

By Donald Glazier and Tara Cummins

A Troubling Opinion Is Overturned

In 2008, an opinion by the Delaware Chancery Court significantly shook director reliance on the advancement of indemnity. It held that a director's interest in advancement does not vest until he is named in an action.¹ Former directors were therefore left to worry whether they might be divested of rights to advancement post facto, thus unable to receive immediate potential indemnification for suits arising out of previous board tenure. In response to this unsettling development, the Delaware legislature recently amended Section 145(f) of the Delaware General Corporations Law ("DGCL") regarding advancement.

Background

The *Schoon* case concerns director William Bohlen, a former director of Tory Corporation. Shortly after his retirement, Bohlen brought suit to review the corporation's books and records. In response to his suit, Bohlen's former company filed a separate action against him, alleging that he breached his fiduciary duties to the company. Additionally, the company changed its corporate bylaws regarding advancement of indemnification such that Bohlen was divested of his advancement rights.

The bylaw change was a significant departure from the rules that were in place when Bohlen agreed to sit on the board, and at the time the alleged breach of fiduciary duties took place. The post-facto change left Bohlen facing legal costs without the prospect of advancement. 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. 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*.

The ramifications of this ruling were significant, especially for board members who left companies after a disagreement with fellow board members. In those cases, the remaining board members might change the corporation's bylaws subsequent to the dissenting director's departure.

Legislative Reaction

To calm the valid concerns of board members fearing post-departure changes to their directorial protections, the Delaware Legislature essentially overruled the *Schoon* decision. It did so by amending Section 145(f) to include language concerning the impairment of rights to indemnification or advancement as follows:

¹ *Schoon v. Troy*, C.A. No. 2362-VCL. We discuss the Chancery Court's opinion at length in our September 2008 publication, "Delaware Case Affects Rights of Former Directors to Indemnity and Advancement." <http://www.integrogroup.com/portal/server1253.html>

“f) ... A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to such provision after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.”

Under the new statute, effective August 1, 2009, a corporation cannot change the rules to indemnification or advancement post-facto unless it specifically delineates the right to do so in its bylaws in a timely fashion. The law helps to address director concerns over advancement by clarifying its certainty and stating with particularity the exception to the rule. Directors who examine a corporation’s bylaws will know if the company has authorized the right to amend advancement. Directors with concerns may consider entering into a separate indemnity agreement with the corporation or reconsidering their agreement to serve on the board altogether.

Prudent D&O Review

Bylaws, separate indemnification agreements and review of D&O insurance.

All current board members, or those considering such service, should closely review the company’s bylaws regarding indemnification and advancement obligations. Such a review should be undertaken regardless of whether the entity is incorporated in Delaware or elsewhere. The review should be made with an eye toward whether the bylaws explicitly grant advancement rights and whether such rights are stated to be immutable.

Moreover, it may be prudent for directors to request a separate indemnification agreement (with advancement obligations) from the company in favor of the Directors/Officers. Such agreement would likely benefit the Directors and Officers if it included an immutability clause stating that the agreement shall not be changed to the detriment of the Director without the written acceptance of the Director. Furthermore, the agreement may even contain a provision that ensures the minimum level of benefit to the Director as stated in the agreement. This would include the possibility of broader benefits automatically incorporated if the company subsequently provides broader benefits to Directors/Officers, or if the law provides greater permissible benefits.

A review of the bylaws and the request for a separate agreement should coincide with a careful examination of the company’s directors and officer’s insurance protection. Ensuring that indemnification and advancement provisions of the insurance policy will respond as intended is a critical component of a successful management risk strategy.

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