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Indemnification of Officers and Directors

It is common for private equity funds to have their principals serve as directors and sometimes also as officers of their portfolio companies. In these arrangements, it is also typical for both the fund and the portfolio company to have indemnification obligations that run to the benefit of the principal. These indemnification obligations are most likely in the fund's organizational documents and in the charter documents of the portfolio company.

In this case, which obligation is primary – that of the fund or the portfolio company?

This is an important issue as it is likely that the fund and the portfolio company have separate insurance policies to cover their indemnification obligations. In most cases, the fund will intend that the portfolio company's indemnification obligations be the primary obligation and for that insurance policy to be looked to first. However, if it is not clear which indemnification obligation is primary, recent case law suggests that both the portfolio company and the fund may have co-equal liability (and as a result, each will be liable for one-half of the costs).

This unexpected result can be avoided with careful advance planning. One way to address this situation is through the use of indemnification agreements among the principal, the portfolio company and the fund that clearly state that the portfolio company's obligation to indemnify is primary and that the fund's obligation comes into play only when the portfolio company is

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unable to fully satisfy the indemnification obligation. Another important issue that can be addressed in such an agreement is the scope of the indemnity obligation, as standard language such as "to the fullest extent of the law" could lead to unintended consequences. Indemnity agreements are particularly useful in the context of advisory committees where statutory indemnification rights will not apply.

Please contact Squire Sanders to learn more about this topic.

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