
COMMENT ON DELAWARE DECISION AND POSSIBLE NEED TO CONSIDER DIRECTOR INDEMNITY AGREEMENTS

By Esther S.J. Oh, B.A., LL.B
Assisted by Pamela Shin, B.A. LL.B, Student-at-Law

A. INTRODUCTION

A U.S. court decision in 2008 may result in individuals who consider becoming a corporate director (whether it be for a for-profit corporation or a non-profit corporation) wanting to obtain personal indemnity agreements from the corporation in order not to face responsibility for paying their own legal costs. This *Charity Law Bulletin* ("Bulletin") provides a brief commentary on *Schoon v. Troy Corp.*,¹ a Delaware court decision (the "*Troy* case"). In the *Troy* case, the board of directors approved an amendment to the general operating bylaw that resulted in former directors no longer being entitled to the advancement of costs by the corporation when defending against legal actions arising from the execution of director duties. The amendment was upheld by the Delaware court thereby leaving the director who had resigned shortly before the bylaw amendment was made, responsible for paying his own legal costs.

Whether or not the *Troy* case will be followed by the courts in other jurisdictions, including Canada, is uncertain at this time. However, much of the case law that has emanated from the Delaware courts over the years has proven in the past to be influential throughout the United States and Canada, and for this reason, the legal principles emanating from the *Troy* case may be of interest to corporations and their directors.

¹ 948 A.2d 1157 (Del. Ch. 2008).

B. SYNOPSIS OF THE TROY DECISION

1. Background Facts

The *Troy* case involves a number of consolidated lawsuits surrounding Troy, a privately held Delaware for-profit corporation; one by Richard Schoon, a current director of Troy, the second by Steel Investment Company (“Steel”), a major stockholder in Troy, and a counterclaim by Troy. The Schoon and the Steel actions were to compel the production of books and records by Troy for inspection, while the Troy claim asserted breach of fiduciary duty claims against Schoon and William Bohnen, a former director of Troy. Bohnen and Schoon both sued Troy for advancement of legal fees and expenses incurred in defending against the lawsuits brought against them.

Shortly after the first lawsuit was filed, the board of directors for Troy, not including Schoon, approved several amendments to the Troy general operating bylaws, which included among other amendments, the removal of the word “former” in describing those directors who would be entitled to advancement of monies required to defend against legal actions arising as a result of duties owed to the Troy corporation. In other words, the director indemnity provision as it relates to former directors was removed from the general operating bylaw.

Troy established a committee to consider the requests by Bohnen and Schoon to receive advancements of funds from Troy for legal fees and expenses and the committee later concluded that only Schoon would be entitled to the advancement of fees he had incurred in defending against the fiduciary duty claims against him.

2. Ruling

In the *Troy* case, the court concluded that under the general operating bylaw amended on November 3, 2005 (the “Revised Bylaw”), Bohnen, as a former director, would not be entitled to advancement of costs. The court found that Schoon, as a current director of the corporation, was entitled to advancement for defending the threatened and pending fiduciary duty based claims. In arriving at this decision the court noted that section 145 of the Delaware Code permits Delaware corporations to indemnify directors and sub-part (e) of that provision authorizes advancement of the expenses a director incurs in defending a lawsuit so as long as the director undertakes to “repay such an amount if it should ultimately be determined such person is not entitled to be indemnified by the corporation ...”, and

provided “such expenses...may be so paid upon such terms and conditions ... as the corporation deems appropriate.”

In light of the flexibility inherent in section 145 of the Delaware Code, the court in *Troy* indicated that it would be guided by the terms of the advancement provisions in Troy’s Revised Bylaw. The court noted that the amendments to the Revised Bylaw established different advancement rights for Bohnen, as a former director, and Schoon, as a then current director.

In this regard, the pre-amendment bylaws had provided that the “Corporation shall pay the expenses incurred by a new president or former director...” The court noted that Troy purported to remove former directors, including Bohnen, from the class of Troy officials entitled to advancement under its November 2005 by-law amendments (“November Bylaw Amendments”). Following the November Bylaw Amendments, the new 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 advancement of the final disposition,” thereby removing former directors from that provision.

In response, Bohnen asserted that in accordance with the *Salaman v. National Media Corp.*² decision, the November Bylaw Amendments do not terminate Bohnen’s right to advancement on the basis that his rights under the pre-amendment bylaws (which granted *former* directors the right to advancement) had vested prior to the adoption of the November Bylaw Amendments. In *Salaman*, the plaintiff was a former director who had sought advancement for fees and expenses incurred in defending a legal claim that he had breached his fiduciary duties in his capacity as a director. The defendant corporation, after advancing the plaintiff a portion of his fees, amended its bylaws to repeal the basis for the claimed advancement and then refused any further advancement to the former director. In the *Salaman* case, the court held that Salaman’s contractual rights, as embodied in the pre-amendment bylaws, had vested when the defendant corporation’s obligations were triggered on the date the pleadings were filed against him. The court arrived at this conclusion by relying on the principle that “the right to advancement and indemnification in a vested contract right cannot be unilaterally terminated.” The court in *Salaman* therefore concluded that the bylaw amendment did not affect Salaman’s

² 1992 WL 808095 (Del. Super. Oct. 8, 1992).

advancements rights since the claim against Salaman was commenced and his advancement rights had vested prior to the amendment to the corporation's by-laws.

The court in *Troy* found that the principles in the *Salaman* case did not apply on the basis that the court in *Salaman* had only upheld Salaman's right to advancement because he was named as a defendant in a legal action that was commenced *before* the corporate bylaw was amended. In this regard, the court rejected Bohnen's assertion that a director's rights to advancement under a company's bylaws vest at the time the director takes office. In other words, the court in *Troy* concluded that Bohnen's rights under the pre-amendment Troy bylaws had not been triggered before the November Bylaw Amendments, since Bohnen had not been named as a defendant in legal actions prior to the November Bylaw Amendments.

C. CONCLUDING COMMENTS

As previously indicated, it is uncertain whether or not the *Troy* case will be followed by the courts in Canada, which would trigger the need for corporations (both for-profit and non-profit) and directors to consider the need for indemnity agreements to prevent a similar situation from occurring. Notwithstanding the above, corporations and their directors would be well advised to be aware of the implications of the *Troy* case and stay tuned for any further developments in Canada in that regard.