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Indemnification Agreements under Maryland Law:
Additional Protection for Directors and Officers

In the current climate of ever increasing scrutiny of public companies, it is important for directors and officers to understand the full range of protections from personal liability available to them.

Directors and officers of a Maryland corporation (or trustees and officers of a Maryland real estate investment trust) have four possible levels of protection from personal liability: (1) adherence to the applicable standards of conduct for directors and officers; (2) exculpation from liability for money damages for state law claims by the corporation or a stockholder; (3) indemnification for liability and expenses; and (4) insurance. Adherence to the applicable standard of conduct avoids the incurrence of a liability; exculpation relieves directors and officers from liability; and both indemnification and insurance assume the incurrence of a liability and/or expenses but provide for reimbursement by the company or the insurer.

Indemnification (including advance of expenses) is important as it not only provides for reimbursement for judgments and settlements but also typically enables the director or officer to avoid paying for defense costs out of his or her own pocket during the litigation. To furnish the broadest and the most reliable and timely indemnification and expense advance protection available under Maryland law, many of our clients have adopted indemnification contracts with each of their directors and senior officers.

The indemnification provisions of the Maryland General Corporation Law ("MGCL") (which also apply to trust REITs) *require* expense reimbursement for successful defenses and *permit* indemnification and advance/reimbursement of expenses in many other situations, even in some cases where the director or officer loses or settles. These rights under the MGCL are broader and more protective for directors and officers than the indemnification provisions in Delaware. Typically, a company's permissive indemnification rights are made mandatory through its charter or bylaws.

An indemnification agreement has two main advantages: First, it provides a contract right to *specific procedures* for indemnification and advance of expenses, including (a) specific time frames for a company to respond to requests for indemnification or expense advance; (b) internal corporate procedures for determining whether the director or officer is entitled to indemnification; and (c) clarity of remedies available to the indemnified party if the company denies indemnification or expense advance or simply stonewalls, which sometimes occurs after a change in control. Second, an indemnification agreement may provide a director or officer *protection beyond the indemnification provisions of the MGCL.* For example, a properly-drafted indemnification agreement may override the MGCL's rebuttable presumption

that a director or officer did not satisfy his or her standard of conduct if the proceeding against the director or officer ends in a conviction or *nolo contendere* plea.

In addition to these benefits, indemnification agreements also provide greater protection of directors and officers than many standard D&O insurance policies, which have some important limitations that may be addressed in an indemnification agreement. First, a carrier or the company may terminate a policy without the director's or officer's consent. Second, D&O policies have dollar limits that apply in the aggregate to all monies paid by the insurer for judgments, settlements and expenses. An indemnification agreement, backed by the company's assets, may cover the full amount of all claims, other than the limited prohibitions on indemnification under Maryland law (and subject to the Securities and Exchange Commission's position, never confirmed by a court, that indemnification against certain federal securities law claims is against public policy). Third, some D&O policies do not cover directors or officers serving as a fiduciary under an employee benefit plan; no such limit exists for indemnification agreements. Finally, most D&O policies do not cover certain types of claims, *e.g.*, a suit by one director against another.

While we strongly recommend indemnification agreements, approval by directors of indemnification agreements for themselves is a serious matter and should not be undertaken without full information and advice. When a company enters into indemnification agreements, the board often tends to favor the broadest possible protection for its directors and officers. Sometimes, however, after the agreements are in place, a claim for indemnification is made by a director or officer in circumstances that make the prospect of paying the defense costs of the director or officer seem unattractive. It is impossible, however, to foresee all the situations in which a director or officer might claim to meet the applicable standards for indemnification or expense advance but the board, with the benefit of hindsight, might wish that it had provided less expansive protection. Indeed, the more one might try to predict and draft for each of these situations, the more the risk of eliminating appropriate situations for indemnification or expense advance increases. The MGCL provides some aid in this regard, which we retain in our form of Maryland-specific indemnification agreement, by requiring, as a prerequisite to expense advance, submission by the director or officer of a good faith affirmation that he or she meets the statutory standard of conduct for indemnification, thus providing the basis for denying expense advance on the ground of lack of good faith. (Delaware has no such requirement.)

Recognizing these difficulties, indemnification agreements should be carefully drafted to reach an appropriate balance between (a) encouraging directors and officers to serve and (b) protecting the company from situations in which directors or officers should not be reimbursed from company funds.

Finally, both the law and practice of D&O indemnification and expense advance is an evolving area and existing indemnification agreements should be periodically reviewed and updated.

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Please feel free to contact either of us if you have any questions with respect to indemnification agreements or the other protections available to a director or officer of a Maryland corporation (or trust REIT).

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