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Delaware Court Decisions Denying Indemnification Rights Underscore Need for Carefully Drawn Indemnification Provisions

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Recent decisions of the Delaware courts raise important issues for directors of Delaware corporations concerning their indemnification rights.[1]

In *Schoon v. Troy Corp.*, the court upheld amendments to the bylaws of a corporation that retroactively stripped a former director of his right to receive advancement of expenses in cases filed after the former director left the board.

In *Levy v. HLI Operating Co., Inc.*, the court denied indemnification to certain former directors because they received separate indemnification payments from an investment fund – which they represented on the board of directors – and there was no contractual provision addressing the relative priority of the indemnification obligations of the corporation and the investment fund.

For Delaware corporations and their directors, these decisions highlight the importance of making clear in the relevant indemnification provisions:

- When a director's indemnification rights become vested and may not be changed without the director's consent;
- The status of indemnification rights as contractual rights that may be enforced by a director;
- The priority of the corporation's indemnification obligations in relation to other indemnitors.

Background to the Cases

Schoon v. Troy Corp.
From 1998 to February 2005, William J. Bohnen served as a director of Troy Corporation ("Troy") pursuant to the designation of the Series B stockholders. Mr. Bohnen and his family held substantial shareholdings in Troy primarily through an investment holding company named Steel Investment Company ("Steel"), which owned approximately 33% of Troy's total equity. Mr. Bohnen resigned as a director of Troy in February 2005, and was replaced on the board of directors by Richard W. Schoon. In November 2005, Troy amended its bylaws to remove the word "former" from its definition of the directors entitled to advancement of expenses. Mr. Bohnen apparently did not have a separate indemnification agreement with Troy. Thereafter, Troy alleged in a plenary action that Messrs. Bohnen and Schoon had breached their fiduciary duties by disclosing Troy's confidential information to Steel and other third parties. In response, Messrs. Bohnen and Schoon sought advancement of expenses under Troy's bylaws.

In this case, Vice Chancellor Lamb found that any contractual right to advancement of expenses under the bylaws only vested upon Mr. Bohnen being named as a defendant in the breach of fiduciary duty action. Accordingly, since Mr. Bohnen was not named as a defendant in the breach of fiduciary duty action until after the amendments to the bylaws took effect, Mr. Bohnen was not able to receive any advancement of expenses under the amended bylaws.

Levy v. HLI Operating Co., Inc.

In late 2001, the audit committee of HLI Operating Company ("Old Hayes") publicly announced that the company's financial statements from 1999 to early 2001 would need to be restated. Shortly thereafter, actions were filed by stockholders and bondholders against the company, its officers, and its directors for various federal securities law violations. In mid-December 2001, Old Hayes filed for protection under Chapter 11 of the Bankruptcy Code. In May 2003, the bankruptcy court approved a reorganization plan that provided for Old Hayes to become an operating subsidiary of Hayes Lemmerz International, Inc. ("New Hayes"). In May 2005, the parties to the federal securities actions and the insurance carriers for the corporation reached a settlement that provided for payment by the insurance carriers and certain former directors. After reaching this settlement, the former directors sought indemnification payments from Old Hayes and New Hayes under the bylaws, each of their separate indemnification agreements, and certain rights provided for in the reorganization plan. In response, both Old Hayes and New Hayes informed the former directors that no indemnification payments would be made.

Vice Chancellor Lamb found that, because four of the former directors had already received indemnification payments from the investment fund, these former directors suffered no actual loss. As a result, the appropriate cause of action was a claim for equitable contribution by the investment fund against the corporation as co-indemnitor, since there was no contractual arrangement as to how the shared liability should be divided.

Key Takeaways

While the decisions in *Levy* and *Schoon* are specific to the facts presented in each case, there are important lessons for Delaware corporations and their directors in relation to indemnification arrangements:

- ***Importance of the Specific Terms of Indemnification.*** Vice Chancellor Lamb's opinions in *Levy* and *Schoon* make clear that the Delaware courts will pay close attention to the specific terms of indemnification arrangements that apply to Delaware corporations and their current or former directors.

- ***Vesting of Indemnification Rights.*** Charter or bylaws provisions for indemnification should provide that any indemnification rights, including a right to advancement of the costs of defense, are express contractual rights that vest by virtue of the director or officer's service at the time when the state of facts giving rise to the claim occurred. Such rights should be enforceable by the director or officer in a court of competent jurisdiction. The charter or bylaw provisions should also state that any vested indemnification rights may not be amended without the consent of the affected director or officer. Note, however, that any vested indemnification rights will be subject to the limits of the corporation's indemnification power under Section 145 of the Delaware General Corporation Law, which requires that directors satisfy their duty of loyalty and duty of good faith.

- ***Consider Use of Indemnification Contracts to Lock in Director Rights.*** In addition to charter and bylaw provisions, consider using separate indemnification agreements with directors and officers that may only be amended with the consent of both the director and the corporation. As noted above, such contracts must be drawn to comply with the limits of permissible indemnification under Delaware law.

- ***Primacy of Corporate Indemnification Obligation.*** The bylaws and separate indemnification agreements should include provisions on the primacy of the corporation's indemnification obligation as against any other indemnitors of the directors. On this point, note that the investment fund community has recently proposed language to address such situations, such as Section 8(c) of the NVCA Form of Indemnification Agreement.

The prevailing practice in respect of indemnification arrangements between Delaware corporations and their directors continues to evolve. Delaware corporations and their directors should, therefore, carefully consider and periodically review the bylaws and separate indemnification agreements that are in effect to ensure compliance with developing law and practice.

In addition, while these cases involve Delaware law, the lessons drawn from *Schoon* and *Levy* may well apply to corporations organized in other states. Accordingly, we urge companies in all jurisdictions to review their indemnification arrangements and consider whether revisions are appropriate to ensure that the company's officers and directors receive the intended protection.

Footnotes

[1] *Schoon v. Troy Corp.*, 948 A.2d 1157 (Del. Ch. 2008); *Levy v. HLI Operating Co., Inc.*, 924 A.2d 210 (Del. Ch. 2007). The parties in *Schoon* have entered into settlement, and no appeal was filed to the Delaware Supreme Court in *Levy*.