

## Delaware Court Allows Retroactive Repeal of Director Advancement Rights

A recent decision from the Delaware Chancery Court has called into question the reliability of advancement and indemnification rights for directors of Delaware corporations. Under the decision, directors may no longer be able to assume that corporations will make advance payment of, or indemnify them for, legal fees incurred in the defense of lawsuits brought against them.

In *Schoon v. Troy Corp.*, the Delaware Chancery Court held that a former director's right to advancement in his former corporation's bylaws did not vest until an indemnifiable claim was asserted against the director and that, prior to the assertion of an indemnifiable claim against the director, the corporation could amend the bylaws to limit or repeal the former director's advancement rights.

Briefly, the facts of *Schoon* are as follows: William J. Bohnen, a former director of Troy Corporation, brought an action under Section 220 of the Delaware General Corporation Laws seeking access to the books and records of Troy Corporation. After the action was brought, Troy amended its bylaws to eliminate advancement for former directors, including Bohnen. Shortly thereafter, Troy attempted to obtain leave to assert a counterclaim against Bohnen in the Section 220 action for breach of fiduciary duty. The Court denied Troy's motion. Troy then brought a separate action in the Chancery Court against Bohnen and others alleging various breaches of fiduciary duty. Bohnen sought advancement of defense expenses incurred in defending against the breach of fiduciary duty claim. Troy refused Bohnen's request for advancement, and Bohnen thereafter filed suit in the Chancery Court to recover his defense expenses.

In a decision issued on March 28, 2008, the Chancery Court held that Bohnen was not entitled to advancement in defending against the breach of fiduciary duty claim. In reaching this conclusion, Vice Chancellor Lamb held that a director's right to advancement did not vest until the director was named as a defendant in a proceeding for which advancement and indemnification are available. The court entered judgment against Bohnen on the grounds that the corporation had effectively amended Troy's bylaws before Bohnen's right to advancement had vested and that, as a consequence, Bohnen was not entitled to advancement of defense costs.

Under *Schoon*, until such time as a director is named in a proceeding for which advancement is available, the director has no vested legal right to advancement, and the director's rights can be lawfully terminated. This holding thus has the potential to disrupt director protections under Delaware law. Prior to *Schoon*, many practitioners had presumed that a director's rights to advancement and indemnification vested by virtue of the director's service as a director and at the time of such service. It was commonly understood, therefore, that advancement and indemnification rights could not be eliminated unilaterally by the director's corporation.

*Schoon* disrupts that settled expectation. Now, any director of a Delaware corporation, with standard advancement and indemnification protections, is at risk of losing the director's right to advancement or indemnification as a result of a subsequent amendment to the corporation's bylaws. If the director is not a defendant or respondent in an indemnifiable

proceeding at the time of such an amendment, the amendment could be upheld by the courts. In that case, the director could be left with only a right to mandatory indemnification under Section 145(c) of the Delaware General Corporation Laws and even then, only if and when the director is “successful on the merits or otherwise.”

As a result of *Schoon*, directors and officers of Delaware corporations should review their corporate documents to ensure that their rights to advancement and indemnification are not unduly exposed to retroactive amendments. A possible solution to the problem posed by *Schoon* is to add to the corporation’s bylaw or charter indemnification provisions a savings provision along the following lines: “any repeal or modification of the foregoing provisions [granting advancement and indemnification rights] shall not adversely affect any right or protection of a director or officer of the corporation with respect to any acts or omissions of such director or officer occurring prior to such repeal or modification.” To further guard against retroactive amendments, advancement and indemnification protections should be included in a corporation’s charter, which can only be amended by the company’s shareholders. The most reliable solution to the problem posed by *Schoon*, however, is to enter into a separate indemnification agreement that prohibits retroactive amendments.

If you have any questions about the court’s ruling in *Schoon*, please contact your regular Ropes & Gray attorney or any of the following attorneys:

[Randall W. Bodner](#)

[Peter L. Welsh](#)

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