

DIRECTORS BEWARE: IT COULD HAPPEN TO YOU!

A recent decision of Delaware Chancery Court (the "Court") has left many corporations and directors wondering whether their current bylaws are sufficient and clear enough to address certain indemnification and advancement issues. Generally, directors are protected to a great extent under a corporation's bylaws, especially with regard to indemnification. Section 145 of the Delaware General Corporation Law (the "DGCL") grants corporations vast power to indemnify directors, officers, employees and others against threatened, pending or completed legal actions; provided that the person being indemnified acted in good faith and in a manner reasonably believed by the person to be in the best interests of the corporation. Additionally, Section 145 of the DGCL allows corporations to advance payment of expenses to directors in defense of legal actions so long as the directors agree to repay the advancement if it is ultimately determined that they are not entitled to indemnification. Typically, corporations draft their bylaws to provide advancement rights to both current and former directors. It was this particular fact that led to the issues and important ruling in *Schoon v. Troy Corp.* ("Schoon").

In *Schoon*, William J. Bohnen, a former director of Troy Corporation ("Troy"), brought an action in September 2005 under Section 220 of the DGCL (the "220 Action") seeking access to Troy's books and records. Troy's board of directors answered Bohnen's complaint in October 2005. While the 220 Action was pending, Troy amended its bylaws in November 2005 to eliminate mandatory advancement of legal expenses for former directors. Thereafter, Troy attempted to obtain leave to assert a counterclaim against Bohnen in the 220 Action for breach of fiduciary duty. At that time Bohnen sought advancement of his legal expenses from Troy for defending against Troy's claims of breach of fiduciary duty. Troy's motion was ultimately denied, and in February 2006 Troy brought a separate action against Bohnen and seven other defendants, pursuant to which Troy claimed breach of fiduciary duties (the "Troy Action"). Due to the recent amendment to its bylaws, Troy refused Bohnen's request for advancement of expenses, and as a result, Bohnen filed a lawsuit in the Court seeking advancement for the legal fees and expenses incurred in defending the breach of fiduciary duty claims Troy sought to raise in the 220 Action and actually raised in the Troy Action.

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On March 28, 2008, the Court held that Bohnen was not entitled to advancement of legal fees incurred in his defense against the breach of fiduciary duty claims because a director's right to advancement does not vest until the director is named as a defendant in a legal proceeding in which advancement and indemnification is available. The Court also held that the allegations made by Troy in its defense in the 220 Action were insufficient to vest Bohnen's advancement rights because they were not actual filed claims. Bohnen argued unconvincingly that his right to advancement instead vested when he became a director; however, the Court rejected his argument. As a result of the Court's ruling, Bohnen was not entitled to advancement of his legal expenses because Troy had amended its bylaws eliminating a former director's right to advancement before Bohnen's right to advancement had actually vested.

Following *Schoon*, directors of Delaware corporations should look to other avenues for ensuring their indemnification and advancement rights are protected. Directors may seek to put indemnification and advancement provisions in a corporation's certificate of incorporation, as opposed to its bylaws, thereby requiring any amendment to or removal of such provisions to be approved by the corporation's shareholders. Alternatively, directors may enter into indemnification and advancement agreements with the corporation so that such indemnification and advancement rights constitute a contractual obligation of the corporation. A corporation's bylaws could also explicitly state that indemnification and advancement rights vest at the time a person becomes a director, as opposed to vesting when the director is named in a proceeding or could provide that advancement provisions cannot be amended to prevent advancement for events that transpired prior to the amendment. Director and officer liability insurance can also provide defense expenses and indemnification to former directors.

The Court's decision in *Schoon* should prompt Delaware corporations to review their bylaws to ensure the indemnification and advancement provisions are clear on when the rights of directors vest, what rights are afforded to current and former directors, and if and when such rights can be removed.