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U.S. case 'a wake-up call' for Canadian directors

Influential Delaware court rules firms can alter bylaws to strip former board members of indemnity for legal costs

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These days, anyone who sits on the board of a publicly traded corporation is well aware of the risk of being pulled into litigation against the company. It's not generally a problem because corporations have bylaws that indemnify directors against the cost of defending themselves - even after they step down from the board. They need that assurance because lawsuits can surface years later.

But a ruling by the Delaware Court of Chancery may wipe out the guarantee of protections that generations of former directors rely on.

In *Schoon v. Troy Corp.*, the court held that a company has the right to amend its own bylaws - even those promising indemnity to former directors, provided the former board members are not named as a party in a lawsuit at the time.

It's a decision that should send everyone who sits or has sat on a board, including directors in Canada, screeching off to their lawyer to try and get a separate indemnification agreement.

If they don't, and the company's bylaws are amended following a change of control or a nasty proxy fight, former directors now risk finding themselves not just out of luck, but out of pocket for their own legal expenses.

"I think in light of this decision directors will want to pay real attention," says Richard Steinberg, national chair of the securities and mergers and acquisitions practice group at Fasken Martineau DuMoulin LLP in Toronto. "They can no longer assume their indemnification will continue for as long as they need it. Delaware jurisprudence is quite influential."

Mary Jane Stitt, who heads the litigation practice group in the Toronto office of Blake Cassels & Graydon LLP, says the thought that directors could be stripped of their rights after they leave the board is "a wake-up call" that has sparked real concern.

"I've received a number of calls about this case from general counsel and from risk managers, as well as from directors asking: 'Could this happen in Canada?' "

What Ms. Stitt tells them is that it absolutely could, under bylaw provisions of the Canada Business Corporations Act and the Ontario Business Corporations Act. Delaware, the most influential business court in the U.S., punches far above its weight in terms of impact and when its vice-chancellors speak, judges throughout North America pay attention.

The notion that promises of indemnity can be retroactively eliminated has got to be an uncomfortable one for anyone who's ever sat on a board. Hollinger Inc., Nortel Networks, Imax Corp. and Celestica Inc. are just a few examples of why.

Schoon began when William Bohnen, a former director of Troy Corp., and Richard Schoon, a friend who replaced him on the board after he stepped down for health reasons, got into a dispute with the rest of the board. The pair sued in September of 2005 to see the company's books and records. As part of its defence filed in late October, Troy suggested past fiduciary breaches by the two men.

In early November, 2005, the board amended the company's bylaws to get rid of mandatory advancement of expenses for former directors made parties to litigation as a result of their actions on the board. The company later sued both Mr. Bohnen and Mr. Schoon for breach of fiduciary duties.

When Mr. Bohnen tried to get funds advanced to pay his lawyers, the company refused, arguing that it was no longer on the hook because of the bylaw amendment. So Mr. Bohnen sued, claiming the original bylaws created a vested contractual right to indemnity at the time he took office - a right that could not later be changed without his consent.

Vice-Chancellor Stephen Lamb disagreed, saying a former director's right to have litigation costs paid for does not actually vest until they are named as a party in a lawsuit.

It's "more than surprising," says Bryn Vaaler, a partner in the corporate group of Dorsey and Whitney LLP in Minneapolis. "It's a bit of a shocker."

Mr. Vaaler says that if there is a board fight and bad blood develops, with some directors forced to step down, the wording in Schoon leaves the door open for remaining directors to amend the bylaws and wipe out not just indemnity, but any access to the company's directors' and officers' insurance.

"I think in a change-of-control situation, this has got people really thinking this could be dangerous."

Ms. Stitt of Blakes says U.S. court decisions are especially important in Canada when they touch on insurance, because insurers and courts are concerned with developing jurisprudence that will help ensure predictability throughout North America. She believes Schoon will have a quick impact.

"It's going to change corporate practice in the drafting of bylaws here in Canada but, even then, this is going to be a wake-up call for directors to actually insist upon indemnity agreements being signed before they accept board appointments.

"Directors can find themselves targets for all sorts of suits, including environmental liability, secondary market liability and derivative actions. To really be able to sleep at night they want to be sure that their personal assets are not going to be put at risk for having served as an independent director on some company. This is not something that can be fixed after the fact."

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to Lexpert

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