director [or officer] who is a party to a proceeding in advance of final disposition of the proceeding if . . . the director furnishes to the corporation a written affirmation of the director’s good faith belief that the director has met the standard of conduct described in [section] 48-18-502 [governing a corporation’s authority to indemnify],” along with “a written undertaking, executed personally or on the director’s behalf, to repay the advance if it is ultimately determined that the director is not entitled to indemnification.”⁵⁵

provide the corporation with ‘an undertaking’ to repay the sums advanced in the event it is determined, at the conclusion of the case, that the defendant is not entitled to indemnification.”).

⁵¹ Discussed *infra* with regard to advancements under the Sarbanes-Oxley Act.

⁵² TENN. CODE ANN. § 48-18-504(b) (2004). *See also* Quinn & Levin, *supra* note 47, at 409 (“the corporation may accept the undertaking even if it knows that the director does not have the wherewithal to make repayment.”).

⁵³ TENN. CODE ANN. § 48-18-504(c).

⁵⁴ Moskowitz & Effross, *supra* note 14, at 911.

⁵⁵ TENN. CODE ANN. § 48-18-504(a).

NEVADA: Nevada authorizes advancements to be made by the corporation to directors or officers pursuant to the articles of incorporation, the bylaws, or by separate agreement “upon receipt of an undertaking by or on behalf of the director or officer to repay the amount if it is ultimately determined by a court of competent jurisdiction that he is not entitled to be indemnified by the corporation.” NEV. REV. STAT. ANN. 78.751(2.) (Michie 2004). Nevada has no statutory requirement

“Nonexclusivity” Provisions

Many jurisdictions include a “nonexclusivity” provision in their statutes governing indemnification.⁵⁶ This provision enables the corporation to provide “additional indemnification protection to its directors, over and above the protection automatically available to directors by statute.”⁵⁷ Citing Delaware’s provision (section 145(f)), the Delaware Supreme Court acknowledged that “[t]he corporation can . . . grant indemnification rights beyond those provided by the statute.”⁵⁸ Consequently, “[t]he effect of the (non-exclusive) clause . . . is to permit courts to establish the outer boundaries of indemnification. Indemnification agreements that go beyond accepted statutory limits are valid if the courts believe that they do not offend ‘public policy.’”⁵⁹ While this appears to be a fairly open-ended license to indemnify in excess of statutory authority, this type of provision is “not a blanket authorization to indemnify directors against all expenses, fines, or settlements of whatever nature and regardless of the directors’ conduct. The statutory language is circumscribed by limits of public policy”⁶⁰ As the Second Circuit has explained, “crucially, subsection (f) merely acknowledges that one seeking indemnification may be entitled to ‘other rights’ (of indemnification and otherwise); it does not speak in terms of corporate power, and therefore cannot be read to free a corporation from

that the determination to advance expenses, unlike the determination as to indemnification, be approved by the board of directors or the shareholders. Expenses may not be advanced, however, “if a final adjudication establishes that [the] acts or omissions involved intentional misconduct, fraud or a knowing violation of the law and was material to the cause of action.” *Id.* § 78.751(3)(a). (“Each state [Nevada, Delaware, and Texas] allows for the advancement of expenses meaning that the corporation is permitted to front the cost of litigation on the director’s behalf.”). Roberts & Pivnick, *supra* note 8, at 52-53.

⁵⁶ Mazur, *supra* note 9, at 216.

⁵⁷ *Id.*

⁵⁸ *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 344 (Del. 1983).

⁵⁹ Mazur, *supra* note 9, at 217 (quoting Dale A. Oesterle, *Limits on a Corporation’s Protection of its Directors and Officers From Personal Liability*, 1983 WIS. L. REV. 513, 538-39 (1983)). “Thus the statutes were conceived to allow courts occasionally to permit more liberal indemnification than the statutes, yet also to encourage courts to stay away from indemnification decisions that satisfy the procedural and substantive criteria of the statutes.” *Id.* at n.81 (quoting Oesterle, *supra*, at 568).

⁶⁰ *Id.* at 217 (quoting S. Samuel Arsht, *Indemnification Under Section 145 of the Delaware General Corporation Law*, 3 DEL. J. CORP. L. 176, 176-77 (1978)).

the ‘good faith’ limit explicitly imposed in subsections (a) and (b).”⁶¹ As this language demonstrates, both “[c]ourts and commentators generally agree that the limits of public policy are found in indemnification statutes themselves.”⁶² Through the statutory body of Delaware corporate law, Delaware’s corporate-friendly atmosphere likely provides the most flexibility and rights to corporations in this area that public policy will allow. According to Mazur, “comprehensive indemnification statutes such as Delaware’s, or those modeled on it, already reach to the limits of public policy.”⁶³

“[T]he Delaware statute, which was one of the first to utilize non-exclusivity, provides for non-exclusive indemnification without any restrictions. The typical statute, however, allows non-exclusive indemnification only to the extent that D&O conduct falls within certain limits.”⁶⁴ Tennessee’s nonexclusivity provision, relatively limited in scope by comparison, states:

The indemnification and advancement of expenses granted pursuant to, or provided by, chapters 11-27 of this title shall not be deemed exclusive of any other rights to which a director seeking indemnification or advancement of expenses may be entitled, whether contained in chapters 11-27 of this title, the charter, or the bylaws or, when authorized by such charter or bylaws, in a resolution of shareholders, a resolution of directors, or an agreement providing for such indemnification⁶⁵

This provision is limited by the statutory prohibition that “no indemnification may be made to or on behalf of any director if a judgment or other final adjudication

⁶¹ *Waltuch v. Conticommodity Svcs., Inc.*, 88 F.3d 87, 93 (2nd Cir. 1996). “The fact that [section] 145(f) was limited by [section] 145(a) did not make [section] 145(f) meaningless . . . , because [section] 145(f) ‘still “may authorize the adoption of various procedures and presumptions to make the process of indemnification more favorable to the indemnitee without violating the statute.”’” *Id.* at 91 (quoting *Waltuch v. Conticommodity Svcs., Inc.*, 833 F.Supp. 302, 309 (S.D.N.Y. 1993) (quoting 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.16, at 4-321 (2d. ed. Supp. 1992))).

⁶² Mazur, *supra* note 9, at 222.

⁶³ *Id.* at 223.

⁶⁴ Moskowitz & Effross, *supra* note 14, at 910.

⁶⁵ TENN. CODE ANN. § 48-18-509(a) (2004).

adverse to the director establishes the director's liability . . . [f]or any breach of the duty of loyalty; . . . acts or omissions not in good faith or . . . a knowing violation of law; or . . . [improper distributions]."⁶⁶

Delaware's statute, by contrast, states:

The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office.⁶⁷

As a Delaware chancery court explained, "to some extent, Section 145(f) allows for a 'private ordering' of indemnification rights above and beyond the statutory terms."⁶⁸ Another court adds that "[t]he statute [section 145] itself makes clear that these are simply 'fall back' provisions which a Delaware corporation may or may not adopt."^{69 70}

Thus, while it seems that "statutory non-exclusivity permits corporations to formulate their own programs for indemnification beyond the limitations of the

⁶⁶ *Id.*

⁶⁷ DEL. CODE ANN. tit. 8, § 145(f) (2004).

⁶⁸ *Unreported Case*: Perconti v. Thornton Oil Corp., *supra* note 16, at 404.

⁶⁹ PepsiCo v. Cont'l Cas. Co., 640 F. Supp. 656, 661 (S.D.N.Y. 1986), *disagreed with on other grounds*, Waltuch v. Conticommodity Svcs., Inc., 88 F.3d 87 (2nd Cir. 1996).

⁷⁰ **NEVADA**: Nevada's non-exclusivity provision reads, in part, as follows:

The indemnification pursuant to NRS 78.7502 and advancement of expenses authorized in or ordered by a court pursuant to this section: (a) Does not exclude any other rights to which a person seeking indemnification or advancement of expenses may be entitled under the articles of incorporation or any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, for either an action in his official capacity or an action in another capacity while holding his office

NEV. REV. STAT. ANN. 78.751(3)(a) (Michie 2004).

statute,⁷¹ this indemnity granted to the directors or officers must still operate within the bounds of the state corporate statutes despite this grant of authority: “[Section 145’s] affirmative grants of power also impose limitations on the corporation’s power to indemnify.”⁷² Likewise,

The RMBCA [now simply referred to as the Model Business Corporation Act or MBCA] mandates that indemnification of directors pursuant to articles of incorporation, bylaws, resolutions of shareholders or directors, a contract or otherwise, be “consistent” with the Act. The Official Comment explains that “consistent” is not synonymous with “exclusive” and does not prohibit the amendment of statutory permissive indemnification to mandatory indemnification, or the use of procedural devices inconsistent with the statute.⁷³

Likewise, in analyzing Delaware case law interpreting the state’s indemnification statute, the Second Circuit stated that “indemnification rights may be broader than those set out in the statute, but they cannot be inconsistent with the ‘scope’ of the corporation’s power to indemnify, as delineated in that statute’s substantive provisions.”⁷⁴

Determination as to Eligibility

Under the Tennessee Code, disinterested directors make this determination of eligibility for indemnification if a quorum is present; if there is not, a majority of a committee of disinterested directors, independent legal counsel, or shareholders other than the director or officer seeking indemnity may determine whether indemnification is appropriate.⁷⁵ Delaware’s provision is slightly different; according to section 145, such determination of indemnification must be made by a majority of

⁷¹ Moskowitz & Effross, *supra* note 14, at 909.

⁷² *Waltuch*, 88 F.3d at 93.

⁷³ Moskowitz & Effross, *supra* note 14, at 910.

⁷⁴ *Waltuch*, 88 F.3d at 92.

⁷⁵ TENN. CODE ANN. § 48-18-506(b) (2004). The same procedure is followed for evaluating the reasonableness of expenses, although if special legal counsel makes the determination as to indemnification, those individuals who selected the special legal counsel must make the evaluation of reasonableness. *Id.* § 48-18-506(c).

disinterested directors (even though less than a quorum may be present), a committee of disinterested directors designated by a majority vote of disinterested directors, by the shareholders, or, where no disinterested directors exist or if so directed by disinterested directors, by independent legal counsel in a written opinion.⁷⁶ While this procedure is similar to Tennessee's, the fact that it does away with any requirement for the presence of a quorum prior to the vote means that under Delaware law, a very small number of directors may ultimately make the indemnification determination.^{77 78}

“Loss of Control” Situation

With specific regard to a “loss of control” situation, little specific guidance exists regarding such a situation in conjunction with indemnification. Any indemnity provision in the bylaws, charter, or other agreement may be susceptible to amendment depending on the prescribed number of votes needed to effect such an amendment. One commentator notes that “[t]he loss of control by founders of a company is also a consideration in the issuance of equity to directors, officer[s], and employees of the company, which many companies are required to do in order to retain, attract and motivate these individuals in the competitive marketplace.”⁷⁹ This source advises that a change in the voting requirements necessary to take corporate action may reduce or eliminate the risk of a loss of control situation:

Many other corporate actions such as a removal of a director or sale of the company can be structured to require the approval of a super majority vote of the outstanding stock. Additional provisions in the company's governing documents can provide indemnification of officers and directors of the company for costs incurred as a result of their good faith actions, including anti-takeover related actions,

⁷⁶ DEL. CODE ANN. tit. 8, § 145(d) (2004).

⁷⁷ *See id.*

⁷⁸ **NEVADA:** Nevada law provides that the determination of discretionary indemnification must be made by the stockholders, by a majority of disinterested directors, or by independent counsel in a written opinion (if neither a quorum of disinterested directors nor a majority vote of disinterested directors can be obtained). NEV. REV. STAT. ANN. 78.751(a)-(d) (Michie 2004).

⁷⁹ Dave M. Muchnikoff, *Maintaining Control When You Issue Stock*, LEADING COMPANIES E-ZINE (Dec. 2000), at <http://www.beysterinstitute.org/onlinemag/dec00/briefcase.htm> (last visited Feb. 8, 2005). The author adds that “the dilution of a founders [sic] voting power in the company can be minimized by experienced counsel who can provide protections in the corporate governance documents.” *Id.*

protecting them against the potential costs and risks of legal proceedings.⁸⁰

This source suggests that increasing the voting requirements to effect corporate action may ward off a loss of control situation, which could hinder the ability of the corporation to provide indemnification of officers and directors by a vote of the disinterested directors or shareholders.⁸¹ It is also important to note that state corporate codes may provide other means by which the indemnification determination may be made (for example, the Tennessee statute allows the board to authorize independent special legal counsel to make the determination).⁸²

Conclusion

The statutory standards for mandatory and prohibited indemnification require no such determination, and thus, a corporation's control is inevitably limited to what falls between those standards. State corporate codes offer the choice of providing certain degrees of protection to the officers and directors of the corporation, but it is always up to the corporation itself to make—or change—its indemnification standards or procedures in this area. Obviously, the extent to which a corporation may decide to extend indemnification or advancement to its directors and officers will depend largely upon the limits established by the particular state law governing the corporation. One consistent thread throughout state corporate codes, however, is permissive indemnification, by which a corporation may choose to extend rights of indemnification and advancement to its officers and directors according to its own procedures, guidelines, and determinations—provided, of course, that the statutory requirements are met, placing the issue between the boundaries of mandatory indemnification and prohibited indemnification. In a complementary fashion, the state nonexclusivity provision allows corporations to grant indemnification or advancement rights beyond those prescribed by statute. While the advancement of expenses is a slightly different creature than indemnification, the two concepts are strongly linked and generally governed by the same statute or group of statutes.

⁸⁰ *Id.* (under subheading titled “Amendment of certificate of incorporation provisions requires a super majority vote of the shares outstanding.”).

⁸¹ *See id.*

⁸² *See* TENN. CODE ANN. § 48-18-506 (2004).

A clear policy for indemnification and advancement generally provides for a more efficient resolution in establishing some objective basis for indemnification or advancement eligibility. While providing such protection to the officers and directors of the corporation will inescapably have its costs, such a policy will help minimize subjectivity and ambiguity and ensure consistency and predictability regardless of the extent to which the corporation chooses to grant such rights.

Should a corporation neglect or choose not to enter into an indemnity agreement or enact an indemnity provision, through its bylaws or otherwise, any determination as to whether an individual is entitled to or eligible for indemnity or advancement may give the impression of being arbitrary and largely subjective. While a corporation is indeed free to make such a determination within the bounds of the applicable state statute regarding permissive indemnification, it is “[t]he bylaw [or agreement, charter provision, etc. that] will serve the purpose of setting the stage for an appropriate decision on indemnification.”⁸³ Thus, perhaps the best reason for indemnity provisions or agreements may primarily be a practical and forward-looking one; according to Fletcher, “it is good practice to adopt a bylaw providing general indemnification to officers and directors. Not the least reason is that such indemnification is expected and generally provided. To attract good managers, the corporation will have to provide such coverage.”⁸⁴ Another commentator adds that

[f]ewer highly qualified individuals may be willing to become or remain corporate directors and officers if there is an erosion of the protections afforded by exculpatory charter provisions, advancement

⁸³ 19 FLETCHER, *supra* note 13, at § 3:17.

⁸⁴ *Id.* The recent supplement to this volume adds the following cautionary information to the cited text:

In drafting such a bylaw, careful consideration should be given to the scope of the coverage intended. A bylaw providing for coverage to the full extent allowed by law might grant more coverage than the corporation intends to grant. Courts have given broad scope to a broad bylaw provision. The corporation may find itself obligated to advance attorneys' fees to officers and directors who the corporation sues for breach of the duty of loyalty to the corporation. To avoid this type of result, which has the effect of virtually insulating executives who disregard their obligations to their corporate employer, the indemnification provision in the bylaw should require an independent or judicial determination that the director or officer acted in good faith before he or she is entitled to advancement of attorneys' fees or other litigation expenses.

Id. at § 3:17 (Supp. 2003).

and indemnification provisions, and director and officer liability insurance coverage. In addition, directors and officers who stay on the job may be less willing to take value-generating risks.⁸⁵

Examining the situation from the perspective of the potential (or, for that matter, the current) officer or director, a corporation that lacks a strong, clear indemnification and advancement policy gives the impression of being a corporation that may choose not to stand behind its director or officer should that person ever become a party to litigation due to their role with the corporation. Thus, “[t]he purpose of indemnification is to encourage capable and responsible individuals to accept positions in corporate management, secure in the knowledge that expenses incurred by them in upholding their duties will be borne by the corporation.”⁸⁶

⁸⁵ William D. Johnston, *Scope of Director and Officer Protection Against Liability in Flux*, ATLANTIC COAST IN-HOUSE, Feb. 13, 2004, at 11 (on file with Transactions: The Tennessee Journal of Business Law).

⁸⁶ 13 FLETCHER, *supra* note 7, at § 6045.10. Additionally,

officers and directors potentially expose themselves to litigation expenses and liability measured not merely in terms of their own personal fortunes, but rather by the vastly larger scale of the corporation’s operations. Indemnification assists corporate officers and directors in resisting unjustified lawsuits and encourages corporate service by assuring individuals that the risks incurred by them as a result of their efforts on behalf of the corporation will be met, not through their personal financial resources, but by the corporation. As a consequence, without indemnification, many corporations likely would find it difficult to attract quality executives.

Lechner, *supra* note 2, at 22. This is not a completely one-sided issue, however. According to Fletcher:

Indemnification of officers and directors has caused concern as to the standard of conduct for officers and directors. On the one hand, there is a need to protect persons who act in good faith from punitive litigation costs. Outside directors, particularly, would be hard pressed to serve on boards, if they were required to fend for themselves with regard to the multitude of litigation to which the director of a large corporation may be made a party. On the other hand, officers and directors of large corporations are hired managers. For the most part, even inside directors do not own a significant amount of the corporate enterprise. They are compensated to serve the entity with care and loyalty. In the past, the theory was that the directors’ and officers’ responsibilities to the enterprise were mainly assured through judicial enforcement of their duties of care and loyalty.

19 FLETCHER, *supra* note 13, at § 3:17.

In addition to attracting quality officers and directors while also simplifying determinations of eligibility, indemnity provisions or agreements may also provide for third-party resolution of indemnity questions. According to Fletcher,

[o]ne suggestion which may serve to expedite resolution of the question of indemnity and provide an impartial basis for the determination and authorization is to have a bylaw provision that all questions of indemnification may be submitted to binding arbitration by the American Arbitration Association, or some other impartial mediation or arbitration panel.⁸⁷

“The advantage of this kind of bylaw agreement is that it can expedite the determination of questions of indemnity.”⁸⁸ An agreement to arbitrate any questions of indemnity “should withstand any subsequent judicial attack, and the corporate shareholders should feel more secure that there will be a fair and impartial determination made on the question of indemnity.”⁸⁹ Regardless of its specific nature, if no such indemnity provision or agreement is in place, potential and current officers and directors are left to speculate about the stability of their own financial futures.

⁸⁷ 19 FLETCHER, *supra* note 13, at § 3:20. *See id.* for sample bylaw electing arbitration.

⁸⁸ *Id.*

⁸⁹ *Id.*