July 24, 2008

Corporate Governance Update: Delaware Decision Highlights Need for Director Protection

David A. Katz
and
Laura A. McIntosh[*]

The surprising result in a recent Delaware case may cause directors to question whether their rights to indemnification and advancement of expenses are secure, particularly once they have retired from a board of directors. The advancement of expenses in corporation-related lawsuits, along with broad indemnification, is an important feature of director protection. It serves not only to enable companies to attract high-quality director candidates but also to encourage directors to contest frivolous lawsuits and generally to promote reasonable corporate risk-taking. Companies should take this opportunity to ensure that their indemnification bylaws are appropriately drafted in light of the Delaware Chancery Court's recent decision in *Schoon v. Troy Corp*.[1]

Background

Typically, companies draft their indemnification bylaws so as to provide their corporate directors with the fullest protection available under the law. In Delaware, the available rights are broad. Under Section 145 of the Delaware General Corporation Law (DGCL), companies have extensive power to indemnify directors, officers and others against threatened, pending and completed legal actions. The only limitations in civil suits are first, that the indemnified person must have acted in good faith and with a reasonable belief that he or she was serving the best interests of the company, and second, that a company may not indemnify a person found liable to the company itself, unless a court rules otherwise.[2]

Delaware companies commonly opt to protect their directors further by including in their corporate charters a provision eliminating or limiting personal liability

---

[*] David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz. Laura A. McIntosh is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.

[1] 948 A.2d 1157 (Del. Ch. Mar. 28, 2008).

[2] Delaware General Corporation Law § 145.

If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to Publications@wlrk.com or call 212-403-1476.

W/1274539

for monetary damages for breach of fiduciary duty as a director. DGCL Section 102(b)(7) [3] permits such provisions so long as they do not eliminate or limit liability for any breach of the duty of loyalty, for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, for unlawful dividend payments or unlawful stock purchases or redemptions, or for any transaction from which the director derived an improper personal benefit.[4] Charter provisions implemented pursuant to DGCL Section 102(b)(7) provide powerful protection for directors.[5]

Expense advancement is an important and customary aspect of indemnification bylaws. DGCL Section 145(e) provides that companies may provide advance payment of expenses to officers and directors in defending legal actions upon receipt of an undertaking to repay the advancement if it is ultimately determined that the person is not entitled to indemnification. It further provides that companies have the discretion to determine the terms and conditions under which they wish to provide advancement to former directors and officers or other employees or agents.[6] Typically, indemnification bylaws are drafted to give former directors the same rights to expense advancement as current directors. This was the case for Troy Corporation, until the board amended the company's bylaws. A brief description of the case follows.

The 'Schoon' Decision

In *Schoon v. Troy Corp.*, former director William Bohnen and current director Richard Schoon sued Troy for advancement of expenses incurred in defending threatened and pending claims filed by the company for breach of fiduciary duties in connection with their service on the Troy board. Bohnen served on the Troy board from 1998 to 2005; Schoon's service began when Bohnen retired in February of 2005.[7] Both directors were designees of Steel Corporation, a major stockholder in Troy. During the

---

[3] Delaware General Corporation Law § 102(b)(7). DGCL 102(b)(7) was implemented following the 1985 Delaware Supreme Court's landmark decision in *Smith v. Van Gorkom* finding directors "grossly negligent" and insurance companies' response to the Supreme Court's decision which resulted in sharply increased rates and limited availability of director and officer liability insurance.

[4] The "good faith" standard was elaborated in the well-known 2006 case involving The Walt Disney Company and its ousted chief executive, Michael Ovitz. The Delaware Supreme Court's ruling affirmed that the protections of the business judgment rule in Delaware remain robust. *See* *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (June 8, 2006). For additional discussion, *see* David Rosenberg, "Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contrarian Approach", Delaware Journal of Corporate Law, Vol. 29, No. 2, 491-506 (2005).

[5] Delaware's lead was followed by many other jurisdictions who adopted similar amendments to their corporation statutes. Directors should carefully consider the implications of serving on a corporate board that does not provide such protection against personal liability, be it for a Delaware corporation or for a corporation located in another jurisdiction.

[6] Delaware General Corporation Law § 145.

[7] *Schoon v. Troy*, 948 A.2d at 1149-50.

time that Bohnen was a director, the Troy bylaws provided advancement of expenses to current and former directors; in November of 2005, the board approved amendments to the bylaws including the deletion of the word "former" from the definition of directors entitled to advancement.[8] The amendments also added a provision intended to deny indemnification and advancement to any person in connection with a lawsuit initiated against the company by such person.[9]

The amendments appear to have been inspired by an ongoing legal battle between Steel and its director designees, on the one hand, and Troy, on the other hand. In September of 2005, Steel and Schoon had sued Troy for access to certain books and records of the company; Troy had refused on the grounds that Schoon intended to share these documents with third parties in breach of his fiduciary duties to Troy. In early 2006, Troy asserted fiduciary duty counterclaims against Bohnen and Schoon, alleging that the two directors had in the past provided Troy's confidential information to Steel and others. Shortly thereafter, the directors contacted Troy seeking expense advancement in defending against Troy's claims. Schoon, as a current director, made a formal request for advancement of expenses and provided the undertaking to repay that is required under Delaware law. Bohnen, now a former director, did likewise.[10]

The issue with respect to Bohnen was whether his right to advancement of expenses vested while he was a director and therefore before the adoption of the bylaw amendments. Bohnen argued that he was entitled to the advancement right that was in place while he served as a director and that the company could not unilaterally change the terms of his vested contract right. However, the Delaware Chancery Court held that the right to advancement vests upon the triggering of the company's obligations. The court relied upon an earlier case in which a company amended its bylaws in an attempt to deny a former director advancement in an ongoing lawsuit; in that case, the court ruled that the company could not unilaterally terminate the contract rights in the pre-amendment bylaws because the rights vested when the suit was filed against the director.[11] The *Schoon* court noted that at the time of Troy's bylaw amendments, Troy had not even conducted the discovery that it later relied upon to assert the fiduciary duty claims against Bohnen; thus it was clear that Troy did not contemplate claims against Bohnen at the time of the amendments. Therefore, Bohnen's rights to advancement were not vested prior to the amendments and could be unilaterally revoked.

Bohnen asserted in the alternative that if the amendments terminated his right to advancement, another provision in the bylaws provided for his right to

---

[8] *Id.* at 1161.

[9] *Id.*

[10] *Id.* at 1161-62

[11] *Id.* at 1165-66 (citing *Salaman v. National Media Corp.*, 1992 WL 808095 (Del. Super. Ct. Oct. 8, 1992)).

advancement as a former director. The provision reads: "The rights conferred … shall continue as to a person who has ceased to be a director … and shall inure to the benefit of such person and the heirs … of such person."[12] However, the court determined that this language simply means that a director whose right to advancement has been triggered does not lose that right when he or she leaves the board. Since Bohnen's right was never triggered, there was no right to be continued.

The court further observed that, while the Troy bylaws do indemnify former directors, the provisions for advancement were separate from the indemnification provisions. The court placed particular emphasis on the fact that the advancement provision was not a subpart of the indemnification provision. Noting that Delaware "has consistently held that advancement and indemnification, although obviously related, are 'distinct types of legal rights,'" the court found that the language of the bylaws "deliberately and unambiguously" provided for unequal treatment of current and former directors with respect to advancement.[13]

Ensuring Director Protection

It is now quite clear that in Delaware, unless otherwise provided in the bylaws or agreed by contract, a director's right to advancement of expenses does not vest until the company's obligation is triggered. This may leave former directors, in particular, vulnerable to bylaw amendments affecting their right to advancement of expenses. As outlined below, companies and directors have many options to consider as they address this issue, depending on their particular circumstances.

First, directors should ask their companies to carefully review their bylaws to ensure that they are drafted effectively to reflect the company's intention with respect to indemnification and advancement. One lesson of *Schoon* is that to the extent a company wishes to treat indemnification and advancement differently (as to former directors, for example), the bylaws should clearly separate these rights, both verbally, through clear language, and structurally, through clear organization. The advancement provision should not be a subsection of the larger indemnification provision, for example, and cross-references between the provisions should be minimal.

If a company wishes to ensure that directors are entitled to the indemnification and advancement of expenses rights in place at the time of their service (as Bohnen unsuccessfully argued that he did and as many former directors likely believed that they did prior to *Schoon*), the bylaw should clearly state that the rights to advancement and indemnification vest at the time a person becomes a director. In that

[12] *Id.* at 1166.

[13] *Id.* at 1167-68.

case, departure from the board will not affect a director's rights, regardless of subsequent amendments.

Another option is for companies to draft a bylaw providing that subsequent amendment of the advancement and indemnification provisions may not adversely affect the rights of directors or officers with respect to events or actions occurring prior to the amendment. It is also possible to add indemnification and advancement provisions in the company's charter, which would require a shareholder vote to amend; the downside of this approach is that it would require a shareholder vote to implement as well.

If the bylaws are inadequate to ensure directors the protection that they desire and that the company wishes to provide, another possibility is for directors to sign individual advancement of expenses and indemnification agreements with the company that cannot be amended or terminated without the director's consent. This turns the indemnification and advancement of expenses rights into contractual obligations of the company to which the director is a party.

Another part of the equation is director and officer (D&O) liability insurance, which likely would provide some protection. Even a former director to whom corporate advancement and indemnification is denied is likely to have a right to defense expenses and indemnification under the company's policy, as most policies define "insured persons" as including former directors.

Finally, former directors who have specific concerns that neither advancement and indemnification nor D&O insurance will be available to them for some reason could purchase D&O liability insurance specifically for themselves. Typically this type of insurance, which is specific to the purchaser, applies regardless of the actions or omissions of other persons and provides coverage for up to six years after the director leaves board service. This is not likely to be necessary in the vast majority of situations.

Conclusion

Companies should review their indemnification and advancement of expenses bylaws at least annually to ensure that they meet the specific needs and goals of the company. If desired, companies and corporate directors should ensure that expense advancement is explicit and mandatory. In the wake of *Schoon v. Troy*, directors will want to be certain that they understand the extent of their rights to indemnification and advancement of expenses and that those rights are secure. Companies likewise should carefully review the drafting of their bylaws and correct any deficiencies or ambiguities well in advance of a situation in which the language may be challenged. Indemnification and advancement will remain important aspects of director protection and directors and companies should take steps to ensure that the appropriate and expected protection is provided.