

by John Orr and Tara Cummins

Former and future former directors take note: if you are named in a claim in your capacity as a former company official, your right to indemnification or the advancement of defense fees may be limited. So says the Delaware Chancery Court in the March 28, 2008 decision of *Schoon v. Troy*, C.A. No. 2362-VCL.

As explained more fully below, the absence of corporate advancement is not entirely offset by the availability of D&O insurance. Because “presumptions” of indemnification are built into D&O policies, coverage under the policies for most claims does not trigger until after satisfaction of an often hefty self-insured retention. If the director’s former company is not advancing expenses to satisfy the retention, it is the former director’s personal assets that may be at risk for this obligation.

Background

Because litigation is a long and costly enterprise, most corporate bylaws provide for “advancement” of defense fees where the company will front defense costs and other expenses, or otherwise reimburse directors for such expenses, as they are accumulated rather than at a matter’s final disposition. If the director or officer is subsequently disqualified from eligibility for reimbursement, he or she is typically required by agreement to pay back those sums received through advancement.

As a practical matter, a company that fails to provide for the advancement of defense costs will find it difficult to attract and retain executives. It is for this same reason that corporations typically provide D&O coverage and advancement not only to present, but also former directors and officers. Because directors may be sued after their departure for wrongful acts during their tenure, coverage for former directors is critical to the development and maintenance of a successful C-suite.

Unfortunately, as the corporation giveth, it may soon taketh away. Companies are generally free to amend their corporate charter and some have gone so far as to remove advancement provisions from the bylaws or, for that matter, advancement rights for former directors.

This begs the critical question of when exactly a director’s right to advancement vests. Once directors begin their service, do they acquire rights to advancement then in place for any and all claims that arise during and after their service? Or, if the advancement rights were changed after they commenced their service, do they acquire the advancement rights in place at the time the claim is first made against them? This was the issue addressed by the Delaware Chancery Court in *Schoon*.

Schoon v. Troy

The relevant facts of *Schoon* are as follows: William Bohlen, a former director of Troy Corporation, sued the company, seeking access to books and records. Shortly thereafter, Troy amended its bylaws to remove advancement for former directors, including Bohlen. In addition, Troy countersued to the books and records action, but was unsuccessful. It did, however, bring a subsequent, separate action against

Bohen for breach of fiduciary duty. Whether or not Bohlen is entitled to advancement for the fiduciary breach claim is the important question.

Bohlen argued that, as a former director, he was entitled to advancement notwithstanding the bylaw amendment because his right to advancement had vested and could not unilaterally be terminated. In other words, the argument was that, even though Troy could remove advancement for future former directors, it could not divest Bohlen of those rights, as they vested *at the time he took office*.

The Chancery Court rejected this argument, holding instead that the rights to advancement for a director vest when *he is a named defendant in an action*. Essentially, because the right had not vested before the bylaw change, the corporation was entitled to divest Bohlen of his rights.

Considerations

The *Schoon* decision alters the perception that many officers and directors have that they can rely on the strong advancement and indemnification rights they have now or may have had when they were serving their companies. Now that they may no longer rely on those expectations, officers and directors of Delaware corporations should:

- Review their companies' bylaws and other corporate documents to ensure that existing rights to indemnification and advancement are not unduly exposed to retroactive modification.
- Where there is such exposure, they should secure separate indemnification agreements. By placing broad indemnification and advancement rights in a contract, changes in corporate bylaws or corporate documents would not alter the terms of pre-agreed protections.
- Confer with outside corporate counsel about ways in which companies may amend existing indemnification agreements and bylaws to protect directors from the retroactive elimination of their rights.

Although retroactive changes to indemnification or advancement rights would not alter the scope of protection afforded by the company's D&O liability insurance, executives may find themselves faced with having to satisfy often significant policy retentions. Specifically, D&O insurers apply these retentions when the corporation is permitted by law to indemnify. If the corporation elects, either through a bylaw change or otherwise, not to advance or indemnify, that does not preclude its legal ability to do so. As a result, directors can anticipate the D&O insurer to impose the retention obligation even if the corporation decides not to indemnify. If the corporation does not pay the retention because of a lawful bylaw restriction, that obligation may fall to the executive.

To address this burden, some insurers are offering an insurance product specifically for former directors and officers. Unlike most D&O products, which the corporation purchases for its executives, this "former D&O" policy belongs to the individual executive. Insurers are writing the policies to be non-cancelable and non-rescindable. Generally, they provide coverage for up to six years after the director leaves the company.

Risk Review

The *Schoon* case reminds us that directors and officers liability exposures are constantly evolving. It is critical that a company review its D&O risk profile and update its risk strategy. Developments that could give rise to uncovered losses must be examined in the context of the current risk solutions. We would be delighted to discuss with you how best to proactively address this and other D&O exposures in today's challenging business climate.

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