

February 28, 2022

INDEMNIFICATION AND ADVANCEMENT: WHAT YOU SHOULD KNOW

The majority of U.S. companies are closely-held businesses owned by a small group of principals that also serve as corporate officials (e.g. officer, director, or manager). When starting a new business, the focus tends to be directed towards concerns like product development, differentiating the business, or profit distribution. Far from the mind is how best to allocate risk between the business and its owners serving as corporate officials. The reality is, however, that corporate service can be risky. Internal disputes will inevitably arise, especially when the performance of the company does not meet expectations. Deals and decisions made in good faith sometimes go south, and long-simmering issues and disagreements surface. When this occurs, the company or some of its owners may bring legal claims against the corporate official they believe responsible. Corporate officials often fail to consider the risk of bearing the cost of a lawsuit arising from their corporate service. Additionally, companies often forego purchasing directors and officers (D&O) liability insurance, thinking it an expendable cost. That is why knowing your business's policies regarding indemnification and advancement is so important.

Indemnification

A zealous legal defense is not cheap, and an official named in a lawsuit may soon be questioning his or her decision to accept a corporate position. The first thing that any officer, director, or manager should do upon becoming aware of a claim against them in their corporate capacity is review the company's governing documents. Documents like the corporate bylaws or the LLC's operating agreement will likely include a section concerning indemnification. This is the company's promise to reimburse officials for all out-of-pocket expenses and losses incurred in defending against claims arising out of their corporate service.

Unfortunately, a provision requiring indemnification of officials does not require the advance payment of expenses as they are incurred. Under North Carolina law, a corporation cannot indemnify an official in connection with a proceeding in which the official is found liable to the corporation or is found liable on the basis of receiving an improper benefit or engaging in bad faith conduct. An LLC's operating agreement is likely to include a similar restriction.

As a result, before the right to indemnification kicks in, the official must mount a successful defense against claims of bad faith and misconduct. The effect is that the official will have to self-fund the ongoing costs of defense. If the official doesn't have the financial resources to achieve a favorable outcome, the promise of indemnification becomes a mirage.

Advancement

Advancement is a related concept to indemnification that provides immediate relief. For qualifying claims, an advancement agreement obligates the company to pay litigation expenses as the official incurs them and before the right to indemnification is established. The official must agree to pay back the funds received if it is found they are not entitled to indemnification. Advancement ensures that company officials have the resources to resist unjustified lawsuits without relieving them of responsibility for any bad faith conduct established.

From the company's perspective, however, an agreement to advance expenses can have serious drawbacks. It places the company in the unenviable position of incurring expenses associated with prosecuting an official it believes to have engaged in misconduct. Simultaneously, the company is required to fund the defense of said official. This creates a dynamic in which the more aggressive the prosecution of the official, the more money the company is required to fund the official's ongoing defense. This is especially problematic for the company when the official is not creditworthy, and therefore, may be unable to reimburse the company upon a determination that indemnification is not justified.

JAH Can Help

Parties involved in disputes relating to alleged misconduct by a corporate official should confirm whether there is an agreement to advance expenses as early as possible, alert the court to the presence of an advancement claim so that a case management schedule may be tailored to account for early motions practice, and the corporate official should be sure to document and segregate those expenses reasonably subject to advancement from those expenses not subject to advancement.

The **attorneys at JAH** are available to counsel executives on how best to minimize their personal legal exposure, including the negotiation of indemnity and advancement provisions. In addition, the attorneys at JAH are ready to assist employers and business owners seeking to minimize the risks associated with indemnification and advancement provisions and executive general employment agreements. If a dispute should arise, our **Litigation Practice Group** has experience litigating all manner of business disputes, including claims for advancement and indemnification.

Click [here](#) to contact a member of our **Litigation Practice Group** if you are in need of assistance.

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