Private Equity Funds: Consider Reviewing Indemnification Arrangements

By Mike Kuhn

It is common for a private equity fund’s principals to serve as directors and sometimes officers of its portfolio companies. In these sorts of arrangements, there are oftentimes overlapping indemnity obligations between the fund and the portfolio company that run in favor of the principal. These indemnification provisions are most typically found in the organizational documents of the fund and the portfolio company and sometimes in stand-alone indemnification agreements between the principal and the portfolio company. While separate fund and portfolio company indemnification obligations protect the principal against personal liability, it often creates confusion regarding the relative priority of the fund’s and portfolio company’s indemnification obligations. That is, if the agreements do not specify whether the fund or the portfolio company will be the indemnitor of first resort, how will courts read such arrangements when faced with this question?

Although possibly unexpected to many private equity professionals, Delaware courts have imposed joint liability between a private equity fund and the portfolio company when no other clear contractual arrangement exists. The Delaware Chancery Court has permitted a director to seek indemnification from the private equity fund without first seeking it from the portfolio company. In that case, the Court held that the private equity fund and the portfolio company were co-indemnitors and therefore should share indemnification responsibilities. The private equity fund was able to seek equitable contribution directly from its portfolio company to pay its share of the settlement amount, but such contribution was to be no more than 50% of the total settlement.

Decisions by Delaware courts underscore the need for private equity funds to clarify their indemnification obligations vis-à-vis those of their portfolio companies. Unintended results can easily be avoided by ensuring that the obligations between the private equity fund and the portfolio company are specifically defined. If the private equity fund’s obligations are properly made secondary to those of the portfolio company, then any amounts that the private equity fund pays on the director’s or officer’s behalf should be fully recoverable from the portfolio company. In light of the uncertainty created by some Delaware cases, private equity funds and their portfolio companies should consider taking the following steps:
1. Review existing indemnification provisions in fund and portfolio company agreements and organizational documents to assess whether they are current.

- Companies should carefully analyze the nature and extent of the indemnification protections that they wish to provide to their directors and officers. Following this analysis, they may then assess with legal counsel whether existing charter and bylaw provisions properly capture the desired protections.

- To the extent that a company wants to limit indemnification protections in certain circumstances, such as when the board has determined that an officer or director acted improperly, such limitations should be clearly specified.

- Advancement of expenses prior to the conclusion of a proceeding is often desired because large defense costs may be incurred in litigation prior to final resolution. Because the right to have such expenses advanced is not automatic and will not be presumed merely by using the words “indemnify,” governing documents should specifically include the right to obtain advancement of expenses, if desired.

2. Clarify priority issues when multiple sources of indemnification are available.

- Ensure that the governing documents of the private equity fund and the portfolio company clearly state that the portfolio company is the primary indemnitor and that the fund is the secondary indemnitor.

- Provide that the fund be subrogated to the director’s or officer’s rights against the portfolio company to the extent of any indemnification payments or advanced expenses which were paid by the private equity fund but were the primary obligation of the portfolio company.

- The portfolio company should release the fund from any claims for contribution, subrogation and any other recovery.

3. Implement indemnification agreements with directors and officers. While many private companies rely solely on charter, bylaw and shareholder agreement provisions to provide comfort regarding indemnification and advancement of expenses issues, there is a growing trend among private equity funds to opt for more detailed provisions that are contained in indemnification agreements. The benefits of having indemnification agreements include the following:

- The director or officer is provided with an express contractual obligation of the portfolio company as to his or her rights to indemnification or advancement of expenses.

- The indemnification agreement will usually provide that the portfolio company may not
unilaterally amend the agreement without the director’s or officer’s consent.

- If there is only one indemnification agreement covering all of the directors and the portfolio company caps the amount of advanced expenses, one person could use the entire amount, leaving other directors and officers without adequate coverage. This issue can also be handled by allowing the cap to be exceeded upon board approval.

4. **Review directors’ and officers’ insurance policies.**

- Private equity funds and their portfolio companies should periodically review directors’ and officers’ insurance policies ("D&O policies") to ensure that they are adequate in terms of the amount and scope of coverage.

- The language of D&O policies should be analyzed to ensure that the private equity fund’s policies provide excess, not primary, coverage for its representatives. Typically, private equity funds want to ensure that a claim is made against their policy only if the portfolio company’s policy is exhausted or the carrier refuses to pay.

- Private equity funds should also consider having the same insurance carrier write the D&O policies for both the private equity fund and its portfolio companies. If the same carrier is responsible for both the private equity fund and the portfolio company, it will eliminate a potential battle of insurance carriers. Furthermore, there may be premium, terms and claims-handling advantages that can be obtained by using the same carrier.

5. **Ensure that when the portfolio company is sold, former directors and officers are not deprived of their rights to indemnification and advancement of expenses.**

- Work with counsel to ensure that a covenant in the sale agreement prohibits the buyer from amending the indemnification and advancement of expense provisions included in the governing documents of the portfolio company for a lengthy period after the closing (six years, for example).

- If there are separate indemnification rights included in a management services agreement between the fund and the portfolio company, insist as a part of your closing that the indemnity obligations survive despite the termination of the underlying agreement.

- Review your portfolio companies’ D&O policies and consider purchasing an extended reporting period (a “tail”) in connection with the closing of a transaction. D&O policies provide coverage for claims that arise during the policy period and are reported to the insurer during that period. Most D&O policies give the policy holder an option to purchase a tail, which has the effect of extending
the period during which the insured may report claims that arose during the policy period.

Delaware case law makes clear that principals cannot assume that a portfolio company will be fully liable for all claims involving its directors and officers and that the private equity fund will only be liable to the extent that the portfolio company is unable to pay. For this reason, to avoid unintended results, private equity funds should consider revisiting their indemnification arrangements to confirm that their portfolio companies have primary responsibility for indemnification and advancement of expenses.

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