DUTIES, EXCULPATION FROM DUTIES AND INDEMNIFICATION OF GOVERNING PERSONS IN LIMITED LIABILITY COMPANIES

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BIOGRAPHICAL INFORMATION

EDUCATION

Ms. Bond is a magna cum laude graduate of Rice University and graduated Columbia University Law School (JD, 1980) as a Harlan Fiske Stone Scholar.

PROFESSIONAL ACTIVITIES

She is a frequent author and lecturer on corporate and securities law issues, and has served as Adjunct Professor of Corporate Law at the University of Houston Law Center. Ms. Bond is a past President of the Women's Finance Exchange and has been a member of the State Bar of Texas' Corporation Law, Continuing Education and Venture Capital Committees and is a member of the Limited Liability Company, Partnership and Unincorporated Entity Committee and the Venture Capital Committee of the American Bar Association.

Adrienne Randle Bond is in private practice in Houston, Texas. Ms. Bond specializes in complex corporate, partnership and securities law, oil and gas finance transactions and mergers and acquisitions. Ms. Bond's, includes initial business planning, venture capital, the formation of corporations, limited liability companies and partnerships, SEC compliance issues, private placements, going private transactions, energy finance, alternative energy, trademark law and licensing, corporate compliance, and acquisitions or sales of assets and other equity interests.

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I. INTRODUCTION

Indemnification provisions under the limited liability company statutes, including the Texas Business Organizations Code (the "TBOC"), are likely to be under significant judicial scrutiny in the next few years, as the economic downturn causes claims and controversies against members and managers to arise. This article will focus on best practices to protect persons serving as members, managers and officers of an LLC, with an analysis of statutory foundations, current and evolving case law and suggested drafting solutions.

As we all understand the basics of corporate law, which serves as the foundation of the TBOC statutory indemnification provisions, indemnification only is available if the accused is able to establish that there was no "misconduct." Stated in the converse, indemnification payments, if successful, will only consist of advancement of defense costs. Once this fundamental premise is clear, indemnification rests on two topics: (A) definition of, and appropriate exculpation for, the duties applicable to the proposed indemnities, and (B) terms and conditions of advancement of expenses. Indemnification insurance also needs to be a part of the indemnification process.

An explanation of terms is also in order. Under the TBOC, the generic term for a person operating in a fiduciary duty capacity is "governing person." The term "governing person" includes directors, members of a member managed LLC and managers of a manager managed LLC. The main provision on exculpation and indemnity are in Section 7 and 8 of the "HUB" of the TBOC, and are drafted in terms of "governing persons," and I will use the LLC specific terms of members and managers, and include a discussion of officers because of the specific statutory structure in place for LLCs.

A cautionary note on ethics is also in order at the beginning of this analysis. Who you are representing as you are exculpating is quite important. This is an area that ALWAYS has a conflict of interest because you are considering the relationship of the agent to the principal, and is a question that is usually resolved in the formation stage, where there is usually only one lawyer. As a result, it is an area where you should take time to explain to the client, whoever that client is, the nature of fiduciary duties, their exculpation and indemnification, because they cannot begin to waive any conflicts until they have had a complete disclosure, which I believe requires the client to actually understand what they are waiving. I personally find this quite difficult to do, but I soldier on.

II. STATUTORY BASIS FOR EXCULPATION FROM LIABILITY

As we learn in sports, and borrowing sports jargon, the best offense is a good defense. Indemnification begins with a careful consideration of exculpation provisions. Under the TBOC, the exculpation provisions are centered in Section 7. The key concept is found in Section 7.001(b) as follows:

> "The certificate of formation or similar instrument of an organization to which this section applies may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person."

An astute student of LLC law will immediately notice that this provision will not directly apply to LLCs. First, Section 7.001(a)(1) expressly states that this Section 7.001(b) applies to "a domestic entity other than a partnership or limited liability company," so that the fundamental provision on exculpation in the TBOC statutorily excludes LLCs. Other issues in the Section 7.001(b) formulation that are of concern is that the exculpation must appear in a specific spot – the certificate of formation. The provision is also not mandatory, in that it states that this exculpation provision "may provide" that a governing person is not liable. Finally, it only applies to governing persons, which means that officers are not covered by this provision. Finally, as we all know from the history of its Delaware counterpart, Section 102(b)(7), this limits liability for monetary damages that do not result from a breach of duty of loyalty, which in the grand scheme of things is the real problem.

This TBOC statutory formulation uses the long established limits for exculpation by the following section of Section 7.001, namely Section 7.001(c), as follows:

Subsection (b) does not authorize the elimination or limitation of the liability of a governing person to the extent the person is found liable under applicable law for:

> "(1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;

(2) an act or omission not in good faith that:

(A) constitutes a breach of duty of the person to the organization; or

(B) involves intentional misconduct or a knowing violation of law;

(3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or

(4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute."

Once again, this statutory formulation is directly derived from the Delaware predecessor, Section 102(b)(7), and has been in our Texas formulations for corporations since shortly after the enactment of the original Delaware provision.

The final portion of Section 7.001 that is an important puzzle piece in this process is Section 7.001 (d)(3) that addresses LLCs, which states as follows:

"The liability of a governing person may be limited or restricted: . . .

(3) in a limited liability company to the extent permitted under Section 101.401."

So inquiring minds next want to know what is in Section 101.401. I consider this section the big sleeper of LLC law, and not just in the state of Texas. This section has proved a trap for the drafting community, and it provides as follows:

"EXPANSION OR RESTRICTION OF DUTIES AND LIABILITIES. The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company."

While Section 7.001 is silent on this point, Section 101.401 has another provision that is directly applicable, which is Section 101.402, as follows:

"PERMISSIVE INDEMNIFICATION, ADVANCEMENT OF EXPENSES, AND INSURANCE OR OTHER ARRANGEMENTS. (a) A limited liability company may:

(1) indemnify a person;

(2) pay in advance or reimburse expenses incurred by a person; and

(3) purchase or procure or establish and maintain insurance or another arrangement to indemnify or hold harmless a person.

(b) In this section, "person" includes a member, manager, or officer of a limited liability company or an assignee of a membership interest in the company."

Why is this language a trap? The Delaware courts (no Texas cases to date) have held that the statutory formulation is drafted as "may" and that means that if there is not a specific contractual provision in the company agreement to mandate these provisions, they are not mandatory, and not available to the member or manager absent express agreement. It is generally difficult to get an agreement to advance expenses after the controversy has started. The first cases have been in the context of advancement of expenses, which of course, is the most critical element of the equation.

III. DRAFTING SOLUTIONS TO THE STATUTORY FORMULATIONS

The literature on the subject of indemnification is clear that the company agreement must contain indemnification provisions, but I would like to suggest a more detailed road map in this paper. First, indemnification provisions under Section 101.401 and 101.402 are not as helpful without consideration of the application of the exculpation provisions of Section 7.001. Thus, good drafting turns on considering the duties of the governing persons, the exculpation of the duties of those governing persons and then thoughtfully providing for reliance on the indemnification and advancement of expenses provisions available in the event of allegations of breach of those duties.

A. Fiduciary Duties of the Governing Persons**.** This paper is focused on elimination of and indemnification for actions by governing persons. The key to this problem is that governing persons, as those persons with management and oversight

responsibility for the enterprise, owe fiduciary duties to that enterprise and its interest holders. We believe that under the TBOC, and relevant case law, that the governing persons and the officers of an LLC have traditional fiduciary duties, just like officers and directors of Texas corporations. While there is extensive case law in the corporate area and the beginnings of case law in the LLC field, this paper is going to make a general assumption that those duties exist, and our job is to think through how those duties should play out in a company agreement. One significant difference between Delaware and Texas is that in Delaware, there is express statutory authority for the elimination of fiduciary duties. Notwithstanding the use of the term "eliminate" in the statutory language of Section 101.401, we do not believe that you can completely eliminate fiduciary duty under Texas law, you may merely reasonably limit those duties.

B. Choices in Drafting Provisions. Once you recognize that the governing persons have fiduciary duties, what are your choices in drafting an LLC Agreement? Under Section 101.401, the drafter is statutorily authorized "to expand or restrict any duties, including fiduciary duties" If you are silent on duties, you will be relying on the existing case law on the subject and also subject to negotiation, mediation, litigation in order to define the boundaries. That might work. When would silence be appropriate? In a single member LLC, it is remote that the member would sue itself, so the fact that an LLC agreement is silent on duties could be appropriate. In these days of economic troubles, you always have to consider what would happen what would happen in a situation where a trustee in bankruptcy took over, and determined to sue the former member for breach of fiduciary duty, so even a single member LLC bears a fiduciary duty risk.

C. Where Do Exculpation Provisions Go in an LLC? The next significant question is where to draft the exculpation and indemnification provisions. I am always troubled by the express language in Section 7.001(b) that states that the exculpation provisions should appear in the certificate of formation. Even if Section 7.001 does not directly apply, I am always concerned about the literal reading of a statutory provision. Therefore, I have put exculpation and indemnification provisions in my Certificate of Formation and my company agreement. My colleagues always assure me that (i) the company agreement is the primary document that governs the LLC, and (ii) the language in Section 101.401, which expressly references the Company Agreement, trumps the certificate of formation. I always argue with myself, and say, even if that is all true, what does it hurt to put exculpation and indemnification provisions in your certificate of formation, just in case. I am slowly coming to the view of the primacy of the company agreement, and actually considering tossing out my suspenders, and simply placing the exculpation provisions in the company agreement. Who knows what the next wild thing that I will do will be.

D. What Should the Exculpation Provisions Say? If you can decide where to put the provisions, what should the provisions say? If you have been tracking my train of thought, the first task is to define the fiduciary duties. What are some possibilities? I have used the following formulations (all of which have been drafted assuming a manager managed company, for simplicity):

a. Managers will owe the Members all of the fiduciary duties directors owe a corporation under the laws of the state of Texas

b. In the performance of their duties under this LLC Agreement, the Managers will conduct the business of the Company in good faith and in a good and businesslike manner and in accordance with sound business practice.

c. The Managers of the Company will devote to the Company such time and effort as is reasonably necessary to diligently manage the Company's business and affairs. The Managers will not be required to devote their full time to the business of the Company.

The following are formulations to limit duties that I have encountered in transactions: You will note that in each provision, the drafter has been careful to recite that there was consideration given for the elimination of the duty, and that the parties considered that the elimination would be reasonable. Those formulations are limitations on duties, as specifically dictated by the Texas law on reduction of duties, as opposed to complete the elimination of duties allowed in Delaware.

a. Neither the Members, the Managers, nor their respective Affiliates, partners, members, officers, directors, managers, employees or agents, shall be liable, responsible, or accountable in damages or otherwise to the Company or its Members for any action taken or failure to act **(EVEN IF SUCH ACTION OR FAILURE TO ACT**

CONSTITUTED THE SOLE, CONCURRENT OR COMPARATIVE NEGLIGENCE OF THE MEMBER, MANAGER, OR SUCH AFFILIATE, PARTNER, MEMBER, OFFICER, MANAGER, DIRECTOR, EMPLOYEE OR AGENT) in connection with the operations, business and affairs of the Company, unless such act or failure to act was the result of bad faith, fraud, willful or intentional misconduct or criminal wrongdoing, gross negligence, or a breach of a material term of this Company Agreement.

b. No Manager (solely in such individual's capacity as a Manager) nor any of its Affiliates shall be liable to the Company of to any Member for losses sustained or liabilities incurred as a result of any act or omission taken or omitted by such manager in his capacity as such; provided that such Manager's conduct did not constitute fraud or a knowing violation of Law.

c. The provisions of this Company Agreement, to the extent that they are deemed to (i) limit or modify a duty or other obligation that may be otherwise owed by the Members or Managers to the Company or its Members at law or in equity, (ii) identify certain activities in which those Members or Managers may engage without being deemed to violate any such duty, (iii) set forth certain standards by which compliance by the Members or Managers with any such duty or obligation is to be measured or (iv) limit or modify any right that the Company or its Members may have at law or in equity, shall be deemed reasonable in form, scope and content.

d. The Members, and the Members on behalf of the Company, waive, to the fullest extent possible, duties, if any, that a Member or Manager may have to the Company or another Member (including Affiliates, employees, or agents of such Member), pursuant to the TBOC or any other applicable law, rule or regulation to the extent necessary to give effect to the terms of this Section __. It is expressly acknowledged and affirmed by the Members (and the Members on behalf of the Company) that the execution and delivery of this Agreement by the each of the Members is of material benefit to the Company and the other Members and that the Members would not be willing to execute and deliver this Agreement without the benefit of this Section ___.

e. To the fullest extent permitted by applicable law and expressly agreeing that all permissive provisions of applicable law shall be mandatory for the purposes hereof, no Covered Person will be liable to the Company or any Member (or Affiliate of a Member) as a result of or in connection with any actions or omissions with respect to the Company on the part of such Covered Person in his, her or its capacity as such based on any claim of breach of fiduciary duty to the extent that such Covered Person (i) conducted himself, herself or itself in good faith and (ii) reasonably believed that his, her or its conduct was in the best interests of the Company, regardless of the negligence or other fault of such Covered Person. In addition, no Covered Person will be liable to the Company or any Member (or Affiliate of a Member) for actions taken by such Covered Person in such Covered Person's capacity as such which would be consistent with the duty of loyalty and care applicable to a member of the board of directors of a Texas corporation the certificate of formation of which limits the liability of its governing persons to the maximum extent permitted by TBOC Section 7.001(b).

f. Whenever in this LLC Agreement a Covered Person is permitted or required to make a decision (i) in his, her or its "sole discretion" or under a grant of similar authority or latitude, the Covered Person will be entitled to consider only such interests and factors as that Covered Person may desire, including that Covered Person's own interests, and will have no duty or obligation to give any consideration to any interest of or factors affecting the Company or any other Person, or (ii) in his, her or its "good faith" or under another express standard, the Covered Person will act under such express standard and will not be subject to any other or different or inconsistent standard imposed by this LLC Agreement or other applicable law.

d. Areas of Special Concern. There are several areas of special concern, other than general fiduciary duties, that are regularly negotiated. Those would include (i) confidentiality, (ii) business opportunities, and (iii) related party contracts. I think that these tend to be treated separately in venture backed transactions because they are chronic and difficult issues. I am going to set out some proposed language on those issues as follows:

a. The Members recognize that the Institutional Investors (i) have participated, directly or indirectly, and will continue to participate in venture capital and other direct investments in Entities engaged in various aspects of the industry that may be competitive with the Company's business ("*Other Investments*"), (ii) may have interests in, participate

with, assist and maintain seats on the board of directors or similar governing body of Other Investments and (iii) may develop opportunities for Other Investments. In their positions with Other Investments, the Institutional Investors may become aware of business opportunities that could be suitable for the Company, but the Members expressly acknowledge that the Institutional Investors will not have any duty to disclose to the Company any such business opportunities, whether or not competitive with the Company's business and whether or not the Company might be interested in such business opportunities for itself. Furthermore, the Members acknowledge that the Institutional Investors have duties not to disclose confidential information of or related to Other Investments. The Capital

b. Contributions to be made by the Institutional Investors to the Company on the terms contained in this Agreement are of material benefit to the Company and to the Members, and the Members are willing to accept the limitations on the duties of the Institutional Investors to the Company described in this Section ___ in order to obtain such benefits. The Members agree that the activities of the Institutional Investors relating to Other Investments that are contemplated by this Section ___ are not unreasonable and would not violate any duty of the Institutional Investors to the Company or the Members.

c. During the term of the Company, (i) except as provided in Section ___, or in any applicable employment or consulting agreement, no member of management or any other employee or consultant of the Company that is a Member, nor their Affiliates shall, directly or indirectly, participate with the Company in any business transaction, and (ii) except for business related to the Company's Affiliates as described in Section __, all opportunities to engage in any project or business opportunity in the Business that are offered to or come to the attention of management or their Affiliates shall belong to the Company and neither management nor their Affiliates shall, directly or indirectly, participate in any such project or opportunity, whether or not the Company participates in such project or opportunity.

d. The Company may enter into contracts and agreements with any Member and/or any of its Affiliates for the rendering of services on arm's-length terms that are no less favorable to the Company than those available from unrelated third parties; provided that, if such transaction involves aggregate consideration with a Fair Market Value in excess of $____ in any one year, such transaction must be approved by a majority in number of the disinterested Managers. No such contract or agreement shall be void or voidable solely for such reason and no Person having an interest in any such transaction shall have any liability to the Company or any Member solely by virtue of such relationship or conflict, if the material facts as to the relationship and transaction are disclosed or are known to the Members and, if required, the transaction is approved by the disinterested Managers. For purposes of this Section __, if approval by the Board of Managers would otherwise require the vote of an interested Manager, the vote of such interested Manager shall not be required for such approval. Agreements relating to the provision of services as set forth in this Agreement shall be deemed approved for all purposes hereunder.

e. Variations Simplified. With the drafting suggestions set forth above, there are other issues that could arise, for which the language I have quoted could be reworked and used. For example, conflict of interest transactions come in all sorts of varieties, not just in the context of corporate opportunities, and simple contract issues, employment contract issues, and any other affiliate relationships (sharing of overhead) may be safeguarded based on the provisions set forth above. One other very helpful provision in a dispute about use of company resources is the standard language that the property acquired and used by the company is "deemed owned by the Company, and that the resources of the Company will be used solely for Company purposes.

f. Duty of Care issues. Procedural rules and following the rules established (i.e. "duty of care") is a topic that deserves special consideration in the LLC context. Because there is a serious dearth of procedural provisions in the LLC statute, many draft extensive provisions in LLC agreements to provide for the basics of entity operation, including provisions permitting the appointment of officers, duties and job descriptions of officers, and rules for holding meetings or obtaining consents for members and managers. Because of the primacy of the company agreement as the governing document, issues of breach of contract arise when those procedures are not followed. Several drafters have been dismayed when their provision that states that a governing person is liable for breach of the contract has been used to hold a member or manager liable for failure to conduct regular meetings. Further, there are IRS rulings in the estate planning arena that state that if the LLC requires corporate formalities

and those formalities are not observed, then the LLC may be pierced. These duty of care issues depend both on thoughtful drafting and consistent application. One approach is to take out any formal procedures, and simply authorize the governing persons to manage the company. That structure is based on the idea that there are no rules to break, and so the duty of care issues are significantly reduced. I would suggest that duty of care is deeply embedded in the common law on fiduciary duty, and that this tactic may not produce the intended result. Another approach is to leave in the procedures and provide an express provision that a failure to observe any formalities in the company agreement is not a breach of the agreement and may not be used to impose personal liability on the governing person. Naturally, there is no comforting case law on point.

IV. MANDATORY INDEMNIFICATION AND EXPENSE ADVANCEMENT

Once you have thought through the duty issues, the next issue is to draft the actual indemnification and advancement language. Indemnification under the TBOC is covered by the provisions starting at Section 8.001, et seq, which is in the "HUB" of the TBOC, and which also do not expressly apply to limited liability companies. Under the express provisions of Section 8.002(a), the "HUB" provisions on indemnification do not apply to LLCs. Section 8.001 is drafted in the same fashion as Section 7.001, in that it expressly excludes limited liability companies from the indemnification provisions of the "HUB" of the TBOC. Once again, you must turn to the specific LLC spoke, and specifically, Section 101.402, which provides that you *MAY* provide for indemnification. The case law interpretations under Delaware law of the statutory language in Section 101.402 of the TBOC has held that the permissive nature of the word "may" means that indemnification and advancement of expenses are not mandatory. You may not simply draft in language that says that governing persons will "be indemnified to the full extent of the Texas law." That results in no mandatory indemnification or advancement of expenses.

There are two basic solutions to this drafting issue. The first is to carefully copy Section 8.001, et seq. the TBOC provisions on indemnification, into the Company Agreement, so that the express provisions of the corporate indemnification and advancement of expense rules are carefully duplicated in your company agreement. That is the safest course. Clients who actually read their documents, however, always ask if all of those provisions are absolutely necessary. One possible fall back position for indemnification is the following language:

> "To the fullest extent allowed by Section 8.001 et seq. of the TBOC, as if the Company were a corporation under the TBOC, without any of the limitations imposed by the TBOC, and as if all permissive provisions thereof are mandatory for the purposes hereof, the Company will indemnify and hold harmless each Covered Person from and against any and all losses, claims, damages, liabilities, judgments, penalties (including excise and similar taxes), fines, settlements and reasonable expenses (including court costs and attorney's fees) actually incurred by such Covered Person in connection with any threatened, pending or completed claim, demand, action, suit or proceeding, whether civil, criminal, administrative, arbitrative or investigative, any appeal in such a claim, demand, action, suit or proceeding and any inquiry or investigation that could lead to such a claim, demand, action, suit or proceeding (any such claim, demand, action, suit, proceeding, appeal, inquiry or investigation being hereinafter referred to as a "Proceeding"), in which such Covered Person was, is or is threatened to be made a named defendant or respondent as a result of or based upon his status as a Covered Person or any action or omission taken by him, her or it in his, her or its capacity as such, regardless of whether any of said losses, claims, damages, liabilities, judgments, penalties, fines, settlements or expenses resulted from the negligence or other fault of such Covered Person."

A standard advancement paragraph under this type of formulation would look like this:

> "To the fullest extent allowed by Section 8.001 et seq. of the TBOC, as if the Company were a corporation under the TBOC, without any of the limitations imposed by the TBOC, and as if all permissive provisions thereof are mandatory for the purposes hereof, the Company will pay or reimburse, in advance of the final disposition of a Proceeding and without the determination specified in Section ___ above, reasonable

> expenses (including court costs and attorney's fees) incurred by a Covered Person who was, is or is threatened to be made a named defendant or respondent in a Proceeding because of his, her or its status as a Covered Person, within thirty (30) days after the Company receives a written affirmation by such Covered Person of his, her or its good faith belief that he, she or it has met the standard of conduct necessary for indemnification hereunder and a written undertaking by or on behalf of such Covered Person to repay the amount paid or reimbursed if it is ultimately determined that such Covered Person has not met such standard or if it is ultimately determined that indemnification of the Covered Person against expenses incurred in connection with the Proceeding is prohibited under Section 11.03(b) above. The written undertaking required by the preceding sentence must be an unlimited general obligation of the Covered Person, but need not be secured. It may be accepted without reference to financial ability to make repayment."

This particular formulation is governing person friendly. For example, it places a time deadline on the payment of the advances by the indemnifying entity. Because advancement is the most important element in the actual indemnification process, there are other issues that you should consider. First, you do not have to mandatorily advance expenses, and you do not have to advance expenses to the extent allowed in the statute. There is currently a case pending in Delaware, in which the corporation had to file bankruptcy after incurring an estimated $100,000,000 in reimbursement costs for its former executives. Where are the boundaries of advancement? The following are suggestions for possible limits or variations in advancement agreements.

A. Consider the capacity in which the governing person was operating. Under the statutory formulation of Section 8.001, there is a definition of "Official Capacity" which is a limit on the nature of the claims for which the governing person may be indemnified. If you will read the suggested provision set forth above, it limits the indemnification and advancement to a "Proceeding" which is one in which the governing person is threatened in its capacity as a governing person. This type of formulation should exclude indemnification and advancement for suits concerning a breach of an employment contract by a manager or officer, as well as other contractual issues that would not involve fiduciary duty issues. Defense for other types of proceedings can also be carved out, for example, governmental actions or proceedings. Should the EPA , SEC, or other regulatory body challenge the governing person, is that a proceeding in which that governing person should be covered by advancement. Further, should the coverage arise only if there is a formal proceeding, or should the governing persons be advanced costs for to cover investigations or other informal

B. Proceedings? Absent specific language limiting the statutory formulations, case law holds that advancement for these matters is appropriate.

C. Consider how long to advance expenses. You are not required to advance expenses until the final disposition of the Proceeding. You may agree to advance expenses through the first judicial determination, or through a mediation, but not court proceeding, or any other sort of permutation of this concept. The leading case on this issue is Sun-Times Media Group, Inc. v. Black, Boultbee, Atkinson and Kipnis, C.A. No. 3518 VCS, Opinion dated July 30, 2008, where the Delaware court held that the traditional language, of "final disposition of such action, suit or proceeding" meant all the way through the complete appeal process, and the Delaware judge required the company in question to advance expenses through the final appeal of a criminal conviction of former officers.

D. You may limit the type of expenses. You do not have to advance all expenses. Many agreements contain language that state that reimbursement will be for "reasonable expenses" but there can be much more definition around that concept. In a complicated case, the governing person may need several different types of counsel, and may face significant conflict of interest issues. As a result, you may consider limiting the advancement to the costs of one law firm or one attorney. You may agree to not advance expenses for other professionals, such as investigators or expert witnesses. You may put dollar or other limits on the amounts advanced by types of expenses.

E. You may require security. You are not required to advance an amount that is not secured, and you may require that the governing person post adequate security for the amounts advanced.

V. SPECIAL DRAFTING CONSIDERATIONS FOR LLCS

One other area of drafting concern in a company agreement for the LLC in the area of duties, exculpation and indemnification is who should be covered, and whether you have actually covered the persons who are managing the LLC. The issue is more complicated in LLC drafting because there are several choices about how to manage the LLC. You may have a member managed LLC or a manager managed LLC, and for both the member managed and the manager managed LLC, you may have a managing member or a managing or general manager. If you have a member, manager or officer that represents a member without an economic interest, but a membership interest, it is likely that the member and its representatives also have fiduciary duties that need to be considered. Fortunately, Texas is clear that you may choose a manager managed LLC, the members are not authorized to bind the LLC, so that if you make a choice, the indemnification and advancement expenses only apply to the class of persons that you have chosen to manage the entity. However you elect to manage the entity, you have to draft different provisions for member managed from manager managed.

Next, there are special TBOC rules for officers. Unlike other jurisdictions, Texas specifically permits PERMISSIVE indemnification of officers. Under Section 8.105(a) which would only apply to a corporation or limited partnership, the TBOC provides as follows:

> "Notwithstanding any other provision of this chapter but subject to Section 8.003 and to the extent consistent with other law, an enterprise may indemnify and advance expenses to a person who is not a governing person, including an officer, employee, or agent."

With respect to LLCs, Section 101.402, also expressly covers officers and statutorily authorizes the Texas LLC to cover officers, but it is also permissive. Because all of these provisions are permissive, to cover officers, you will have to specifically draft a mandatory provision into the company agreement. You may elect to cover officers separately, or include them in the group that is entitled to indemnification (and also duties and exculpation). The Texas statute is relatively favorable, but because it is permissive, you must affirmatively invoke its protective provisions for officers.

VI. INSURANCE

Buy it. If your company has (and it should have) comprehensive general liability insurance, it can also purchase officer and director insurance. Officers and managers that are not both owners and operators of the business should consider O&D insurance for their activities. Family held businesses or similar closely held businesses may be possible exceptions. If, however, you have independent, third party investors, institutional or otherwise, O&D insurance is highly advisable. The TBOC expressly permits corporations to purchase insurance for activities that are not permitted indemnification from the entity itself. Under Section 8.004, the TBOC provides as follows:

> "Except as provided in Section 8.151, a provision for an enterprise to indemnify or advance expenses to a governing person is valid only to the extent it is consistent with this chapter."

I will say that I am troubled about how this section fits with Sections 101.401 and 101.402 of the TBOC LLC spoke. I think that it is fair to read Section 8.151 as prohibiting any indemnification provisions that are in excess of the statutory provisions of the TBOC, and that the only way to go beyond the TBOC is to purchase insurance. Because of the reference to Section 8.151, which is the section on insurance, this provision it is saying that you may buy insurance that covers more than the indemnification provisions of the statute. Practically speaking, this statutory provision also means that the terms and conditions of insurance policies are negotiable. If you determine to purchase insurance, you should read and negotiate on the boundaries of the coverage before you finally purchase.

There is also current Delaware case law that is affecting practices for O&D insurance. Under an opinion in the Delaware case of Levy, Lightcap, Ying & Grillo, v. HLI Operating Company, Inc., et al, C.A. No. 1395-VCL, Memorandum Opinion and Order dated May 16, 2007, the insurance company for the private equity investor was held to be the primary coverage for the directors that were serving on the board as the representatives of the private equity investor. The insurance company for the target company was held to be the secondary coverage. This holding is causing a new practice of requiring an indemnification contract between the investor company and the investment target to provide that the investment target's insurance is primary and the investor's insurance is secondary.