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Advancement Rights of Former Directors and Officers

A recent settlement in the case of *Schoon v. Troy Corporation* pending before the Delaware Supreme Court should cause all directors and officers to review their rights to advancement of litigation expenses. Last March, the Delaware Court of Chancery permitted a board of directors to amend a company's bylaws to unilaterally revoke a former director's advancement rights before bringing suit against the director. Corporate law practitioners have closely followed the case's subsequent appellate proceedings with some speculation that the Court of Chancery decision would be reversed. Because the litigants recently settled their dispute, however, the Delaware Supreme Court will not address the merits of the lower court's decision. Accordingly, it is important for all directors and officers to undertake a careful review of the advancement provisions of their corporations' charters and bylaws to ensure that their advancement rights are properly defined.

In *Schoon v. Troy Corporation*, 948 A.2d 1157 (Del. Ch. 2008), a former director of Troy, William Bohnen, sought advancement of legal expenses from the company in a breach of fiduciary duties claim brought against him by the company. During the period in which Bohnen

was a director of Troy, Troy's bylaws provided advancement of expenses to both current and former directors. However, after Bohnen retired from the company and several months before the commencement of the litigation between Troy and Bohnen, Troy's board of directors amended the bylaws to eliminate advancements to "former" directors.

In response to the board's action, Bohnen filed suit to force the company to advance his legal expenses. He argued that his right to advancements had vested at the time he took office as a director and Troy could not terminate that right without his consent. He also argued that Troy's bylaws, which stated that all advancement rights "shall continue as to a person who has ceased to be a director or officer," expressly provided for his right to advancement as a former director, notwithstanding the amendments. Thus, according to Bohnen, the amendment to Troy's bylaws could not revoke his vested contract right.

The Court of Chancery disagreed and ruled in favor of Troy. It held that the right to advancement of legal expenses does not vest until a corporation's obligations are triggered — that is, *on the date of the filing of the pleading*

against the director. The court also found that the bylaw provision on which Bohnen relied did not preserve his right to advancements as a former director. Instead, the court concluded that the bylaw was "better understood as providing that a director, *whose right to advancement is triggered while in office*, does not lose that right by ceasing to serve as a director" (emphasis added). As a result, Bohnen was left to fund his own defense in the litigation.

The court's holding and lack of any appellate review have important implications for directors and officers of corporations incorporated in Delaware and in other states that may look to Delaware for precedent. Depending upon the specific language of the advancement provision, corporations could unilaterally terminate a former director's right to advancement. As a practical matter, such an amendment would present directors who retire, resign or are ousted in a proxy contest with the potentially daunting prospect of paying up front the often extraordinary expenses of complex litigation relating to their actions on the board.

Advancement and indemnification are important rights that encourage service on boards of directors and, subject to

certain limitations, assure directors that the costs of litigation incidental to their duties will be borne by the corporation. Therefore, directors should work with the corporations they serve to ensure that their rights to advancement and indemnification are properly defined and adequately protected. Importantly, the result in *Schoon* can be avoided through careful drafting: any advancement rights set forth in the corporation's charter or bylaws should expressly address when the directors' rights vest and should

provide that no retroactive amendment can deny any director such advancement rights. In some cases, it may also be prudent for corporations to enter into indemnification agreements with directors.

In addition to reviewing advancement and indemnification rights, companies would also be well-advised to undertake a comprehensive review of their bylaws prior to the upcoming 2009 proxy season in light of recent legal

developments relating to advance notice provisions, including the Delaware Court of Chancery decisions in *Levitt Corp. v. Office Depot Inc.* and *JANA Partners v. CNET*, and Judge Kaplan's ruling from the U.S. District Court for the Southern District of New York in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*. Already more than two hundred companies have amended their bylaws in the wake of these important decisions and we expect more to do the same.

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