



IN THE SUPREME COURT OF THE STATE OF DELAWARE

RICHARD W. SCHOON, ) PUBLIC VERSION  
 )  
Plaintiff Below, Appellant, ) FILED October 5, 2007  
 )  
v. ) No. 554, 2006  
 )  
DARYL D. SMITH, JOHN F. BECKERT, ) On Appeal from C.A. No.  
MARK C. GWILLIM, CONRAD A. ) 1753-N in the Court of  
PLIMPTON, and TROY CORPORATION, a ) Chancery of the State of  
Delaware corporation, ) Delaware  
 )  
Defendants Below, Appellees. )

APPELLANT'S OPENING BRIEF

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NATURE AND STAGE OF THE PROCEEDINGS

This appeal presents an issue of first impression for this Court: Can a director assert a derivative claim on behalf of the corporation he serves when a majority of the board is conflicted? As a matter of law and public policy, the answer must be "yes."

Plaintiff-below appellant Richard W. Schoon became a director of Troy Corporation ("Troy" or the "Company") on February 28, 2005. He quickly learned that Daryl Smith, Troy's Chairman and CEO, operated the Company as his personal fiefdom, and that the other three members of the board were beholden to Smith and were dominated and controlled by him. On November 3, 2005, Schoon filed this derivative suit to remedy the self-serving, disloyal, and bad faith acts that Smith has carried out with the assistance of Troy directors Conrad Plimpton, John Beckert, and Mark Gwillim. Schoon filed an amended complaint (the "complaint") on April 17, 2006. The defendants moved to dismiss the complaint on May 12, 2006.

On the day scheduled for oral argument on the motion to dismiss, Vice Chancellor Stephen P. Lamb issued a two-page letter opinion (the "Opinion" or "Op.") cancelling oral argument and dismissing the complaint on the grounds that Schoon lacked standing to sue. According to the trial court, "Delaware law does not recognize the right of a director, acting in that capacity, to sue on behalf of the corporation he or she serves . . . ." Op. 1-2.

The issue of director standing is of utmost importance to Delaware's system of corporate governance. Although the Court of Chancery held in *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del.

Ch.), *aff'd on other grounds*, 500 A.2d 1346 (Del. 1985), that a director lacks standing to assert individual claims on behalf of stockholders, the decision did not reach the question of a director's standing to assert derivative claims and implied that derivative standing would exist. This Court in *Moran* did not address the issue.

For the same reasons that equity originally granted stockholders the right to sue derivatively, this Court should hold that a director has the same right. Permitting directors to sue derivatively is consistent with Delaware decisions describing the fiduciary duties of directors and with the principles of trust law, from which the fiduciary duties of directors are derived. It accords with the recommendations of the American Law Institute in its Principles of Corporate Governance. Most importantly, it promotes the core Delaware public policy of protecting against misconduct by faithless fiduciaries. Of all corporate constituents, directors are best positioned to identify fraud, mismanagement, and other misconduct and then to take action to correct it.

The Opinion, by contrast, denies directors the right to sue, thereby depriving both corporations and their stockholders of their most powerful advocates. The Opinion would leave directors who learn of board-level misconduct with no choice but to turn a blind eye to the wrongdoing, to resign in silence, or to go hat-in-hand in search of a stockholder champion or otherwise publicize their concerns. Directors would thus have to abdicate responsibility or risk of being sued by the corporation for disclosing corporate confidences.

The Opinion is bad law and worse policy. It should be reversed.

### SUMMARY OF THE ARGUMENT

1. The trial court erred as a matter of law by holding that directors do not have standing to bring derivative claims. A director of a Delaware corporation has an affirmative duty to protect the interests of the corporation, and he must have appropriate tools to discharge that duty. A director should be able to sue derivatively to remedy corporate misconduct when a majority of the board is disabled or conflicted. A director should not have to publicize his concerns or shop for a stockholder plaintiff in the hope that board-level misconduct will be challenged. The director's fiduciary duties, the origins and purposes of the derivative action, and the underlying principles of trust law all militate in favor of directors having the right to sue on the corporation's behalf. Court of Chancery Rule 23.1 and 8 *Del. C.* § 327 do not preclude directors from pursuing derivative actions. Rule 23.1 and Section 327 apply by their terms only to *stockholder* derivative actions.

STATEMENT OF FACTS

**A. The Parties And Relevant Individuals.**

Nominal defendant Troy is a privately held Delaware corporation with its principal place of business in Florham Park, New Jersey. A16-17 at ¶ 11. Troy develops and manufactures specialty chemicals, including biocides. *Id.* Troy's capital structure consists of three series of capital stock. *Id.* The holders of Troy's Series A Common stock are entitled to one vote per share and have the right to elect four directors (the "Series A Directors"). The holders of Troy's Series B Common stock are entitled to one vote per share and have the right to elect one director (the "Series B Director"). Troy's Series C Common stock has no voting rights. *Id.*

Defendant Smith dominates Troy. He is a **REDACTED** Director and chairman of the Board. At the time Schoon filed suit, Smith comprised the entire senior management team of Troy,

**REDACTED**

Through certain of the transactions challenged in the complaint, Smith came to be Troy's controlling stockholder.

**REDACTED**

**REDACTED**

Smith treats Troy as his own personal fiefdom.

**REDACTED**

As described below, Smith has repeatedly demonstrated the lengths to which he will go to maintain control of Troy.

Defendant Gwillim is a **REDACTED** Director. He is the son of one of Troy's original employees, and his father was part of the group that sold Troy to Smith and his co-investors in 1980. A18 at ¶ 14. Smith keeps Gwillim on as an officer and employee. *Id.*

**REDACTED**

In these positions, he reported directly to Smith. *Id.* Gwillim's livelihood depends on his continued status as a director, officer and employee of Troy.

**REDACTED**

Defendant Plimpton is a **REDACTED** Director. He was an initial investor with Smith in Troy, and the two are close personal friends. A19 at ¶ 16.

**REDACTED**

Defendant Beckert has been a close personal friend of Smith's since college. A18-19 at ¶ 15. Smith elected Beckert as a **REDACTED** Director in 2001. *Id.*

**REDACTED**

Non-party Steel is a privately held Delaware corporation used by members of the Bohnen family as a holding company for investments. A20 at ¶ 18.

**REDACTED**

REDACTED

Plaintiff Schoon is the Series B Director. A17 at ¶ 12. He was elected to the Board by Steel in February 2005. A35-36 at ¶ 81. Schoon is a financial consultant who, since 1995, has provided accounting, tax and financial advisory services to Steel and the Bohnen family, who are his primary clients. A17 at ¶ 12.

Non-party David Singer is a member of the law firm of Dorsey and Whitney LLP and is the executor of the Singer Estate. A20 at ¶ 19. The Singer Estate owns shares of

REDACTED

**B. Schoon Challenges The Defendants' Acts Of Self-Dealing And Breaches of Fiduciary Duty.**

Schoon was elected to the Board in February 2005. A35-36 at ¶ 81. He quickly learned that Smith operated the Company for his own benefit and that the other three members of the Board were beholden to Smith and were dominated and controlled by him. Schoon watched as his fellow directors summarily approved Smith's initiatives without asking questions and without seeking additional information. Schoon was the only director to ask questions, to raise issues, and (on several occasions) to vote against Smith's proposals. In November 2005, Schoon filed this action (the "Derivative Action"), in which he asserted challenges to various acts of self-dealing and breaches of fiduciary duty committed by Smith and his cronies.

**1. Smith's Scheme To Entrench Himself At Troy.**

REDACTED

**REDACTED**

To protect himself, his positions, and perquisites, Smith unilaterally rejected, blocked, or otherwise killed potential transactions that were in the best interests of Troy, even when the Board instructed him to pursue them. A11 at ¶ 2, A21 at ¶ 20.

**REDACTED**

REDACTED

**REDACTED**

REDACTED

In the Derivative Action, Schoon seeks damages on behalf of Troy for Smith's breaches of fiduciary duty in failing to comply with the Board's instructions and acting in his own self-interest at Troy's expense.

2. Troy's Stockholders Demand Liquidity.

Although Smith had successfully thwarted at least three threats to his position, power, and perquisites, he still had a problem: a majority of Troy's Board and a majority of Troy's stockholders favored some form of value-maximizing transaction; only Gwillim's refusal to confront Smith preserved smith's control.

REDACTED

Smith realized that to protect his position and perquisites, he needed to break up

the Board and stockholder majority that favored a business combination. A11-12 at ¶ 3, A25-26 at ¶ 44. Smith therefore set out to cement his control over Troy at both the Board and stockholder level. *Id.*

3. **Smith Uses Corporate Resources To Cement His Control Over Plimpton.**

To gain control of both a mathematical majority of the Board and a mathematical majority of Troy's voting power, Smith targeted the other **REDACTED** Directors. A11-12 at ¶ 3, A26 at ¶ 45. Smith first set his sights on Plimpton, with whom Smith already had close and longstanding ties. A26 at ¶ 45.

**REDACTED**

**REDACTED**

**REDACTED**

Smith further cemented his control over Plimpton by threatening him with a lawsuit.

**REDACTED**

In the Derivative Action, Schoon seeks to set aside

**REDACTED**

Alternatively,

Smith seeks damages on behalf of Troy for the defendants' breaches of fiduciary duty in connection with these transactions.

4. **Smith Uses Corporate Resources To Cement His Control Over Beckert.**

Smith also took steps to reinforce his control over Beckert.

**REDACTED**

Smith later pushed through a resolution establishing the new position of Vice Chairman. A13 at ¶ 5, A32 at ¶ 68. Beckert was appointed to this position and given an annual salary **REDACTED**

**REDACTED** Troy has no need for a Vice Chairman, the compensation is inappropriate and Beckert is not qualified to serve as an officer of Troy. A32 at ¶ 68. Smith engineered the creation of the Vice Chairman position so he could funnel money to Beckert and render Beckert even more beholden to him.

In the Derivative Action, Schoon seeks to set aside the Beckert Stock Grant and the Beckert Appointment. Alternatively, Schoon seeks damages on behalf of Troy for the defendants' breaches of fiduciary duty in connection with these transactions.

5. The Defendants Carry Out Smith's Wishes And Entrench Him Further.

In the beginning of 2005, Smith became increasingly fearful that Troy stockholders, including Steel and the Singer Estate, might sell their shares to a third party, including possibly a competitor of Troy. Smith viewed any potential sale as a threat to his self-satisfying status quo. A14 at ¶ 7. Smith therefore used his control over four out of the five Board votes and a mathematical majority of Troy's outstanding voting power to force the approval of a series of draconian defenses with the purpose and effect of blocking Troy's stockholders from selling their shares and further entrenching Smith (the "Challenged Amendments"). A13-14 at ¶¶ 6-7.

REDACTED

The Challenged Amendments proposed significant changes to Troy's Charter and By-laws, including an article authorizing the issuance of blank check preferred stock (the "Blank Check Preferred Provision"), an article and corresponding by-law imposing a director qualification provision, and a 120 day advance notice by-law (the "Advance Notice Provision"). Without careful review or consideration, the defendants rubberstamped the Challenged Amendments and agreed to submit them to stockholders. *Id.* Only Schoon voted against the proposals. *Id.* Smith then caused the Challenged Amendments to be approved by written consent, even though Troy's annual meeting of stockholders was only a few weeks away. A34 at ¶ 76. Had Smith been remotely interested in an open and honest debate, he easily could have waited for the annual

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meeting. But Smith had no interest in corporate democracy. He was interested in entrenching himself, and he rammed through the amendments to achieve that goal.

**REDACTED**

In the Derivative Action, Schoon seeks to set aside the Challenged Amendments.

**C. The Trial Court Opinion.**

Schoon filed the complaint on April 17, 2006. The defendants moved to dismiss on May 12, 2006.

On the day scheduled for oral argument on the motion to dismiss, the trial court issued the Opinion, cancelled the oral argument and dismissed the complaint. Citing *Moran*, the trial court stated that

"Delaware law does not recognize the right of a director, acting in that capacity, to sue on behalf of the corporation he or she serves . . . ." Op. 2. According to the trial court, "[t]here are powerful policy interests embodied in both Section 327 of the Delaware General Corporation Law and Court of Chancery Rule 23.1 that militate against recognizing the standing of an individual director to bring such litigation." *Id.* As discussed below, these holdings were wrong. Schoon timely filed this appeal.

## ARGUMENT

### I. THE TRIAL COURT ERRED AS A MATTER OF LAW IN REFUSING TO RECOGNIZE DIRECTOR DERIVATIVE STANDING.

As a matter of first impression, this Court should hold that a director of a Delaware corporation has standing to sue derivatively on behalf of the corporation he serves. Allowing a director to sue derivatively comports with the origins and purposes of the derivative action and is a necessary corollary of the affirmative and unremitting fiduciary duties that Delaware law imposes on directors. It is consistent with American Law Institute's Principles of Corporate Governance, which expressly recognize director standing. It also comports with principles of trust law, from which the duties of corporate directors are derived. None of the trial court's reasons for rejecting director standing have merit.

#### A. Standard of Review.

The trial court's ruling on director standing is an issue of law that this Court reviews de novo. See *Rosenbloom v. Esso Virgin Islands, Inc.* 766 A.2d 451, 458 (Del. 2000).

#### B. A Director Has Standing To Bring A Derivative Action.

This Court has held that directors have an affirmative and unremitting obligation under Delaware law to protect the corporation they serve and its interests. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993) ("directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders"); accord *Sealy Mattress Co. of N.J., Inc. v. Sealy, Inc.*, 532 A.2d 1324, 1338 (Del. Ch. 1987) (noting that directors have an "affirmative duty to protect the

interests" of the corporation). In this Court's words, "[a] public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . to protect the interests of the corporation committed to his charge . . . ." *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

The Court of Chancery has recognized that the fiduciary duties of directors can require them to take action against a fellow director or controlling stockholder. See *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1055-56 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005). Directors of a Delaware corporation have been found to have breached their fiduciary duties when they did not take action to protect the corporation. See *Strassburger v. Earley*, 752 A.2d 557, 581 (Del. Ch. 2000) (finding that directors breached their duty of loyalty where "[t]heir sin was not one of venality, but, rather, of indifference to their duty to protect the interests of the corporation and its minority shareholders"). In some instances, a director's duty to act affirmatively requires the filing of a lawsuit. See *Zapata Corp. v. Maldonado*, 430 A.2d 770, 783 (Del. 1981) (observing that directors can breach their duties by failing to pursue a derivative action); *AIG v. Barbizet*, C.A. No. 974-N, 2006 WL 1980337, at \*7 (Del. Ch. July 11, 2006) (holding that plaintiff stated a claim against directors who refused to authorize a suit on the corporation's behalf).

If a director has a fiduciary duty to take action to protect the corporation, if a lawsuit is the necessary action, and if the director

can be held liable for failing to proceed with a lawsuit, then a director necessarily must have standing to sue derivatively on behalf of the corporation if the board refuses to take action or cannot do so because it is conflicted or disabled. A rule of law that denies standing to a director creates an impossible situation where the director cannot fulfill his fiduciary duties. Acknowledging director derivative standing upon a finding of demand futility is analogous to constituting by court order a special litigation committee invested with the power to bring suit on behalf of the corporation. See *Zapata*, 430 A.2d at 785-789. This, of course, is precisely the mechanism Delaware corporations regularly employ once a stockholder plaintiff has successfully pled demand futility.

The nature of the derivative action provides further support for a director's right to sue. While it is true that derivative suits are usually brought by stockholders, stock ownership is not the only permissible basis for derivative standing. For the same reasons that equity originally granted stockholders the right to sue derivatively, this Court should hold that directors have the same right.

Overwhelming authority establishes that the derivative action did not originate as a right unique to stockholders, but rather as an equitable means to remedy harm to the corporation. "Devised as a suit in equity, the purpose of the derivative action was . . . to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'" *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) (quoting *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949)). "This form of lawsuit evolved during the

nineteenth century as an equitable device allowing courts to protect corporations and minority shareholders 'against the frauds of the governing body of directors or trustees.'" 2 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE 1380 (5th ed. 1998) (quoting *Hawes v. City of Oakland*, 104 U.S. 450, 453 (1881)). "The derivative proceeding developed as an equitable device ... to enforce a corporate right against faithless officers and directors, or abusive majority shareholders, that the corporation had either failed or refused to assert on its own behalf." 13 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5940 at 28-29 (Rev. ed. 2004); accord id. § 5941.10.

Delaware authorities agree. Derivative suits are "potent tools to redress the conduct of a torpid or unfaithful management." *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984). "The derivative action developed in equity" so that suit could be brought "in the corporation's name where those in control of the company refused to assert a claim belonging to it." *Id.* "The fundamental purpose of a derivative action is to enforce a corporate right that the corporation has refused for one reason or another to assert." 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 13.9 at 13-20 (Supp. 2005). Derivative suits are a "necessary check on the behavior of directors that serve in a fiduciary capacity . . . ." *Agostino v. Hicks*, C.A. No. 20020-NC, 2004 WL 443987, at \*3 (Del. Ch. Mar. 11, 2004).

Because the derivative action is a "uniquely equitable remedy," broad principles of equity must guide who can assert it. *Levine v.*

*Smith*, 591 A.2d 194, 200 (Del. 1991). "[R]igidity is not needed [when] seeking to protect the corporate interests." *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106, 112 (Del. Ch. 1948). "[T]his Court, as a Court of Equity, must examine carefully the particular circumstances of each [derivative] case." *Schreiber v. Carney*, 447 A.2d 17, 22 (Del. Ch. 1982). Directors should be able to sue derivatively to fulfill the powerful public policies underlying the recognition of derivative actions.

Authority from the field of trust law further supports the conclusion that directors have standing to sue derivatively. Delaware courts frequently look to trust law to give content to directors' fiduciary duties. See, e.g., *Bovay v. H. M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944); *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 798 n.77 (Del. Ch. 2004); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1146-47 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995). The Court of Chancery has noted that the derivative action "is analogous to the right of a trust beneficiary to call his trustee to account for the management of the trust corpus." *Maldonado v. Flynn*, 413 A.2d 1251, 1261 (Del. Ch. 1980), *rev'd on other grounds sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

Under trust law, a trustee has standing to sue a co-trustee on behalf of the trust:

If there are several trustees, one or more of them can maintain a suit against another to compel him to perform his duties under the trust, or to enjoin him from committing a breach of trust, or to compel him to redress a breach of trust committed by him. A trustee is not precluded from maintaining such a suit by the fact that he himself participated in the breach

of trust, since the suit is on behalf of the beneficiary.

RESTATEMENT (SECOND) OF TRUSTS § 200 (1959 & Supp. 2005) at cmt. e. In some instances, a trustee can be required to file suit against a co-trustee to fulfill his fiduciary duties to the beneficiary. Section 224 of the Restatement provides that "[a] trustee is liable to the beneficiary, if he . . . (e) neglects to take proper steps to compel his co-trustee to redress a breach of trust." *Id.* § 224; accord *Sergeson v. Del. Trust Co.*, 413 A.2d 880, 882 (Del. 1980) (following the Restatement). The same should be true for a director.

The American Law Institute ("ALI") recognizes that a director is entitled to sue derivatively on behalf of the corporation he serves:

A director of a corporation has standing to commence and maintain a derivative action unless the court finds that the director is unable to represent fairly and adequately the interests of the shareholders.

2 PRINCIPLES OF CORP. GOV. § 7.02(c) (1992 & Supp. 2006). According to the ALI, this principle "can be implemented by judicial decision or rule, except to the limited extent that a contrary statutory provision has been enacted, in which case legislation would be required." *Id.* at cmt. b. Delaware has no contrary statutory provision. The Supreme Court of Pennsylvania has adopted Section 7.02. See *Cuker v. Mikalauskas*, 692 A.2d 1042, 1049 (Pa. 1997). At least one other court has recognized as a matter of law that directors have standing to sue. See *Dotlich v. Dotlich*, 475 N.E.2d 331, 339 (Ind. Ct. App. 1985) (holding that a director can sue derivatively on behalf of a corporation).

The ALI explains the director standing rule as follows:

The implicit rationale . . . is that a director who discovers illegal or fraudulent behavior has a fiduciary duty to act to prevent its consummation or continuation. The necessary response may sometimes require litigation (just as a trustee may be required to defend the trust estate) . . . . [T]here is little, if any, evidence of its abuse. Indeed, New York's long experience with a statute that gives directors standing suggests that the potential for "strike suits" by directors is small or trivial. **Conversely, denying the director the right to sue could render the director unable to fulfill effectively the director's fiduciary duty to the corporation,** and might as a practical matter increase the director's own exposure to liability if no other means were available to oppose questionable transactions or conduct. Furthermore, particularly in the closely held corporation, a director will typically learn of an impending fraud or the misdeed well before the shareholders and is thus in a superior position to seek an injunction or other preventative remedy.

2 PRINCIPLES OF CORP. GOV. § 7.02(c) at cmt. h (emphasis added). Delaware should embrace the ALI's position on this fundamental issue of director duties and corporate governance.

In an effort to justify its determination that a director cannot assert a derivative claim, the trial court cited the contemporaneous ownership requirements of Section 327 and Court of Chancery Rule 23.1. Op. 2. According to the trial court, these authorities "militate against recognizing the standing of an individual director to bring such litigation." *Id.* That is incorrect. These authorities apply only to derivative actions brought by *stockholders*, and they function to limit the universe of *stockholders* who can bring a derivative action. These authorities do not say that no one other than a stockholder can bring a derivative action, and they have no

application to a derivative action brought by a party other than a stockholder.

Section 327 "does not create the right to sue derivatively but rather restricts that right." *Harff v. Kerkorian*, 324 A.2d 215, 218 (Del. Ch. 1974), *aff'd in part, rev'd in part in other grounds*, 347 A.2d 133 (Del. 1975). Section 327 provides that before a *stockholder* can bring a derivative action, the stockholder must have owned stock "at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law." 8 Del. C. § 327. "[R]ead literally § 327 does not provide that only stockholders have standing to sue derivatively." *Harff*, 324 A.2d at 218. To the contrary, by requiring an averment of contemporaneous stock ownership "[i]n any derivative suit instituted by a stockholder of the corporation," the statute expressly contemplates that there could be a "derivative suit" instituted by a party other than "a stockholder of the corporation." See 8 Del. C. § 327. Any other reading would render superfluous the language "by a stockholder of the corporation," which is contrary to well-established canons of statutory interpretation. See *Keeler v. Harford Mut. Ins. Co.*, 672 A.2d 1012, 1016 (Del. 1996) (citing 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 46.06 (1995)). There is thus nothing in the plain language of Section 327 that would prevent a director from bringing a derivative suit, and the implication of Section 327 is that there are parties other than stockholders (presumably directors) who can bring a derivative suit.

The legislative purpose of Section 327 likewise does not provide any reason to bar a director from suing derivatively. Prior to the enactment of the statutory predecessor to Section 327, "a stockholder was not required to be the owner of the shares at the time of the transaction of which he complained" in order to bring a derivative suit. *Burry Biscuit*, 60 A.2d at 110. The General Assembly's "sole purpose" in adopting what is now Section 327 was "to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the stock." *Id.* at 111.<sup>1</sup> Moreover, the contemporaneous ownership requirement that was later codified in Section 327 was originally created as a matter of equity by the United States Supreme Court in *Hawes v. City of Oakland*, 104 U.S. 450 (1881), for an entirely different purpose: to prevent corporations from manufacturing a basis for diversity jurisdiction in federal court. See *Burry Biscuit*, 60 A.2d at 111 n.4. The requirement has no relevance to the issue of director standing.

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<sup>1</sup> *Accord Shaev v. Wyly*, C.A. No. 15559-NC, 1998 WL 13858, at \*4 (Del. Ch. Jan. 6) (following *Burry Biscuit* and declining to deny standing to sue derivatively where it would not serve the "sole aim of section 327"), *aff'd*, 719 A.2d 490 (Del. 1998); *Jones v. Taylor*, 348 A.2d 188, 191 (Del. Ch. 1975) ("The purpose of the rule requiring the plaintiff to be a shareholder at the time of the transaction of which he complains is to prevent what is considered to be a wrong, namely, the purchasing of shares in order to maintain a derivative action so as to attack a transaction which occurred prior to the purchase of stock."); *Harff*, 324 A.2d at 218 ("The purpose behind [the statute's] enactment in 1945 was to prevent what has been considered to be an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of stock.").

The trial court also relied on Rule 23.1, which simply implements the statutory requirements of Section 327. The same analysis therefore applies. Rule 23.1 does not provide that only stockholders can bring derivative actions. It instead provides that "[i]n a derivative action brought by 1 or more shareholders . . . the complaint shall allege" that the plaintiffs meet the contemporaneous ownership requirement of Section 327. Ch. Ct. R. 23.1. As with Section 327, by explicitly referring to "a derivative action brought by 1 or more shareholders," Rule 23.1 implies that there could be derivative actions brought by other corporate constituents who are not "shareholders." Otherwise this language would be superfluous. Section 327 and Rule 23.1 thus support the right of directors to sue derivatively.

The purposes underlying the contemporaneous ownership requirement do not apply to a director of a corporation who seeks to assert derivative claims on the corporation's behalf. As the ALI explains,

The logic of the contemporaneous ownership rule does not apply to a director's suit, because the director's fiduciary obligation entitles the director to seek to rectify wrongs to the corporation that do not directly injure the director. For the same reason, the continuing ownership requirement should also be inapplicable.

2 PRINCIPLES OF CORP. GOV. § 7.02(c) cmt. h. Directors are elected by stockholders with the charge of protecting the corporate enterprise. There is therefore no reason for the law to be concerned about the evil of a purchased lawsuit and, as the ALI has observed, "the potential for 'strike suits' by directors is small or trivial." *Id.*

The goal of avoiding a manufactured basis for diversity jurisdiction is clearly inapplicable.

Delaware law must allow a director who learns of corporate wrongdoing or malfeasance to take meaningful action. Our system of corporate governance places significant trust in directors. We rely on them to act as a check on management, to guard against potential conflicts of interest, and to protect the corporation and its stockholders. See generally E. Norman Veasey, *Law and Fact in Judicial Review of Corporate Transactions*, 10 U. MIAMI BUS. L. REV. 1, 3 (2002) (stating that "the most effective stockholder protection device is the independence of directors"). Without the proper tools, however, directors are all bark and no bite.

When a director of a Delaware corporation learns of corporate misconduct or malfeasance, he can be expected to raise the matter with the rest of the board. But if the other board members are conflicted or were the principal actors in transactions that could give rise to personal liability, or if they improperly refuse to take action, the director cannot be expected (much less required) to sit idly by.

Without derivative standing, an independent director cannot ensure that corporate misconduct is challenged in court. The director would have to disclose his concerns publicly and hope someone would sue, or the director would be forced to go hat in hand to the stockholders in an effort to find a stockholder champion. This is inconsistent with our director-centered norm of corporate governance. It would exacerbate agency costs and render more difficult the vital monitoring function that directors perform. It also would put the

director at risk of a breach of fiduciary duty suit for disclosing corporate information. Here, for example, Troy has sued Schoon to block any information sharing with the stockholders. A director also may not be able to publicize the misconduct of his fellow directors. See *Disney v. Walt Disney Co.*, C.A. No. 234-N, 2005 WL 1538336, at \*5-6 (Del. Ch. June 20, 2005) (refusing to permit a former director to publicly disclose information purportedly evidencing board-level misconduct).

Simply put, it is unfathomable that the courthouse doors are closed to a director who wishes to bring a derivative action on behalf of the corporation he serves against fiduciaries who have breached their duties of loyalty, care, and good faith. Directors of Delaware corporations should be able to redress wrongs done to the corporation without first recruiting stockholders to their cause.

Finally, as a practical matter, a director is likely to be a superior derivative plaintiff than a stockholder. The director has a mandate to protect the corporation from harm and a fiduciary obligation to do so. A stockholder derivative plaintiff is not elected and does not owe the corporation fiduciary duties. A director already possesses the information about the corporate wrongdoing. He has greater information rights and the ability to access historically privileged information. See *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, C.A. No. 13911, 1998 WL 71836, \*7 (Del. Ch. Mar. 5, 1998). A stockholder plaintiff typically is not as informed as a director and cannot as readily access privileged information. See *Deutsch v. Cogan*, 580 A.2d 100, 104 (Del. Ch. 1990) (requiring good

cause to pierce privilege). Yet, when the full board cannot impartially consider a demand, Delaware law confers derivative standing on stockholders. Far better that the responsibility be shouldered by a director who owes fiduciary duties, carries an electoral mandate, and has personal knowledge of the misconduct.

C. Moran Does Not Control The Outcome Of This Case.

According to the trial court, a director's standing to sue derivatively "is controlled by well settled authority." Op 2. The trial court cited for this proposition a single case, *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.), *aff'd on other grounds*, 500 A.2d 1346 (Del. 1985). *Moran*, however, can only be read to hold that a director cannot challenge corporate misconduct *individually*. *Moran* says nothing about whether a director can sue *derivatively*. Here, Schoon has sued derivatively.

In *Moran*, John A. Moran, a director of defendant Household, and Dyson-Kissner-Moran Corporation ('D-K-M'), Household's single largest stockholder, challenged the implementation of a stockholder rights plan. *Moran*, 490 A.2d at 1063. Another large stockholder intervened as a plaintiff just before trial. *Id.* Moran and D-K-M attempted to assert **direct** claims against Household's directors. *Id.* at 1066, 1069. The defendants moved to dismiss pursuant to Rule 23.1 because the claims were "actually derivative claims." *Id.* at 1069. Moran responded that (i) "the Rights Plan directly affect[ed] fundamental shareholder rights, including voting rights," giving rise to individual claims, and (ii) "he ha[d] individual standing as a director of Household to enforce the rights of its stockholders." *Id.*

The Court of Chancery rejected both of Moran's arguments. On the question of director standing, the court held that Moran did not have "individual standing to maintain this suit as a director of Household to protect the rights of Household's shareholders." *Id.* at 1071. The court then pointed out that "Moran's attempt to act as a surrogate to enforce the rights of shareholders merely emphasizes the derivative nature of plaintiffs' claims." *Id.* The court thus held that Moran did not have standing as a director to assert **individual** claims on behalf of Household's stockholders.

The Court of Chancery went on to hold that the plaintiffs had adequately pled derivative claims, including facts sufficient to show demand futility for purposes of Rule 23.1. *Id.* Critically, the court did **not** dismiss Moran from the case or deny Moran's right to assert derivative claims. Thus, at least implicitly, *Moran supports* the right of a director to bring claims derivatively. This Court did not address the issue of director standing on appeal.

D. **This Is A Paradigmatic Case For Director Standing.**

In this case, four of five Troy directors are incapable of impartially considering a demand. Smith is the controlling stockholder and the prime mover behind the challenged misconduct. Plimpton is beholden to Smith

**REDACTED**

Gwillim is a Troy employee whose livelihood depends on remaining in Smith's good graces. Beckert receives

**REDACTED** annual salary courtesy of Smith,

**REDACTED**

**REDACTED**

Schoon was right to bring suit on his own, without

seeking the approval of four interested directors, and the trial court was wrong to deny him standing to seek a remedy on Troy's behalf.

Schoon has witnessed much of the misconduct at Troy with his own eyes. Schoon knows the defendants personally and understand the complex dynamic that has enabled Smith to dominate his fellow directors and to run Troy as he pleases. Thus, Schoon is uniquely positioned to represent the interest of the Company effectively, and the trial court was wrong to deprive the corporation of its most powerful advocate.

Schoon has asked the hard questions an independent director should ask, and he has not received satisfactory answers. By November 2005, Schoon felt compelled to take action. Resignation was not a suitable option. Stepping down would have deprived Troy of the one director capable of looking after its interests and the interests of its stockholders. Schoon brought suit on his own because it was the best tool he had to combat the pervasive problems at the Company. This Court should recognize Schoon's standing to sue.

CONCLUSION

For all of the foregoing reasons, the Opinion should be reversed and the case remanded for further proceedings.

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