

**DELAWARE CHANCERY COURT UPHOLDS AMENDMENTS TO BYLAWS  
DENYING FORMER DIRECTOR ADVANCEMENT RIGHTS****Introduction**

A recent decision of the Delaware Chancery Court upheld amendments to a corporation's bylaws that eliminated advancement of expenses for legal proceedings arising out of a former director's service to the board. Based on this ruling, directors must be wary of relying on advancement rights contained in a corporation's bylaws since those rights may be lost if the bylaws are amended, even after the cause of action accrues.

In *Schoon v. Troy Corporation*,<sup>1</sup> following the resignation of William J. Bohnen ("Bohnen"), a director of Troy Corporation ("Troy"), the board approved amendments to its bylaws that eliminated advancement rights for former directors.<sup>2</sup> Shortly thereafter, Bohnen became involved in litigation with Troy and sought advancement rights, arguing that the amendments did not terminate his right to advancement.<sup>3</sup> Bohnen based his argument on the principle that the right to advancement is a vested contract right that cannot be unilaterally terminated, as well as on his belief that his rights became "vested" at the time he took office.<sup>4</sup> The court rejected Bohnen's argument, finding that his rights "vested" at the time litigation commenced.<sup>5</sup>

**Background**

Bohnen served as a director of Troy from 1998 until his resignation in February 2005. In November 2005, the Troy board of directors approved amendments to the corporation's bylaws that removed former directors from the definition of individuals entitled to advancement of litigation-related expenses. Thereafter, Troy filed an action against Bohnen, asserting claims of breach of fiduciary duty for actions taken by Bohnen while serving as a Troy director. Bohnen then filed an action seeking judicial recognition of his right to advancement under Troy's bylaws, after Troy refused his request for advancement of the legal fees and expenses to be incurred in defending the breach of fiduciary duty claims.

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<sup>1</sup> *Schoon v. Troy Corporation*, No. 2362-VCL, 2008 WL 821666 (Del. Ch. Mar. 28, 2008) (not reported).

<sup>2</sup> *Schoon*, 2008 WL 821666, at \*2.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*, at \*5.

<sup>5</sup> *Id.*

## Decision

Vice Chancellor Lamb held that, based on the November amendments, a former director did not have advancement rights.<sup>6</sup> Bohnen argued that the amendments did not terminate his right to advancement because his right to advancement had vested when he took office and the original bylaws were in place. Moreover, based on *Salaman v. National Media Corp.*<sup>7</sup>, a prior Delaware court decision, “the right[] to advancement . . . [was] a vested contract right which [could not] be unilaterally terminated.”<sup>8</sup> The court rejected Bohnen’s argument, holding that the language of the original bylaws did not preserve his right to advancement because his right “vested” only after the amendments took place, upon the commencement of litigation.<sup>9</sup>

Although subsequent language in the same article of the bylaws provided that “[t]he rights conferred by this Article shall continue as to a person who has ceased to be a director or officer and shall inure to the benefit of such person and the heirs . . .,” the court explained that this provision should be understood to mean that “a director, whose right to advancement is *triggered* while in office, does not lose that right by ceasing to serve as a director.”<sup>10</sup> Thus, the article was inapplicable to Bohnen given that he resigned prior to the vesting of his advancement rights.

Finally, the court noted that although the corporation’s bylaws provided for indemnification of former directors, the “clear separation of the indemnification and advancement provision” precluded the interpretation that the advancement provision was a subpart of the indemnification provision. The court stressed that although advancement and indemnification are obviously related, they remain distinct types of legal rights.

## Implication

The *Schoon* decision makes clear that rights to advancement of expenses under corporate bylaws may be lost by subsequent amendments to the bylaws that occur prior to the vesting of director’s advancement rights. Moreover, these bylaws are capable of being amended without the director’s consent.

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<sup>6</sup> Troy’s bylaws had originally provided that “the Corporation shall pay the expenses incurred by any present or former director.” *Schoon*, 2008 WL 821666, at \*5. “Following the amendment, the successor provision read ‘[l]osses reasonably incurred by a director or officer in defending any threatened or pending Proceeding . . . shall be paid by the Corporation in advance of the final disposition. . . .’” *Id.*

<sup>7</sup> *Salaman v. National Media Corp.*, 1992 WL 808095 (Del. Super. Oct. 8, 1992).

<sup>8</sup> *Schoon*, 2008 WL 821666, at \*5, quoting *Salaman*, 1992 WL 808095, at \*6 (emphasis added).

<sup>9</sup> Thus, the court noted that *Salaman* was distinguishable from the present case, because in *Salaman* the former director’s rights had already vested at the time of the amendment to its bylaws. *Schoon*, 2008 WL 821666, at \*5.

<sup>10</sup> *Schoon*, 2008 WL 821666, at \*6.

Most private equity and venture capital investors typically have a veto or consent right over bylaw amendments, so directors representing these types of investors may not face the risks presented by the *Schoon* decision. However, in cases where they do not have the benefit of such veto or consent rights, there are a number of ways that directors can protect themselves from the adverse effects of the *Schoon* decision, including:

- a written indemnification agreement between the director and the corporation, specifically providing for advancement of expenses (which agreement cannot be amended or terminated without the director's consent),
- a bylaw provision that expressly states that vesting occurs when the director joins the board, or
- a bylaw provision that otherwise makes it clear that the indemnification and advancement provisions cannot be amended to the detriment of any former or current director without that director's consent.

Finally, the *Schoon* decision reminds us that courts treat the concepts of advancement and indemnification separately. Directors should review charters and bylaws to ensure that advancement of expenses is explicitly provided for and that such advancement is mandatory (subject to the receipt of an appropriate undertaking) rather than permissive.

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May 29, 2008

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