EXHIBIT A

IN THE SUPREME COURT OF THE STATE OF DELAWARE

LINDA J. BOHNEN, as Executrix for the Estate of William J. Bohnen, Plaintiff Below, Appellant, v. TROY CORPORATION, a Delaware corporation, Defendant Below, Appellee.	)	No. 280, 2008 Court Below: Court of Chancery of the State of Delaware in and for New Castle County C.A. No. 2362-VCL

BRIEF OF THE NATIONAL ASSOCIATION OF
<u>CORPORATE DIRECTORS AS *AMICUS CURIAE* URGING REVERSAL</u>

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STATEMENT OF INTEREST

The National Association of Corporate Directors ("NACD") submits this brief as *amicus curiae* seeking reversal of the decision below. The Court of Chancery allowed Troy Corporation unilaterally and retroactively to eliminate a corporate director's right under the corporation's bylaws to mandatory advancement of defense costs, and to do so long after the director had completed his service to the corporation. This decision flies in the face of settled principles of contract and corporate law. Moreover, because the holding below applies not only to privately-held corporations like the defendant here, but to any corporation with advancement and indemnification bylaws, the decision may have severe adverse consequences for corporate governance and shareholder interests throughout the United States. For this reason, NACD concluded that it should seek to participate as an *amicus curiae*. NACD urges this Court to confirm the central importance of director indemnification and advancement rights to corporate governance and to reaffirm that bylaws that create these rights embody contractual obligations that cannot unilaterally and retroactively be set aside.

Founded in 1977, NACD is dedicated to improving the quality of corporate governance. NACD is an objective source of information on issues concerning corporate governance and publishes a variety of standard-setting research on the topic. NACD's membership comprises board members from hundreds of U.S. and overseas corporations, large and small, public and private. NACD is independent, apolitical, and non-profit.

As a professional association of corporate directors, NACD recognizes that directors' exposure to individual liability and legal defense costs is an issue of surpassing importance for corporate governance. Legal rules that leave directors vulnerable to lawsuits—many of which are meritless, but nonetheless impose immense costs for directors forced to mount a defense—create a strong disincentive to board membership, which in turn imposes substantial harm on corporations and their shareholders. The decision below, if affirmed, will render suspect the charters and bylaws upon which countless directors of Delaware corporations—and their counterparts in other states that look to the Delaware courts for guidance in this area—have until now relied. If, as the lower court held, corporate directors' entitlement to advancement—and, concomitantly, indemnification—can be unilaterally and retroactively eliminated, then directors will, at best, be forced to enter into complicated, costly and otherwise needless contractual arrangements, and, at worst, be forced to resign their posts and to decline to accept new positions. In support of its member corporate directors and the broader interests of sound corporate governance, NACD urges reversal.

INTRODUCTION

A fundamental tenet of the American system of corporate governance is that corporations operate under the supervision of a board of directors. Under that system, corporations—and more broadly, our national economy—have flourished. The success of this board-centric model entirely depends, however, upon the willingness of qualified individuals to serve and actively participate as corporate directors.

The protections provided to corporate directors by advancement and indemnification provisions are essential to the recruitment and retention of qualified directors. The twin protections benefit not only directors by reducing the substantial personal risks of liability and defense costs that complicate corporate board membership, but also corporations and shareholders by enabling directors to act in the best interests of the corporation free from concerns about personal liability for actions taken in good faith.

Advancement and indemnification rights most effectively provide these benefits, however, only when they are mandatory, for only then can a director be assured that a hostile board will not exercise discretion to deny protection. For this reason, corporate bylaws typically provide for mandatory indemnification and advancement for directors. The ruling below, by permitting a corporation unilaterally to eliminate those protections after-the-fact, renders such "mandatory" provisions illusory and exposes directors to risks they never agreed to accept and did not believe they were accepting.

This unbargained-for increase in personal risk comes as a host of factors are converging to drive those most qualified to serve as directors away from the boardroom. Corporations are finding it increasingly difficult to recruit and retain knowledgeable and experienced directors. Many have cited the risk of sizable personal liability and the burden of legal defense costs as significant deterrents to board membership. The lower court's ruling can only exacerbate these problems.

Beyond its negative policy implications, the lower court's decision is legally wrong. Fundamental contract principles show that a director's rights to indemnification and advancement vest at the time the director undertakes the indemnified conduct. Thus, the corporation is legally precluded from unilaterally eliminating that vested right.

The Court of Chancery's ruling should be reversed.

STATEMENT OF THE CASE

Troy is a privately-held Delaware corporation. *See Schoon, et al. v. Troy Corp.*, C.A. No. 2362-VCL, Memorandum Opinion and Order, March 28, 2008, at 2 (hereinafter "Op."). Troy's board includes five directors—four elected by holders of Troy's Series A stock, and the fifth by holders of Troy's Series B stock. *Id.* Ninety-five percent of Troy's Series B stock is owned by Steel Corp., an investment holding company owned by the Bohnen family; the remaining 5 percent is directly owned by the Bohnen family. William Bohnen was elected to Troy's board by the Series B shareholders, and he served from 1998 until he resigned for health reasons in February 2005. *Id.* Bohnen was succeeded by Richard Schoon. *Id.*

In 2005, Schoon requested books and records from Troy, which Troy did not provide. Op. at 3. In September of that year, Schoon filed an action in the Court of Chancery under 8 *Del. C.* § 220. Troy asserted as an affirmative defense that Schoon had breached his fiduciary duties to Troy. Op. at 4. Later, Troy sought leave to file counterclaims against current-director Schoon and a third-party complaint against former-director Bohnen (who had not until then been a party to the § 220 action). That leave was denied. Troy then instituted a separate lawsuit, claiming that Bohnen and Schoon, in the course of their service as Troy directors, had breached their fiduciary duties. Op. at 5-6.

In February and March 2006, Bohnen and Schoon formally requested advancement from Troy for their expenses in defending against the claims Troy had attempted to assert in the § 220 action, as well as the claims Troy did assert in its separate lawsuit. Both Bohnen and Schoon provided undertakings to repay all advanced sums in the event that their defenses were unsuccessful. Op. at 5-6. Troy failed to pay the requested advancements, and Bohnen and Schoon filed the present action to compel payment. *Id.* at 8.

The Court of Chancery's decision on the directors' advancement claims turned on Troy's bylaws. Before the litigation began in 2005, Troy's bylaws provided that "the Corporation *shall* pay the expenses incurred by any present *or former* director" in defending against litigation arising from service as a director of Troy. *See* Op. at 13 (emphasis added). In November 2005, after Schoon filed the § 220 action, Troy's board members other than Schoon voted to amend the bylaws to provide that "losses 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.*

The Court of Chancery interpreted the new bylaw to preclude advancement for former directors, because "Troy removed the word 'former' from its definition of the directors entitled to advancement." Op. at 4. The court then held that the amended bylaw controlled Bohnen's demand for advancement of the costs of defending Troy's breach of fiduciary duty claims, even though it was materially different from the bylaw that had been in place during his tenure. *See* Op. at 13-15.

The court reasoned that "Bohnen's rights under the pre-amendment bylaw had not been triggered before the November amendments" because Bohnen had not been named in the original § 220 action—the only suit pending before the bylaw amendment. *Id.* at 15. According to the court, because the bylaw was amended before Troy named Bohnen in its subsequent lawsuit, Bohnen's advancement right was unilaterally eliminated before it could "vest." *Id.* at 14-15. The court noted that "the Troy bylaws permit the board of directors, at any regular or special meeting, 'to alter or repeal any bylaws of the Corporation and to make new bylaws ... .'" *Id.* at 15 n.37. Thus, Troy was free to wipe out protections that it had pledged to Bohnen, and that Bohnen had relied upon, so long as it did so before it filed a complaint against him.

In the remainder of its opinion, the court held that—because of unrelated ambiguities in the amended bylaws and admissions by Troy—Bohnen was entitled to advancement of expenses for his defense of Troy's attempt to add a third-party complaint to the § 220 action. *See* Op. at 19-20 & n.44. The court also held that the bylaw amendments did not affect Schoon's advancement claims because he was a current director. *Id.* at 20-24.

ARGUMENT

I. ADVANCEMENT AND INDEMNIFICATION PROVISIONS EXIST TO PROVIDE SECURITY FOR CORPORATE DIRECTORS AND SIGNIFICANTLY CONTRIBUTE TO DIRECTORS' WILLINGNESS TO SERVE.

A. The Benefits of Mandatory Advancement and Indemnification Have Been Widely Recognized.

The corporate governance system established in Delaware law rests on the principle that every corporation will be overseen by a board of directors. *See* 8 *Del. C.* § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors … ."). That system assumes that qualified men and women are willing both to serve on corporate boards and to participate actively as directors. Delaware law therefore seeks to reduce disincentives to service on corporate boards and to encourage directors' vigorous participation. One of the greatest obstacles to these goals is the exposure to personal legal liability—as well as the up-front cost of mounting a defense to even non-meritorious claims.

To that end, Section 145 of the Delaware General Corporation Law authorizes corporations to indemnify directors for expenses and losses incurred in connection with litigation and other proceedings arising out of the director's service to the corporation. *See* 8 *Del. C.* §§ 145(a)-(c). Section 145(e) further authorizes corporations to advance defense costs incurred by a director, so long as the director undertakes to repay those costs if he ultimately is found not entitled to indemnification. These twin rights of indemnification and advancement protect directors from the risk of personal financial ruin that service on a corporate board otherwise could impose. *See Scharf v. Edgcomb Corp.*, 1997 WL 762656, *4 (Del. Ch. Dec. 4, 1997) (Ex. A) ("Indemnification provisions authorized by statute and incorporated into bylaws by shareholder action demonstrate the desire to broaden the flexibility of decision making by eliminating the chilling effect of potential personal liability on the part of officers and directors.").

Though advancement and indemnification are different in nature, and a bylaw that provides for one does not automatically include the other, *see Advanced Mining Sys., Inc. v. Fricke*, 623 A.2d 82, 84-85 (Del. Ch. 1992), they serve the same purpose: they provide advance assurances to directors that the corporation will reduce the personal risk of board service. Indeed, "[a]dvancement is an especially important corollary to indemnification as an inducement for attracting capable individuals into corporate service.

Advancement provides corporate officials with immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings." *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005). *See also* Edward P. Welch *et al.*, *Folk on the Delaware General Corporation Law* § 145.8 (5th ed. 2008 Supp.) ("*Folk*") ("Mandatory advances, like indemnification, encourage qualified persons to become or remain corporate directors by assuring them that they may resist lawsuits they consider meritless, free of the burden of financing (at least initially) their own legal defense.").

By reducing the risk associated with board service, indemnification and advancement redound to the advantage of not just directors, but also corporations and shareholders, which benefit from directors' vigorous defense of unjustified lawsuits. In *VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998), this Court cited the "dual policies" served by indemnification and advancement:

> We have long recognized that Section 145 serves the dual policies of: (a) allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity.

See also Stifel Fin. Corp. v. Cochran, 809 A.2d 555, 561 (Del. 2002) (same); *Folk*, § 145. The Court of Chancery has emphasized that "[w]ithout affording this protection, corporations would find it difficult to retain high-quality directors and officers, especially ones willing to make socially useful decisions that involve economic risk. [This protection will] encourage well-qualified persons to serve as directors and officers of Delaware corporations and, in that capacity, to be willing to commit their corporations, after the exercise of good faith and care, to risky transactions that promise a lucrative economic return." *Fasciana v. Electronic Data Sys. Corp.*, 829 A.2d 160, 170 (Del. Ch. 2003).

B. Advancement and Indemnification Are of Greatest Value to Directors When They Can Be Relied Upon with Certainty.

Section 145 authorizes corporations to provide for most indemnification and advancement to be discretionary. But, realistically, the "dual policies" identified by this Court can be best served only when a corporation guarantees indemnification and advancement to any director who meets specified, objective criteria, for only then can directors be truly "secure in the knowledge" that they

will be protected. Thus, "[w]hile the permissive authority to indemnify its directors, officers, etc., may be exercised by a corporation's board of directors on a case-by-case basis, in fact most corporations and virtually all public corporations have by by-law exercised the authority recognized by Section 145 so as to mandate the extension of indemnification rights in circumstances in which indemnification would be permissible under Section 145. Such provisions serve obvious corporate interests." *Advanced Mining*, 623 A.2d at 83.

Indeed, it is only mandatory advancement and indemnification provisions that guarantee that hostile boards will not use their discretion to reject a director's claim for advancement and indemnification when the need arises:

> Mandatory indemnification is intended . . . to protect directors and officers from an antagonistic board that might otherwise refuse to indemnify them even when they have been successful in the defense of proceedings. This could happen when, for example, the board resisted a successful takeover attempt. In the absence of a mandatory indemnification provision, the new board might refuse indemnity to the members of the former board sued by shareholders for their actions in resisting.

Zolman Cavitch, *Business Organizations with Tax Planning* p. 129-24, § 129.03[3] (1997). *See also* Oesterle, *Limits on a Corporation's Protection of Its Directors and Officers from Personal Liability*, 1983 Wis. L. Rev. 513, 519 n. 9 (1983) ("If the target company's officials believe that they will not get indemnification for their personal costs arising out of the litigation following a successful tender offer, many of them (particularly the outside directors, who have less to lose if the tender offer succeeds) are unlikely to put up, or approve of, an aggressive defense unless the chances of defeating the tender offer appear to be high.").

In this way, mandatory advancement and indemnification are particularly important to promote director independence. It is directors who go against the grain—whistle-blowers and other dissenters—who are most likely to be targeted by hostile boards. *See, e.g.*, *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339 (Del. 1983) (ordering indemnification of former directors pursuant to bylaws after new board denied indemnification requests). Yet good corporate governance demands that independent voices not be muted. A guarantee that advancement or indemnification obligations will be honored serves both to aid recruitment of board members who will provide independent viewpoints and to promote the directors' assertion of those views without fear of retribution.

The rule announced by the lower court eliminates the guarantee provided by mandatory advancement and indemnification bylaw provisions. So-called "mandatory" advancement is not certain if it can be reduced or revoked by amendment of the bylaws. Though Troy amended its bylaws to target only former directors, nothing would prevent a similar amendment from being employed to the detriment of one or more sitting directors as well. Advancement or indemnification remains "mandatory" under the holding below only to the extent that the beneficiary director can and does file a claim under the provision—and the director's rights thus "vest"—before the board has an opportunity to eliminate the right. Such a right is not "mandatory" in any meaningful sense. *Compare Tafeen v. Homestore, Inc.*, 2004 WL 556733, *10 (Del. Ch. Mar. 16, *revised*, Mar. 22, 2004) (Ex. B) ("[T]o allow a financial hardship exemption, without more, would be to undermine the salutary purpose of allowing advancement. Advancement would be less of an inducement to becoming a director or officer of a company if the company could simply avoid its advancement obligation when times are difficult.").

C. Qualified Corporate Directors Are Becoming Increasingly Difficult to Recruit.

Providing directors with security to defend against litigation as they see fit benefits corporations and shareholders alike, both by promoting the proper outcome of litigation and by encouraging talented men and women to serve on corporate boards. *See VonFeldt*, 714 A.2d at 84. The converse, of course, is equally true: the absence of such security discourages the vigorous defense of even unfounded lawsuits and presents a major obstacle to recruiting qualified directors. The benefits of board membership simply do not outweigh the tremendous personal risks posed by exposure to the costs of defending modern corporate litigation.[1]

Almost 15 years ago, the United States Congress recognized the difficulty of attracting qualified directors to corporate boards and the negative effects such recruiting problems were having on the economy. A Conference Report in support of the Private Securities Litigation Reform Act of 1995 cited evidence that "the investing public and the entire U.S. economy have been injured by the unwillingness of the best qualified persons to serve on boards of

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[1] Directors' legal bills "routinely run into six or even seven figures when they are hauled into court." Stephen Taub, *Delaware Decision Leaves Directors in Lurch*, Compliance Week (July 8, 2008), *online at* http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=4247.

directors … because of fear of baseless and extortionate securities lawsuits. In these and other examples of abusive and manipulative securities litigation, innocent parties are often forced to pay exorbitant 'settlements.'" H.R. Conf. Rep. 104-369 (Nov. 28, 1995), 1995 U.S.C.C.A.N. 730, 731-32.

Ten years later, a symposium on director liability held at Harvard Law School recognized that these concerns continued to hold true. As one participant observed, "The critical question is how can the legal regime function so that men and women of intelligence and energy will feel comfortable sitting on the board of directors, doing their job and not fear that they will get second-guessed for investment decisions or other activities that don't necessarily work out. We don't want to discourage risk taking. We don't want to discourage imagination." *Director Liability Symposium Transcript*, 31 Del. J. Corp. L. 1011, 1015 (2005). Another participant, commenting upon the recent *Worldcom* and *Enron* settlements in which outside directors had been forced to assume personal liability, observed that "if you want to set the deal with corporate America that independent directors will be held liable for negligence, if that's the deal … you will get directors along the lines you ask for. That may not be good for you as an investor." *Id.* at 1021.

Surveys of board members themselves confirm that these predictions are being realized. A 2003 study of Fortune 1000 board members found that "[d]ue to the increased liability of serving on corporate boards, 23 percent of Board Directors on Fortune 1000 companies in the Americas turned down additional board roles in 2002, compared to only 13 percent the previous year." Business Editors, *Fortune 1000 Board Members Are Turning Down Directorships at Twice the Rate of Last Year Due to Personal Liability Risk*, Bus. Wire (Oct. 28, 2003). A 2005 survey by *Corporate Board Member* examined the views of directors in the wake of the *Enron* and *Worldcom* settlements. *See* John R. Engen & Charlie Deitch, *What Directors Think of the Enron/Worldcom Settlements*, Corp. Board Member (Mar./Apr. 2005), *online at* http://www.boardmember.com/magazine/archives-04-05/marchapril-2005/what-directors-think-of-the-enronworldcom-settlements/. Seventy-nine percent of the surveyed directors felt that their personal assets were more at risk because of the settlements. *Id.* Some 61 percent stated that the payments required from directors in *Enron* and *Worldcom* would affect their willingness to serve on other boards. *Id.* Under current circumstances, as one director observed, "only idiots and paupers will serve on boards." *Id.*

Reports from those who work in fields that serve directors confirm the impact of these fears. An official with D&O insurer Chubb & Son has "seen a sharp spike in requests for so-called Side A coverage, bought by companies to

provide additional protection for individual directors, and for personal directorship liability policies, purchased by board members themselves. 'Directors are terrified' by the heightened sense of risk, he says." John R. Engen, *Making Sense of the Worldcom/Enron Settlements*, Corp. Board Member (May/June 2005), *online at* http://www.boardmember.com/ magazine/archives-04-05/mayjune-2005/making-sense-of-the-worldcomenron-settlements/. Similarly, "headhunters say board searches have already become more difficult, with nominees showing far greater caution. 'They want to be bulletproof before they sign up, especially if they have a lot of personal worth.'" *Id.*

Other observers are likewise in agreement that "[a] number of developments have begun to create problems in recruiting the best candidates for director." Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 Bus. L. 67, 86 (Nov. 2003). One commentator observed that "[p]ublic corporations are finding it increasingly difficult to recruit and retain qualified independent directors. Relatively low pay, compensation in stock rather than cas[h], and increased time demands and liability exposure have all combined to render board service far less attractive than it once was." Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, Research Paper No. 02-15, *online at* http://ssrn.com/abstract_id=317121. Many other sources agree with that assessment. *See, e.g.*, Michael Klausner, *Reducing Directors' Legal Risk*, Harv. Bus. Rev. 28 (Apr. 2007); Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley*, 41 Willamette L. Rev. 707, 728 (2005); *The Fading Appeal of the Boardroom*, Economist (Feb. 10, 2001); Harvey L. Pitt, *et al.*, *Walking the Walk and Talking the Talk: Responding to Management Misconduct after the* Caremark *Decision*, PLI Corp. L. & Prac. Course Handbook Ser., PLI Order No. B0-001E, at *49 (June-July, 1998). Given the chilling atmosphere that already exists, this Court should tread cautiously before endorsing further disincentives to corporate board service.

Moreover, this Court's decision will affect recruitment and retention of corporate directors across the country. As hardly needs emphasizing, this Court's rulings on corporate governance and corporations law bear unique significance in the U.S. legal system and economy. The number of business entities formed under the laws of Delaware is approaching the 1 million mark and includes more than half of the corporations in the Fortune 500. *See* Lewis S. Black, Jr., *Why Corporations Choose Delaware* 1 (2007), *online at* http://corp.delaware.gov/whydelaware/whycorporations_web.pdf; Del. Dep't of State, Div. of Corps., *2007 Annual Report* 1, *online at* http://corp.delaware.gov/2007DivCorpAR.pdf. And Delaware's prominence appears, if anything, to be increasing: over 90 percent of U.S.-based corporations

making public offerings in 2007 were incorporated in the State. Dep't of State, *Annual Report* 1. The rule that this Court announces thus will directly govern the rights of directors across the nation.

And beyond those entities directly subject to Delaware law are the many corporations incorporated in states that model their corporate governance laws on Delaware's. Because Delaware courts are widely recognized as expert on corporate governance matters, numerous states look to the opinions of this Court and the Court of Chancery when considering such issues. As the Supreme Court of New Mexico recently observed, for example, "[m]ost persuasive to us is the approach taken by the courts in Delaware, which several other states have followed, Delaware being widely recognized as 'the fountainhead of American corporations' whose courts 'are known for their expert exposition of corporate law.'" *McMinn v. MBF Operating Acquisition Corp.*, 164 P.3d 41, 53 (N.M. 2007) (internal citation omitted). *See also, e.g., First Union Corp. v. Suntrust Banks, Inc.*, 2001 WL 1885686, *8 (N.C. Super. Aug. 10, 2001) (Ex. C); *Connolly v. Agostino's Ristorante, Inc.*, 775 So.2d 387, 388 n.1 (Fla. App. 2000); *IBS Financial Corp. v. Seidman & Assocs., LLC*, 136 F.3d 940, 949-50 (3d Cir. 1998) (New Jersey law); *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342, 1346 (D. Nev. 1997) (Nevada law).

D. The Potential for Separate Agreements Does Not Resolve the Problems Created by the Court of Chancery's Ruling.

Despite the decision below, directors conceivably can secure the protection of unalterable rights to indemnification and advancement by entering into separate agreements with the corporations they serve. *See, e.g., Citadel Holding Corp. v. Roven*, 603 A.2d 818, 823-24 (Del. 1992) (interpreting agreement to provide greater rights to advancement and indemnification than bylaws). Rights provided for in such contracts, pursuant to longstanding principles of contract law, presumably would not be revocable by a later unilateral act by the corporation.[2] *See, e.g., Havens v. Attar*, 1997 WL 55957, *13 (Del. Ch. Jan. 30, 1997) (Ex. D) ("When mandatory advancement is

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[2] In this regard, separate contracts might offer somewhat more certainty than a bylaw provision that purported to limit a later board's ability to amend or rescind indemnification or advancement provisions, because the logic of the lower court's ruling indicates that such a limiting bylaw could itself be amended away. Moreover, even if some such limit could be imposed by bylaw, the mere prospect of a possible amendment would destroy the certainty essential to the recruitment and retention of directors and to the encouragement of their active participation.

contractually provided, however, a board may not change the terms of 'mandatory' advancement by later conditioning that advancement upon a showing of financial responsibility."). To the contrary, agreement and consideration would be necessary for any subsequent change. *See infra* at 14.

But even if directors and corporations could avoid some or all of the deleterious effects of the lower court's rule by entering into individual indemnification agreements, this alternative would be both impractical and highly inefficient. Most present and future directors would be required to negotiate new separate agreements in order to secure their rights to indemnification and advancement in the face of possible amendments to corporate bylaws. Even though these agreements would do no more than return directors to what, prior to the decision below, had been widely viewed as the *status quo*, they would give rise to substantial new transaction costs—a boon to the lawyers who would negotiate and draft such agreements, to be sure, but an unproductive expenditure of resources for corporations and their directors and shareholders. Avoiding pointless transaction costs is reason enough to question the rule adopted by the lower court. *Cf., e.g., Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2723 (2007) ("[I]t is a flawed antitrust doctrine that serves the interests of lawyers—by creating legal distinctions that operate as traps for the unwary—more than the interests of consumers—by requiring manufacturers to choose second-best options to achieve sound business objectives."); *Ty, Inc. v. Publications Int'l Ltd.*, 292 F.3d 512, 517 (7th Cir. 2002) (Posner, J.) ("[I]n the absence of a fair-use doctrine, most publishers would disclaim control over the contents of [book] reviews. The doctrine makes such disclaimers unnecessary. It thus economizes on transaction costs.").

Moreover, former directors who served recently enough to remain vulnerable to lawsuits related to their board service face a particularly acute situation. Entering into such an agreement would amount to a modification of the terms of their existing contractual relationship with the corporation. To secure any guarantee of indemnification and advancement regardless of amendments to bylaws, they might be obligated to provide some form of consideration to the corporation. *See, e.g., De Cecchis v. Evers*, 174 A.2d 463, 464 (Del. Super. 1961) ("A contract having been made, no modification of it could be brought about without the consent of both parties and without consideration."); *Continental Ins. Co. v. Rutledge & Co., Inc.*, 750 A.2d 1219, 1232 (Del. Ch. 2000) ("Any amendment to a contract, whether written or oral, relies on the presence of mutual assent and consideration."). In the absence of an ongoing relationship, it is not clear what form such consideration would take.

And, even if some work-around solution to the practical problems created by the decision below can be devised, the overall uncertainty that the decision creates is problematic in itself. Any disruption of settled expectations as to the degree of financial risk that corporate directorship entails will inevitably make the prospect of board service less appealing. For example, following *Smith v. Van Gorkom*, 488 A.2d 858 (Del. Super. 1985), which unexpectedly held that the business judgment rule did not protect board members from personal liability for gross negligence, there was a "directors and officers insurance liability crisis," *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. Super. 2001). The decision, part of a "'sea change' in the dynamics of corporate governance," helped to bring about "the ultimate irony in corporate governance—outside directors refusing to serve." E. Norman Veasey, *et al.*, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 Bus. Law. 399, 399, 401 (1987). Similarly here, the change that the lower court's decision effects in the legal backdrop to corporate directorship makes directorship a far riskier endeavor.

This increase in risk may be particularly damaging to small or new corporations that can offer directors less financial or reputational reward than larger, more established corporations. Moreover, the burden and complexity of negotiating separate indemnification and advancement agreements may disproportionately affect small and newly-formed corporations that have fewer established resources on which to draw. Yet it is those companies that could benefit most from active participation by experienced outside directors.

No such costs or uncertainties are imposed by holding that corporations cannot unilaterally and retroactively rescind directors' rights to indemnification and advancement provided by corporate bylaws. Should any corporation wish to reserve the option to rescind such rights, it need only specify in its bylaws that the indemnification or advancement right those bylaws set forth is not mandatory, or is specifically subject to later amendment with retroactive effect.[3] With such a possibility spelled out in the bylaws, no potential director would place undue reliance on an illusory guarantee of indemnification or advancement.

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[3] The corporation's ability to rescind the right to indemnification is, however, subject to 8 *Del. C.* § 145(c), which mandates indemnification of present and former directors who have been "successful on the merits or otherwise in defense of any action, suit or proceeding referred to in" §§ 145(a) and (b). *See Folk*, § 145.4.

II. THE DECISION OF THE COURT OF CHANCERY IS CONTRARY TO DELAWARE LAW.

Not only is the legal rule advocated by Appellant Bohnen sound as a matter of policy, it is also the rule dictated by existing law. The bylaws that are in place when a director agrees to provide his or her service to the corporation are in the nature of an employment contract for that director. The decision below effectively permits the corporation retroactively and unilaterally to amend that contract. That is inconsistent with longstanding principles of contract law as well as this Court's and the Court of Chancery's prior decisions in the area of corporate governance.

"A company's bylaws are contractual in nature. Thus, indemnification is a right conferred by contract, under statutory auspice." *Jackson Walker L.L.P. v. Spira Footwear, Inc.*, 2008 WL 2487256, *4 (Del. Ch. June 23, 2008) (Ex. E) (quotation marks and citations omitted). *See also Stifel Fin. Corp.*, 809 A.2d at 559 (noting that "indemnification is a right conferred by contract, under statutory auspice" and applying statute of limitations for contract claims to suit asserting indemnification provision in corporate bylaws); *Salaman v. Nat'l Media Corp.*, 1992 WL 808095, *6 (Del. Super. Oct. 8, 1992) (Ex. F) (ordering indemnification despite *post hoc* amendment to bylaws); *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 492 n.6 (Del. Ch. 1995) (*citing Salaman*); *Beneficial Indus. Loan Corp. v. Smith*, 170 F.2d 44, 50 (3d Cir. 1948) (applying Delaware law) ("The right of the officers and directors of Beneficial to indemnification under the by-law is analogous to a contract right."). If a corporation is permitted to amend its bylaws so that an indemnification or advancement right is retroactively diminished, then it will have effectively unilaterally modified its contractual relationship with a director without the director's consent and without providing consideration. That is contrary to foundational principles of contract law. *See De Cecchis*, 174 A.2d at 464 ("A contract having been made, no modification of it could be brought about without the consent of both parties and without consideration."); *Continental Ins. Co.*, 750 A.2d at 1232 (same).

The Court of Chancery held as much in *Salaman v. Nat'l Media Corp. Salaman* considered whether a former director was entitled to advancement where bylaws that provided for mandatory advancement had been amended to provide only for discretionary advancement. The amendment was made after Salaman's tenure, and after Salaman had been sued for conduct related to his board service. The *Salaman* court examined whether the corporation's reservation in its bylaws of the right to amend those bylaws permitted it to amend the advancement provision. *See* 1992 WL 808095, at *6.

The court first noted that "corporate documents such as bylaws have the force of a contract between the corporation and the directors." *Id.* It then stated that "[t]he power to alter, amend, or repeal bylaws cannot confer authority to make an amendment which amounts to the destruction or impairment of vested or contract rights." *Id.* (*citing* 8 W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 4177.10 at 711 (rev. perm. ed. 1991)). From these two core principles, the court concluded that "Salaman's right to advancement and indemnification is a vested contract right which cannot be unilaterally terminated." *Id.* The same logical steps, and the same conclusion, apply here.

The court below distinguished *Salaman*, however, on the ground that the *Salaman* court's holding rested on its finding that Salaman's advancement right had "vested" when the suit against him was filed—an event that took place *before* the bylaws were amended. *See* Op. at 14-15. Here, by contrast, Troy amended its bylaws before Bohnen was named in any litigation. The lower court, however, misread *Salaman*. Although the *Salaman* court stated that "Salaman's rights to advancement of expenses vested when the Eastern District Litigation was filed" before the bylaws were amended, 1992 WL 808095, at *6, neither the court's reasoning nor its ultimate holding rested on that precise sequence of events.

Indeed, it makes no sense to hold that the right to indemnification or advancement "vests"—*i.e.*, becomes legally binding—only when a suit is filed. Indemnification and advancement rights are part of the consideration the corporation provides to the director for his or her service. The director fulfills his or her end of the bargain by performing that board service. The legal right to the consideration promised in exchange for that performance—the right to indemnification or advancement for claims arising from the director's performance of his or her duties—vests upon that performance. *Compare Myers v. Myers*, 408 A.2d 279, 280 (Del. 1979) (insurance policy beneficiary's legal right to proceeds of the policy vests at the time the beneficiary is named, not when event precipitating payment on policy occurs or when claim on policy is made). If the consideration that the corporation provides in exchange for the director's service could be so easily withheld as the Court of Chancery's decision permits, then the contractual relationship between the director and the corporation must fail for lack of mutuality.

Moreover, the beneficiary of the promised right—the director—begins to act in reliance on that promise as soon as he or she undertakes board service. That reliance, which is after all based on written bylaws, is both reasonable and foreseeable. *See* Restatement 2d of Contracts § 90 ("A promise which the promisor should reasonably expect to induce action or forbearance on the part of

the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise."). Even without a written agreement, the doctrine of promissory estoppel would preclude the corporation from avoiding liability once it had induced the director's reasonable reliance on the guarantee of indemnification or advancement. *See id.* at comment 1. In light of the express bylaw that provided for advancement for Bohnen, the binding nature of the promise is *a fortiori*.

In light of these considerations, the only point at which vesting of the rights to advancement and indemnification can be reasonably understood to occur is at the time of the board service to which the indemnification or advancement applies—that is, at the time the director undertakes the conduct that exposes him or her to liability and defense costs. It is at that point that the director completes his or her end of the contractual bargain; that the director acts in reasonable and foreseeable reliance upon the promise; and that the vesting of the legal right will best promote the purposes behind advancement and indemnification.

Consistent with these conclusions is the Court of Chancery's decision in *In re Central Banking Sys., Inc.*, 1993 WL 183692 (Del. Ch. May 11, 1993) (Ex. G). The court in that case examined whether a corporation could place advancement funds into escrow rather than pay them directly to the director, where the bylaw that provided for mandatory advancement did not so limit its payment. The court concluded that the corporation could not do so: "The only condition imposed by the By-laws is that the recipient furnish an undertaking to repay the amounts advanced in the event he is found to be not entitled to indemnification. That condition has been satisfied. ... Therefore, no basis in law has been shown for the proposed escrow arrangement." *Id.* at *3. Even though the corporation could have imposed the escrow requirement up front, it had elected not to do so, and it was not "permitted to do retrospectively what it has precluded itself from doing ex ante." *Id.* at *4. If a corporation cannot retroactively encumber the advancement right in this relatively modest way, then Troy clearly cannot retroactively vitiate the right.

Similarly, in *Bernstein v. TractManager, Inc.*, 2007 WL 5212035, *4 (Del. Ch. Nov. 20, 2007) (Ex. H), the Court of Chancery reviewed whether directors who had served as managers of a limited liability company were entitled to the same protections afforded to the directors who served after the LLC became a corporation. The court answered in the negative, observing:

> This point would, perhaps, be more easily understood if the tables were turned and it was the later adopted bylaw that contained more restrictive provisions applicable on their face

> only to the corporate officers and directors. In that case, there is little likelihood that a court would infer a silent intention to alter the more generous contractual arrangements previously enjoyed by the managers or officers of a predecessor limited liability company. Instead, the court would look to the terms of the limited liability company's operating agreement or other contracts to determine the rights and duties of the parties.

Id. Similarly here, this Court should look to the "more generous contractual arrangements previously enjoyed by" Bohnen during his term of service to Troy—not the "more restrictive provisions" adopted after Bohnen's service had ended.

CONCLUSION

As one experienced observer noted in a recent speech to directors and their advisors, directors today face unprecedented pressures:

> The situations they face and the decisions they must make are complex and nuanced and require the willingness to take risk, all the while knowing that failure may have devastating consequences for shareholders, employees, retirees, communities and even the economy as a whole. . . . We cannot afford continuing attacks on the board of directors at a time when their full commitment and their most talented members are so acutely needed. It is time to recognize the threat to our economy and reverse the trend.

M. Lipton, "Shareholder Activism and the 'Eclipse of the Public Corporation': Is the Current Wave of Activism Causing Another Tectonic Shift in the American Corporate World?," Keynote Address, The 2008 Directors Forum of the Univ. of Minn. Law School (June 25, 2008). The factors that have contributed to this trend are many and varied and are largely beyond this Court's ability to address in this case. But this Court can and should reverse a decision that is both legally wrong and has the effect of undermining one of the most important protections available to corporate directors in increasingly perilous times.

Respectfully submitted,

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