20 Questions

Directors Should Ask about

Directors' and Officers' Liability Indemnification and Insurance

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Chartered Accountants of Canada

How to use this publication

Each "20 Questions" briefing is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management — and themselves — tough questions.

In most cases, boards will not want to ask the questions directly but will ask for briefings from the corporation's legal counsel, insurance broker and/or risk manager, or from independent legal or other advisors retained by the board itself, to address the points raised by the questions. The questions are not intended to be a comprehensive checklist, but rather a way to provide insight and stimulate discussion on the risks that directors face and the protection that is available to them.

The comments that accompany the questions are not intended to provide legal advice to directors but rather to give them a basis for critically assessing the answers they get from their legal counsel and insurance professionals. Although the questions apply to any organization, the answers, and the level of protection to directors and officers through indemnification and insurance, will vary according to the size, complexity and sophistication of each individual organization. They may not be the best answers for every organization and boards would do well to get advice specific to their situation from legal counsel and insurance professionals.

After the comments there are personal checklists that directors can use to assess their understanding of the "answer" as it applies to their own situation and to prompt further questions if they are not fully satisfied with the answers.

Appendix 1 contains Section 124 of the Canada Business Corporations Act which addresses indemnification of directors. Appendix 2 is a glossary of selected insurance terms.

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INSTITUTE OF CORPORATE DIRECTORS

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Preface

The Risk Management and Governance Board of the Canadian Institute of Chartered Accountants has developed this briefing to help directors understand the protection available to them under corporate indemnification and directors' and officers' insurance. It is intended primarily to help individual directors but boards may also wish to use it for orientation and discussion.

Indemnification and insurance are complex, technical subjects and it can be tempting for boards to rely on management to handle them. This can result in directors learning the details of their protection only when problems arise. Boards are well advised to take an active interest in their corporation's provisions for indemnification and insurance for directors' and officers' liability. They should do this when things seem to be going well, and schedule regular reviews as part of their responsibility for risk management.

This briefing, like others in the CICA "20 Questions for Directors" series, provides suggested questions for boards to ask the CEO and professional advisors. For each question there is a brief explanatory background and some recommended practices. We hope that it will be useful to boards, board committees, CEOs and others who work with or advise boards.

The document has been developed to address the needs of the directors of publicly held corporations. It may also be a useful reference for the directors and management of other types of organizations.

The Board acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, Richard J. Berrow, who wrote this briefing, the editor, Hugh Lindsay and the CICA staff who provided support to the project. Thank you as well to Aon Reed Stenhouse and Marsh Canada for their review and helpful suggestions.

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Introduction

Directors face a range of legal exposures in respect of their association with, and fiduciary duty to, a corporation. They increasingly look to the state of their indemnities and insurance and to their professional advisors for assurances that they have an appropriate level of protection in place.

There are a number of sources of exposures:

- Federal and provincial statutes provide means of enforcing the rights of shareholders and other stakeholders including secondary market investors. Examples include the elaborate oppression remedies found in most corporate statutes, and the surprising ease with which a dissident shareholder or other stakeholder may obtain the leave of the court to commence a derivative action in the name of the corporation, even where the corporation's directors have made a *bona fide* business decision not to do so.
- Other federal and provincial statutes in areas such as environmental remediation and occupational health and safety include civil causes of action and fines for directors.
- Directors owe a duty of care to the corporation, which requires them to act without negligence.
- Directors also owe the corporation a fiduciary duty, which requires them to act with loyalty to the corporation, and not to serve their own interests or those of anyone other than the corporation. This fiduciary duty to the corporation includes a duty not to misappropriate a corporate opportunity. This can result in directors being liable to the corporation for taking advantage of business opportunities that came to them in the course of their directorship without the proper consent, even if the corporation could not have taken up the opportunity itself.
- The duties of care and of loyalty to the corporation are not always as easy to apply as they might appear. A recent suggestion from the Supreme Court of Canada that the duty of care is owed not only to the corporation itself, but also to other stakeholders such as creditors, could bring new exposures.[1]
- In commercial disputes between corporations, it is not uncommon for one litigant to sue not only the opposing corporation, but also its directors and officers, on a variety of legal theories. Sometimes this is done for tactical reasons, even though the claim against the individuals lacks merit. Even so, it can be difficult to extricate the director from the action before trial.
- Class actions in Canada can add to the risk associated with some of these exposures.
- In the modern litigation environment, securing funding for a proper defence can be as important for a director as securing indemnification for any liability that might be imposed.

Directors can reduce their risk by performing their duties competently and honestly but they may inadvertently be negligent. They may also need a legal defence even though they have done nothing wrong.

In most cases the directors will look to the corporation to protect them by reimbursing or directly paying the cost of their defence and any judgments against them – either from corporate funds or through a directors' and officers' insurance (D&O) policy. Directors have, however, very limited statutory protection under the *Canada Business Corporations Act* (CBCA) and equivalent provincial statutes, although the statutes allow corporations to extend directors' right to indemnification and to buy D&O insurance for them. It is important that directors understand their statutory entitlement to protection and that any extension of their rights can and should be specified in written contracts with their corporations.

A good program of insurance that includes coverage for directors' and officers' liability is usually the best way to protect directors.

This document discusses indemnification and insurance in three sections:

- **Indemnification** of directors by the corporation on whose board they serve, or by another source such as a shareholder;
- **Insurance coverage** under a directors' and officers' liability insurance (D&O) policy;
- **Insurance claims** under D&O policies.

[1] Supreme Court of Canada: ***Peoples Department Stores v. Wise***, May 2004.

The terms "indemnification" and "indemnity", as used in law and insurance policies, refer to the right of a person to recover the amount of a financial loss or a liability to a third party. In the case of directors' liability, this generally means the amount of a judgment or similar award resulting from civil, criminal or administrative proceedings. It includes the cost of defending the director but not non-financial items such as pain and suffering, or loss of reputation.

The CBCA and most provincial corporate statutes are broadly similar and generally permit the indemnification of directors and officers, subject to a number of restrictions and qualifications.

Indemnification is sometimes prohibited. The corporation may not pay an indemnity at all where the director failed to meet a conduct threshold. In civil cases, meeting the threshold means that the individual has acted in good faith with a view to the best interests of the entity concerned. In the case of a criminal or administrative action (such as a prosecution for an offence punishable by a fine or imprisonment) the individual must have had reasonable grounds for believing that his or her conduct was lawful.

Also, a corporation cannot indemnify an individual who serves at its request on the board of a second entity and attracts a liability by acting in bad faith toward the second entity, even if the misconduct benefits the appointing corporation.

Conversely, indemnification is sometimes mandatory. A director is entitled to indemnification from the corporation if he or she was not judged to have committed any fault or to have omitted to do anything he or she ought to have done.

Between those two extremes lies a zone of discretion in which the corporation has the option of providing indemnification on a case by case basis. Corporations may also (with some exceptions) pay defence costs on behalf of directors and treat the payments as loans. If the director is found by the court to have met the "conduct threshold" the loan may be converted to an indemnity—if not, the director must repay the loan.

In some instances corporations must ask the court for approval before loaning defence costs or paying indemnities to their directors.

The corporate statutes do not govern the provision of legal advice to a director for ordinary purposes of corporate governance or for serving as a witness in an action against the corporation.

1. Can the sitting directors be held liable for approving the payment of an inappropriate indemnity?

Yes, the sitting directors (those deciding whether to pay an indemnity to another present or former director) can be held liable to the corporation for causing the corporation to pay an indemnity that is prohibited by statute—for example, to a director who is found to have acted against the best interests of the corporation concerned. An indemnification contract will not relieve against this liability.

Where indemnification is discretionary, different considerations apply. The statutes contemplate that the directors sitting on the board at the time a request for indemnification is received will consider it and apply their judgment as to whether indemnification is permitted, perhaps obtaining the assistance of the court. They must then exercise their discretion to cause the company to pay or withhold indemnification by applying their business judgment in the best interests of the corporation as they do with other corporate decisions that come before the board. But they are not entitled to exercise their business judgment to pay an indemnity to a director who did not meet the conduct threshold. For that reason the decision whether or not to pay an indemnity is often deferred until the quality of the director's conduct can be clearly established, which sometimes requires a judicial decision.

The sitting directors might be held liable to the corporation if they pay an indemnity that, while not prohibited, is not in the best interests of the corporation at the time of payment. Having a by-law or, better still, a contract in place to make indemnification mandatory wherever it is permitted by the statute helps to protect the sitting directors against this exposure. The decision to enter into the contracts can be justified with regard to the interest of the corporation in attracting and keeping qualified directors at the time the contract is entered into. When it comes time to pay the indemnity (or to advance defence costs) the sitting directors are entitled to take into account the mandatory terms of the indemnification by-law and contract which the company has already entered into and is now being called upon to perform.

I understand that:

- **corporations may only pay indemnities which are not prohibited by statute**
- **directors must meet a conduct threshold to be eligible for indemnification**
- **sitting directors can be held liable for approving payment by the corporation of an inappropriate indemnity.**

2. How can directors secure indemnification beyond that which is mandated by statute?

Canadian corporate statutes make indemnification of directors discretionary in many cases, and mandatory in only limited cases, and do not provide for mandatory advancement of defence costs. To protect themselves, directors should have their rights to the advancement of defence costs and to indemnification against judgments or settlements specified formally, preferably in the corporation's by-laws and written contracts.

Provisions in the by-laws of a corporation calling on the corporation to indemnify the director to the fullest extent permitted by law are common. However, by-laws are not ordinarily regarded as constituting a contract between the corporation and the director, and can be altered by the corporation, for instance after a change of control. Hence many corporations contract directly with their directors to indemnify them to the full extent lawfully permitted. The decision to enter into the contracts can be justified with regard to the interest of the corporation in attracting and keeping qualified directors at the time the contract is entered into. Indemnification contracts can also deal expressly with the many practical issues that are not addressed explicitly in the statute, such as the appointment of defence counsel, whether security may be required for defence cost advancements, and so on.

Some indemnification contracts are relatively modest, saying little more than that the corporation will indemnify to the fullest extent of the law and will pay for applications to obtain any court approvals that may be required. Others provide much more detailed guidelines, so as to provide certainty and enhance the protection of the individual directors. Such contracts sometimes contain a "severability" provision, saying that if any provision of the contract offends the statute then it is to be disregarded or "read down" so as to comply with the statute, without affecting the other provisions of the agreement.

Enhancements that can be provided through an indemnity contract include:

- requiring the corporation to provide the director with insurance during his or her tenure on the board and for a stated period thereafter, and not to change the terms of the policy without advising the directors;
- an expanded definition of the type of "proceeding" against which the director is to be indemnified, for example: requests for information by regulators, situations where the individual reasonably anticipates a proceeding that has not yet been threatened, and applications for leave to commence a proceeding such as a derivative action or a statutory securities claim;
- the procedures directors must follow to receive advances of defence costs, which are often needed promptly, for example: to provide a certification that the individual believes in good faith that his or her conduct in the matter satisfied the conduct threshold for indemnification;
- express exclusion of any requirement for directors to provide security for repayment of advances of defence costs, or to pay interest on the advances;
- a mechanism to govern the selection and instruction of defence counsel for the director, and to address whether the corporation must provide separate defence counsel for each director if they could be represented commonly;
- a clear statement of any exclusions from the coverage of the indemnity—for the directors, ideally there will be no exclusions other than the conduct

threshold required by the statutes ("honesty and good faith", in civil matters);

- a clear statement that the corporation must advance defence costs in all cases, subject to the director's undertaking to repay if his or her conduct is found not to have met the conduct threshold required by the statute;
- whether the director is entitled to funding for coverage counsel in relation to disputes about the indemnity itself;
- who will bring and fund any applications for court approval that may be required;
- whether the director can settle the underlying claim without the corporation's approval and then look to the indemnity for payment; and
- provision for the arbitration of indemnity coverage disputes in order to maximize speed and privacy (subject to the court's supervisory jurisdiction).

These are only a few examples of the enhancements that might be provided in a corporate indemnification contract. The mix and extent will vary from case to case depending on the inclinations of the parties. One point to consider is that if the indemnity contract requires the corporation to fund the defence of a director who has been accused of excluded misconduct, up to the point where a judge actually makes a finding of misconduct, then the funds expended might well be irrecoverable from the director.

It is also possible for a director or officer to obtain an indemnity from a shareholder or another source. However, if the entity giving the indemnity is a corporation, it may be limited in its capacity to make such a commitment. For example, its corporate constitution may restrict its ability to indemnify a person who occupies a director or officer position at its request with a second entity.

> **I am satisfied that the corporation's by-laws and indemnification contracts protect the directors to the fullest extent permitted by law.**

3. Do the CBCA and other statutes allow advancement of defence costs by the corporation?

When a proceeding is commenced against a director, he or she will need immediate funding to defend against the claim. Whether the director's conduct met the indemnification threshold will often be uncertain, particularly when the claimant's allegations put the director's good faith toward the corporation into doubt. The statutes give the corporation a broad discretion to advance defence costs without requiring interest on or security for the advance, on the condition that the director will repay the funds to the corporation if the director is ultimately found not to have met the conduct threshold.

If the director is found to have met the conduct threshold, the advance can be converted from a loan to an indemnity. If not, the director must repay the advance. In cases where the claim against the director is brought by or in right of the corporation, court approval to advance defence costs is always required. Advancement of defence costs is never required by the corporate statutes.

> **I understand that the corporation may advance defence costs to directors, subject to repayment if their conduct is found not to have met the statutory conduct threshold.**

4. Do the CBCA and other statutes allow the corporation to indemnify a director against a judgment (or settlement) in favour of the corporation itself?

In some cases directors may be required to pay a judgment or settlement to the corporation on whose board they have served. This could occur either where the corporation itself has sued the director, or where a shareholder or other stakeholder has obtained court approval to bring an action in the name of the company against the director—a "derivative action". Although court permission to bring such an action is required in Canada, it is relatively easy for a shareholder to obtain permission, even where the corporation's sitting directors have declined to cause the corporation to bring the action for valid business reasons. This is an apparent exception to the "business judgment rule" by which courts tend to defer to the business judgment of directors in business matters.

Those familiar with corporate law in the United States will recognize that derivative actions are far more easily commenced in Canada than in many American state jurisdictions. In the same vein, Canadian corporate statutes do not permit corporations to exempt directors from liability for negligence in cases where the director has nevertheless acted in good faith—a common form of "raincoat" provision in the United States. In these respects, directors face more exposure in Canada, to claims by or in right of the corporation itself.

Some legal commentators interpret the CBCA and similar provincial statutes as prohibiting indemnification of a director against a judgment or settlement in favour of the corporation itself. Other commentators consider that the CBCA does not prohibit indemnification against such claims so long as the court approves the indemnification. Some corporate statutes (such as the British Columbia *Business Corporations Act*) which do not track the CBCA wording appear to permit indemnification against this type of claim, but only with court approval.

If the CBCA is taken to mean that a corporation cannot indemnify a director or officer at all against a judgment or settlement in a derivative action, then the availability of insurance against derivative action risks becomes especially important. This is discussed below under "Insurance Coverage".

Even if the CBCA and like statutes are interpreted to prohibit indemnification against corporate claims, they do permit the advancement of defence costs for such claims, but only with court approval.

I understand that:

- the corporation may bring an action against its directors
- the shareholders, with court permission, can bring an action against the directors in the name of the corporation (a derivative action)
- the board cannot prevent a derivative action
- a director who is sued by the corporation may not be entitled to indemnification from the corporation for defence and other costs.

Directors' and officers' liability insurance serves several purposes.

- The insurance can respond where the indemnity cannot. D&O policies exclude serious misconduct (such as deliberate fraud or crime) but do not exclude all situations where the individual failed to act with good faith toward the corporation, unlike the statutory indemnification regimes where good faith is always a precondition to indemnity in civil matters. D&O insurance policies can be worded to respond to derivative actions (brought in the corporation's name by shareholders or other stakeholders, with leave of the court), which arguably fall outside the indemnification regime of the CBCA and similar statutes.
- D&O insurance benefits the corporation itself by reimbursing it where it is obliged to indemnify the directors, so that the indemnification does not consume corporate funds. D&O insurance can also provide "entity" coverage for the corporation itself, in respect of some forms of corporate wrongdoing, such as securities claims, when it is sued along with, or even separately from, its directors.
- Insurance provides the directors with indemnity from another source if the corporation becomes insolvent. Insurance can also provide them with a source of indemnity when the corporation is solvent but refuses to honour its indemnity obligations. (However, it should be noted that some insurance policies apply a significant deductible against the individuals in this situation.)

It should never be forgotten that D&O insurance is not the only form of corporate coverage applicable to directors. Important areas of coverage are provided through other types of policies as well, including general liability (for bodily injury or property damage), employment practices liability (often packaged with D&O insurance), fidelity liability, fiduciary liability, and institutional errors and omissions coverage. Directors should work with management to satisfy themselves that D&O insurance is purchased as part of a coordinated corporate risk management process that includes the advice of insurance professionals with expertise in the corporation's coverage needs. It is also increasingly common for directors to obtain a review of the insurance coverage from legal counsel.

5. How are directors' and officers' liability insurance policies structured?

The D&O policy for a corporation's board and senior management is almost always placed and paid for by the corporation itself. Usually the insurance applies only to director and officer positions with that corporation or its affiliates, or outside boards upon which the individual sits at the request of the corporation.

In recent years it has also become possible for an individual to acquire personal D&O coverage that applies only to that individual and his or her board positions, which may be with different corporations. This type of policy is relatively rare.

D&O policies are complex documents that need to be interpreted with care and with the help and guidance of knowledgeable professionals. It can be tempting for boards to rely on management to buy insurance for them but this can result in inadequate protection that may only become apparent when problems arise. Price should not be the only criterion when placing coverage. Boards are well advised to take an active interest in their D&O insurance. They should do this when things seem to be going well and schedule regular reviews, as part of their involvement in risk management.

D&O policies typically consist of a basic form, with endorsements that augment or replace various elements of the basic form. It is not unusual to see upwards of a dozen endorsements, often making the package difficult to follow. No two D&O policies are the same.

Although D&O policies begin with a relatively broad grant of coverage, a variety of exclusions can reduce the scope of coverage significantly.

The basic form typically includes:

- **Declarations**—which include a list of the coverages requested by the insured, the policy dates, limits, deductibles and premiums, and the endorsements and other forms attached to the policy (Questions 6–7)

- **Insuring agreements**—details of the coverages and exclusions (Questions 8–11)
- **Conditions**—the rights and responsibilities of the insurer and insured under the policy (Questions 12–16)

Policies typically provide separate coverages for indemnifying individual directors and officers and reimbursing the corporation where it has indemnified the individuals. The coverage provided directly to the individuals is often referred to as "Side A" coverage. The coverage provided to the corporation to reimburse it for the cost of indemnifying the individual directors where it has done so is referred to as "Side B". Special Side A only policies are now available, providing coverage solely for the individuals themselves. Some D&O policies also offer "entity coverage" for the corporation itself, in some respects, and this is commonly referred to as "Side C".

I am satisfied that the Board:

- receives information and advice on D&O coverage from an insurance broker and/or legal counsel
- regularly reviews and approves the terms of the D&O policy.

Declarations

The declarations deal mainly with the dollar amounts of the policy: the cost (premium), the maximum amount of the coverage (the policy limit) and the deductibles payable by the corporation and/or the directors.

6. How much insurance is appropriate?

There is no simple answer or formula for deciding how much D&O insurance a corporation should buy. Firstly, D&O insurance is just one element in a corporation's risk management process and should not be considered in isolation from other insurance and risk mitigation strategies. Secondly, each corporation has its own unique combination of internal and external factors which help determine the need for insurance.

Internal factors include the type of corporation (private or public), its size, complexity and commercial activities. Corporations which do business in the United States probably have more risk because of the more litigious environment in that country and the presence of additional statutory exposures. It is generally accepted that corporations with shareholders in the United States carry the risk of exposure under the American state and federal securities laws, which facilitate class actions on behalf of secondary market investors against issuers and management. Led by Ontario, Canadian jurisdictions have begun to adopt statutory schemes that will facilitate securities class actions along the same lines. For the directors and officers of issuers who are subject to these exposures, it can be a great comfort to have a D&O policy with sufficient limits to cover defence costs in the event of a claim, and provide a reasonable contribution to a settlement.

See CICA's 20 Questions Directors Should Ask about Risk

The corporation's financial strength and risk tolerance will influence the policy limits and deductibles it can afford and accept. High-quality policies with broad coverage and few exclusions are generally available but can be expensive.

External factors include the legislation and litigation experience in the jurisdictions in which the corporation has exposures and the cyclical nature of the insurance market. This affects the prices of policies, the willingness of insurers to accept risks, and the availability of specific coverages.

The policy limit is invariably eroded by defence costs. It is not uncommon for much or all of the policy limit to be consumed by defence costs, particularly in major securities related claims litigated in the United States or England. Defence costs in garden variety corporate litigation cases can run into the hundreds of thousands and occasionally millions, or even tens of millions, of dollars.

The Board should take an active interest in the selection of D&O coverage and not leave the decision entirely to management and the corporation's insurance broker.

> I am satisfied that the Board:
> - reviews all corporate insurance coverage as part of its responsibility for risk management
> - reviews the adequacy of the dollar amount of coverage in the D&O policy.

7. Is the director at risk of having to pay the deductible?

D&O policies, like other insurance, typically require the insured to assume losses up to an agreed sum (the deductible) which often, but not always, applies to defence costs. The deductible is often substantial, in the order of $100,000 or more. There is also often a higher deductible for securities claims. Typically the policy declarations show a deductible of zero, or a low amount, for the Side A coverage, where the insurer indemnifies the individuals directly. But a much larger deductible is often shown against the Side B coverage, where the insurer reimburses the corporation for indemnifying the individuals. Larger deductibles are often seen in policies for corporations issuing securities in the United States.

This does not necessarily mean that, if the corporation does not indemnify the individuals, no deductible applies. Many policies contain one form or another of "presumptive indemnification" provision. These provisions cause the deductible to apply to the individuals where the corporation is legally permitted to indemnify the individual but does not choose to do so. If the insurer takes the view that the corporation can indemnify the director, and the corporation takes the view that it cannot, or cannot do so yet, until the nature of the director's conduct is determined, then the director could be left without a ready source of funding for defence costs, within the deductible layer.

Presumptive indemnification provisions make it all the more important that individual directors and officers have enforceable rights of indemnification from the corporation so that they will not have to bear the deductible. It is important to review presumptive indemnification language closely. Among other considerations, the policy should clearly provide that if the company is legally permitted to indemnify the director but cannot afford to do so because it is insolvent, the deductible will not apply against the director.

> I am satisfied that the directors are protected to the fullest extent permitted by law against paying the defence and other costs of actions against them. This may include:
> - a zero deductible on payments to directors under "Side A" coverage, or
> - a contractual right to be indemnified by the corporation for eligible costs up to the amount of the policy deductible.

8. How important is the choice of insurer?

The policy declaration includes the names of the insurance company or companies that issued the policy. An experienced insurance broker will check that all participating companies are creditworthy by ensuring that they meet the solvency requirements of the insurance regulators and have a good reputation for honouring claims.

Insurance policies, particularly for larger amounts, are sometimes placed with insurers that are not subject to regulation in Canada. This does not necessarily signal a problem, but it is customary for most policies to be written on "admitted paper" by carriers which are licensed in Canada and have a presence in Canada so that, among other things, they can be sued here if the need arises. Acquiring coverage from a non-admitted carrier can also attract increased taxes.

Insurance coverage with high dollar limits like major D&O policies is frequently arranged in layers, with a primary carrier and one or more excess carriers. The excess carriers' policies typically follow the form of the primary policy for the major policy terms. The primary carrier will typically play the lead role in responding to a claim, at least at the outset, but the excess carriers may take different positions and retain control of the proceeds of their respective tiers of coverage.

D&O insurers typically adjust claims in house, and employ staff lawyers to assess coverage and to oversee the defence of the claim. The D&O insurer's staff lawyers never act as defence counsel for the insured on the claim. Where the policy gives the insurer the right to appoint defence counsel, defence counsel from a law firm (not in-house counsel working for the insurer) will be appointed, often from a law firm with significant financial and other ties to the insurer. Even where the insurer is entitled to select defence counsel, it is precluded from looking to the defence counsel for advice concerning the scope of coverage. Many policies entitle the insured to select defence counsel, although this is typically subject to the insurer's approval of defence expenditures. It is generally considered desirable for the insured to have the right to appoint defence counsel.

Just as their forms differ, D&O insurers have significantly different claims handling practices, and reputations for honouring claims. One of the more obvious differences is that some insurers oversee their Canadian claims from offices in the United States, while others have separate Canadian claims handling offices. It is sometimes said that this can lead to a difference in claims handling style, arising from the generally more litigious environment in the United States. Insurers who handle claims from the United States may also be more likely to have clauses in their policies which select the law of an American state as the governing law, and/or select an American court or arbitration organization as the forum for resolving disputes. Some American jurisdictions, such as New York, are generally regarded as more favourable to insurers on insurance coverage issues.

Similarly, policies issued from London, through the Lloyd's market, sometimes call for the application of English law. Under Lloyd's policies, an adjuster or law firm in Canada will typically be appointed to deal directly with the insured and with defence counsel.

> **I am satisfied that the corporation buys D&O coverage from an insurance company or companies that can and will honour legitimate claims.**

Insuring agreements

The insuring agreements describe in detail what is covered and what is not covered (excluded) by the policy. The coverage in a D&O policy should be compatible with the corporation's by-laws and director indemnification contracts.

9. What is typically covered under a D&O policy?

D&O policies are broadly similar, but since no standard form exists, they differ considerably in the details. Modest differences in the wording from one form to another can have major consequences for the scope of coverage and the exclusions.

Most D&O policies will cover the directors and officers (past, present and future) for their own wrongdoing, within the terms of the policy (the Side A coverage). There will also be coverage for the corporation itself for the cost of indemnifying the directors and officers (Side B). As noted above, there is often a significant deductible under the Side B coverage, and little or no deductible under Side A. But the concept of presumptive indemnification (see Question 7) can mean that the Side B deductible applies to Side A claims, even if the corporation does not indemnify the director, if it is legally entitled to do so.

Ordinary Side B coverage does not cover the corporation for its own wrongdoing. But many policies also cover the corporation itself for at least some types of wrongdoing committed by it, for example securities claims, which are often advanced against the corporation as well as the individual. This arrangement is often referred to as "entity coverage" (or "Side C") because it affords a measure of coverage to the entity itself.

Opinions differ on whether entity coverage is a good idea. Having it in place does simplify "allocation" disputes where the directors and the corporation are sued together, and the insurer resists paying the full amount of the directors' liabilities on the ground that the corporation, which is not an insured, will reap a benefit. On the other hand, entity coverage means that the directors share the policy limit with the corporation, and the policy proceeds could be eroded or even exhausted by defence costs and claim payments for the benefit of the corporation. That risk can be limited to some extent by a priority of payments clause, giving priority to claims against the individuals. Where the policy provides entity coverage, it is possible to provide a further layer of coverage for the directors and officers alone, which will not be shared with the corporation. This is typically referred to as "Difference in Conditions" or "DIC" coverage.

A typical D&O policy will contain both Side A and Side B coverage. It is also possible to acquire coverage which operates as Side A only, indemnifying the directors without regard to the corporation. Pure Side A coverage can, for example, be acquired as an additional layer of protection either for all of the directors, or for the independent directors only.

The coverage grant typically requires the insurer to respond to claims alleging a "wrongful act" against a director. The phrase "wrongful act" is usually defined to mean claims arising from the individual's conduct in the capacity of a director or officer, or claims arising against him or her as a result of having held a director or officer position. The second limb of the definition exists to cover claims attracted by status, such as statutory claims for unpaid wages. The first limb of the definition exists to cover claims arising from the actual or alleged acts or omissions of the director.

Most "wrongful act" definitions are not limited to negligent acts or omissions, or the negligent infliction of loss. There is some uncertainty as to the scope of coverage for situations where the director has acted intentionally, but without intending to cause a loss to the claimant, or without intending his or her conduct to be unlawful. Business activity typically involves economic competition in which success brings profit to one party and economic loss to another. For example, the directors might quite deliberately cause the corporation to engage in conduct that attracts business from a competitor, with the result that the competitor brings action for interference with its economic relations. The directors should not be denied insurance coverage on the theory that their conduct was deliberate, unless their conduct falls into an exclusion for deliberately breaking the law. When placing coverage, the "wrongful act" definition should be examined carefully to ensure that its wording is not limited to negligence claims.

The definition of "wrongful act" typically contains a reference to the capacity in which the director was acting at the time of the alleged wrongful act—in his or her capacity as a director or officer. Some policies require the conduct to have been solely in that capacity. This wording is intended to allow the insurer to avoid or limit coverage where there is a basis for saying that the individual was acting entirely or partly in another capacity, such as a professional advisor (lawyer, accountant, engineer, and so on) or, perhaps, as a shareholder. When placing coverage, it is preferable to avoid "sole capacity" wording, if possible, and especially in the first limb of the definition of wrongful act (concerning conduct).

D&O policies typically cover claims for damages and appurtenant defence costs. Policies vary in the extent to which they cover administrative or regulatory proceedings as well as civil matters. Punitive damages are sometimes covered. Fines and penalties are typically not covered, although some policies provide coverage for defence costs in proceedings which are taken to exact a fine or penalty. The scope of coverage is heavily influenced by the types of proceedings encompassed within the policy's definition of "claim", since it is a "claim" that triggers rights under the policy and the insurer's duty to provide a defence. Policies often contain a variety of other exclusions in the definition of "loss", which should be examined carefully to assess its scope.

> I understand the relationship between the coverage afforded to the individual directors and the corporation itself, including the effect of entity coverage (if any) and the concept of presumptive indemnification.

10. What exclusions typically apply for personal misconduct?

All D&O policies contain an exclusion for major personal misconduct such as fraud, other criminal activity, or willful breach of a statute or regulation. A narrower exclusion is preferable, such as one limited to deliberate fraud, or deliberate crime.

The wording of the major personal misconduct exclusion determines another very important (but easily overlooked) coverage point: when is the exclusion triggered? Can the insurer refuse to defend any allegation of major misconduct, since any such finding would always be excluded? Or must the insurer fund the defence of these allegations, unless and until a judge makes a finding that the director actually committed the misconduct described in the exclusion? Having the exclusion triggered only by an actual judicial finding of excluded misconduct is usually considered preferable for the insureds. The misconduct exclusion should be examined carefully to see whether it contains clear self-limiting language to this effect. A statement that the exclusion only applies if the insured has committed the excluded misconduct "in fact" is not sufficient. (However, it is to be expected that the policy will require the insured to pay back the defence costs to the insurer if the exclusion is eventually found to apply.)

Misconduct exclusions should also be subject to a clear severability provision, so that the exclusion can only affect the insured who actually committed the fraud or other excluded misconduct. Otherwise, the exclusion could apply not only to the guilty insured, but also to other insureds who might be sued for negligence because they did not prevent the fraud of the guilty insured. That could result if the clause excludes claims against all insureds which arise from the fraud of any one insured.

Similarly, D&O policies typically exclude claims based on the receipt of a profit or advantage to which an insured was not legally entitled. This type of exclusion could for instance apply to a claim that a director took up a corporate opportunity without the informed consent of the corporation. Often these clauses are worded in an open-ended fashion which allows the insurer to contend that if any one insured obtained any illicit benefit at all, every claim against every insured which is in any way factually related is entirely excluded also. The insureds are best protected when the illicit benefit exclusion is worded to apply only to the recipient of the benefit. That way, coverage will be preserved for other insureds who might, for instance, be sued for having negligently permitted the guilty insured to obtain the benefit.

Severability provisions should be examined closely and, if there is any doubt about their meaning, clarified.

I am satisfied that the corporation's D&O policy wording:

- specifies that the exclusions for major personal misconduct must be for "deliberate" or equivalent misconduct
- requires the insurer to fund defences even against excluded claims on the basis that the insured will refund the defence costs amount should the defence fail
- contains a "severability provision" that limits the misconduct exclusion to the insured(s) who committed the fraud or other misconduct
- applies the illicit benefit exclusion only to the recipient(s) of the benefit.

11. Are there other exclusions that directors should be concerned about?

D&O policies can contain a wide variety of other exclusions which can be problematic depending on circumstances. These include exclusions for claims arising from pollution, which can negate coverage not only for remediation claims, but also for derivative action claims alleging that the directors failed to manage the corporation's environmental risks correctly. Claims that directors were negligent because the corporation failed to have adequate insurance coverage are often excluded, as are defamation claims, claims brought outside North America, pension fund claims, claims by major shareholders, and claims for property damage or bodily injury (which are typically covered by the corporation's general liability coverage). These are just a few examples of the possible exclusions. The scope and nuances of the exclusions can vary widely from policy to policy. For example, where a particular subject matter is excluded, such as pollution or property damage, does the exclusion affect only the claims of third parties who are claiming directly against the directors and officers for a pollution loss? Or would the exclusion also apply indirectly, to a claim by a shareholder on behalf of the corporation, alleging that the board caused loss to the corporation by managing its affairs in such a way as to risk pollution claims from third parties?

Many policies state expressly whether statutory claims for taxes or wages are or are not covered, often in the definition of covered loss. Where the policy is silent, it is widely thought that typical D&O wordings do cover these types of claims, but coverage must always be assessed in light of the policy contents and the circumstances of the claim.

There are differences between Canada and the United States regarding directors' responsibilities for payroll taxes and other withholdings. Corporations that operate in both jurisdictions should have policy wordings that are appropriate for both.

Policies typically do not provide coverage for fines or penalties. (This is a significant difference between D&O insurance and corporate indemnification, which often can encompass fines and penalties, if the individual is found to have met the conduct threshold set out in the indemnification, which often turns on whether he or she had reasonable grounds to believe that his or her conduct was lawful.) A number of statutes create exposures for directors in the form of fines or penalties, rather than by creating a right to sue for a monetary judgment. Some policies provide coverage for defence costs in fine or penalty cases, although not for the payment of the fine or penalty itself, and typically the defence costs have to be repaid if the defence fails.

> I understand that there is a wide variety of potential exclusions in D&O policies and am satisfied that the corporation has taken steps to minimize the risk to its directors.

12. Are claims by other directors, the corporation, or its shareholders typically covered?

D&O policies almost invariably contain some form of "insured versus insured" exclusion which reduces the coverage of the policy to an often surprising degree. This is one of the more complex policy provisions and requires special attention. It means that, with some exceptions, the policy does not cover claims:

- by directors (even former directors) against other directors,
- by the corporation against the directors (past or present), or
- by a shareholder, creditor, or other complainant who has brought action in the name of the corporation to enforce a right belonging to the corporation (a derivative action).

Since all present and former officers and directors are insureds, the "insured v. insured" exclusion can negate coverage for any claim by any former director against any other director, even if the claim has nothing to do with the former director's period of service to the corporation. A former director who is also a shareholder might, for instance, sue a current director for some wrong allegedly done to him as a shareholder, for instance a negligent misrepresentation. To mitigate this exclusion, policies often contain an exception for claims brought by former directors after a period of time, such as four years.

Claims against directors by or in right of the corporation itself are also typically excluded. This can have serious consequences for directors, who can find themselves without coverage. There is typically an exception for actions brought against a director in the name of the corporation by a shareholder or other stakeholder with the permission of the court—a "derivative action". The exception applies only where none of the insureds, past or present, solicits or assists in the bringing of the derivative action—a true arms-length derivative action. Again, the involvement of a past director on the complainant side can negate coverage. The insurer might invoke this exclusion even where the involvement of another insured is incidental, such as providing a witness statement to the shareholder conducting the derivative action.

Some policies apply this exclusion not only to claims by or in right of the corporation, but to all claims by security holders, even in their own right. This small difference on the page produces a much broader type of exclusion, because it means that even a claim by a shareholder acting in his own right — not a derivative action — can be excluded if a past director is somehow involved in assisting with the claim.

The "insured v. insured" exclusion can also be a problem where the corporation has become insolvent and its receiver or bankruptcy trustee proceeds on its behalf against its former directors. It is unclear whether this counts as a claim by or in right of the corporation so as to attract the exclusion. Increasingly, policies state expressly that insolvency generated claims are not within the exclusion.

These nuances of the "insured v. insured" exclusion can often be improved by negotiation, or by acquiring an additional layer of "Difference in Conditions" coverage, containing a more limited form of the exclusion.

> I understand the concept of the "insured vs. insured" exclusion which excludes claims among the corporation and directors, and am satisfied that the corporation has taken steps to minimize the risk to its directors.

13. After the D&O coverage has been placed, or renewed, is there a risk of coverage being cancelled or denied in the future?

D&O policies generally permit the corporation to cancel coverage at any time, and appoint the corporation as the individual's agent for this and other purposes.

Basic policy forms often allow the insurer to cancel coverage without cause upon notice to the corporation, typically after 60 days. This provision is often varied to make the policy non-cancellable by the insurer, except for non-payment of premium.

An even more serious concern is the insurer's right of "rescission" — the principle of insurance law that a policy may be rescinded (declared void) if it is found that the insured failed to disclose a fact material to the risk or made a material misrepresentation. The nondisclosure or misrepresentation does not have to be fraudulent, or even negligent. It only has to be material, in the sense that it might have affected a reasonable insurer's decision to take on the risk. It does not have to be relevant to the actual claim that has arisen. A completely innocent, but material inaccuracy or omission in the application or renewal process can result in the entire loss of the coverage. An insurer could take the position that even points which they did not enquire about in the application process, through their application or renewal forms, are nevertheless material, and should have been volunteered by the insured.

For contentious claims, it is not uncommon for the insurer to review the underwriting process to confirm that the information supplied in the application form was complete and correct, and in an effort to find some basis for rescission. For example, an insurer could seek to rescind coverage on the basis that some innocent but material error is to be found in the financial information that was attached to the application form. A restatement of financial results can conceivably lead to rescission of the policy. To reduce the risk of this, corporations should promptly advise the insurer of any restatement of financial results.

Insurers will sometimes raise the possibility of rescission not to deny coverage outright but to assist them in negotiating a limitation on their contribution to defence costs, or to settlement.

Fortunately, the rescission doctrine can be negated in the policy itself. It is not unusual for policies to be declared non-rescindable, at least so far as the "Side A" coverage for the individuals themselves is concerned.

If a policy is not declared to be non-rescindable, those who are protected by it will want to see that great care is taken in the application and renewal process to avoid any material inaccuracy or omission. It is also possible to limit the insurer's right to rescind so that it may only be triggered by inaccuracies or omissions in specific types of documents, such as annual reports and financial statements. Conversely, it is best to avoid policy wordings saying that every statement in the application materials and accompanying documents is deemed to be material to the insurer.

It is also important to ensure that the application form or the policy contains a severability provision that exempts innocent insureds from responsibility for the knowledge or actions of other insureds. Otherwise the coverage of an innocent insured could be voided because of another insured's failure to disclose a material fact known only to that insured. Many wordings contain no severability clause, or only a partial severability clause that imputes to each insured all the knowledge of the individual signing the application. As with the exclusion clauses in the policy, severability provisions dealing with the application for coverage should be reviewed with care, and may need to be clarified.

Many application forms also contain express warranties, for instance to the effect that none of the insureds is aware of any fact or matter that might (not would) give rise to a claim. If a claim arises based on an undisclosed risk that was known to at least one insured, the claim might be excluded for all, or the coverage might even be fully rescinded for all. The insureds are best protected if there are no such warranties or if they are subject to a strong severability clause.

I am satisfied that consideration has been given to obtaining D&O coverage with provisions that:

- make the policy non-cancellable by the insurer—except for non-payment of premium
- make the policy non-rescindable by the insurer
- exempt innocent insureds from responsibility for the knowledge and actions of other insureds.

14. How does corporate insolvency affect the administration of the policy?

In Canada, the directors and officers usually cease to function as such when a receivership or bankruptcy occurs. Coverage usually remains in place for claims arising from prior events until the policy period runs out. However, the directors do continue to have a role when the corporation becomes subject to administration under the *Companies' Creditors Arrangement Act* (CCAA), in an attempt to reorganize itself on a solvent basis and resume trading. Keeping coverage in place for the directors and officers of a corporation under CCAA administration can be a major challenge, but it is important to do so because of the new exposures that can arise in the event of insolvency.

In the United States, bankruptcy courts sometimes take control of D&O policies, tying up the proceeds, on the theory that the policy proceeds are an asset of the bankruptcy estate and should be preserved for the benefit of the creditors. When this happens the directors can experience difficulty getting access to the policy proceeds for the payment of defence costs and substantive liabilities. American courts differ in their approaches to this issue, but the problem appears to be more likely to arise where the policy provides entity coverage to the corporation for its own wrongful acts. It is uncertain whether this doctrine will enter into Canadian law, but it is reasonable to assume that American based insurers are more likely to be concerned about it and to consider requiring the consent of the bankruptcy court before releasing policy proceeds for the benefit of the insureds.

I understand the extent to which coverage under the corporation's D&O policy continues if the corporation goes into receivership, bankruptcy, or restructuring.

15. What considerations arise on a change of corporate control?

The extent to which directors and officers of a corporation's newly acquired subsidiaries will become covered under the corporation's existing D&O coverage depends on the wording of the policy. Notice to the insurer may be required.

The directors of a corporation undergoing a change of control should expect that the corporation's pre-existing D&O coverage may well cease to apply to their activities after the change of control. They should consider protecting themselves by including in the purchase contract the obligation for the purchaser to maintain their D&O coverage. Otherwise they may have to look to a new policy, or to coverage already in place with the acquirer. It is important to identify the transition point and if necessary agree on it with the insurers to avoid a gap in coverage. Typically the policy will not apply to future claims arising from pre-acquisition events. The old policy will continue to apply until its policy period runs out. Often the coverage of the old policy is extended, but only for the reporting of new claims based on pre-acquisition matters. Coverage extended in this way is referred to as "run-off" coverage. The run-off period is negotiable. A period of six years is not uncommon. Run-off coverage for pre-acquisition matters is useful regardless of the form of the transaction (be it a sale of the shares of the corporation, or its assets). There have been cases in which run-off coverage turned out, unexpectedly, to be a major benefit both for the directors and for the corporation (given its indemnity obligations), where a "long tail" claim emerged.

I understand the need to continue D&O coverage in the event of a corporate takeover, and the options for achieving this.

D&O forms are invariably written on a claims-made basis, or some variation of it. This means that the principal trigger of coverage is the making of a claim by a third party against the individual director, and the policy must be in force at that time in order for the claim to be effectively reported to the insurer. There is also a duty on the insureds to report claims promptly within the policy period. In contrast, general liability policies are often written as "occurrence" policies, so that coverage applies according to when the alleged injury occurred, and expired policies must respond if they were in place at that time.

Typically both past and current directors and officers are covered for new claims made during the current policy period. Matters that relate back to old claims under earlier policy periods are usually assimilated to the earlier claim rather than the current policy. Policies sometimes contain a "retroactive date" and do not cover matters arising from events before that date.

16. What kinds of situations should be reported to the insurer in order to trigger coverage, and when?

The main trigger of coverage in a D&O policy is the making of a claim against the insured. It is this—rather than the date of the alleged wrongful act—that governs coverage. Policies are either "claims made" (coverage is triggered by the third party making the claim against the insured) or "claims-made-and-reported" (requiring the claim to also be reported to the insurer within the policy period for coverage to attach). The "claims made" trigger is simpler and generally preferable.

Most policies require claims to be reported to the insurer promptly (rather than waiting until near the end of the period for reporting). In order to deal with the problem of claims asserted to the insured very late in the policy period, most D&O policies contain some provision to permit reporting to the insurer of claims made during the policy period over the next 30 or 60 days after the end of the policy period.

Most D&O policies also contain a provision that allows the insured to report potential claims that have not yet been asserted by a claimant but which the insured has reason to apprehend in the future, often because the insured is concerned that an error has been committed that could give rise to a future claim. The insured can report the matter at once, and if an actual claim is asserted in the future, coverage will be triggered as if the claim had been made in the earlier policy period when it was reported as a potential claim. The ability to secure coverage for potential claims is an important advantage. Insurers are understandably reluctant to accept reports of mere general exposures as opposed to specific potential claims under these provisions.

Policies often entitle the insured to acquire an extended reporting period, in the event that coverage is not renewed. This gives the insureds additional time to report claims arising from activities in the policy period but asserted afterwards. Ideally the premium to be charged for the extended reporting period will be specified in the policy rather than being left to the discretion of the insurer.

Ideally the extended reporting period will be available bilaterally, whether it is the insured or the insurer who has decided not to renew coverage.

Policies differ in what they regard as a "claim" that must be reported. Some require reporting of claims asserted orally, while others require reporting only of written demands. This can be important because of the risk that the insurer could resist coverage on the basis of a delay on the corporation's part in reporting the third party claim to the insurer. This is more likely to occur where the policy treats informal, oral demands or allegations as claims.

> I understand the need to promptly report potential and actual claims to the insurer and am satisfied that the corporation has appropriate procedures in place.

17. How will the D&O insurer respond in the event of a claim?

Typically, a D&O insurer will examine the document constituting the claim, along with other background information, and consider:

- whether the claim was reported to the insurer promptly enough, or could be denied for late reporting;
- whether the circumstances of the claim (or anything else in the affairs of the corporation) suggest that there may have been a material misrepresentation or non-disclosure in the application for coverage, enabling the insurer to rescind the policy;
- whether the claim falls within the coverage grant at all, or within an exclusion;
- whether the insurer should deny coverage outright, and perhaps take the initiative in seeking a court ruling that the claim is not covered;
- whether the insurer should reserve the right to deny coverage in the future, or demand that the insureds sign a non-waiver agreement;
- to what extent the insurer will fund defence costs;
- whether to seek the insureds' agreement to a percentage allocation of defence costs and, if so, whether the allocation should be fixed, or subject to future claw-back or renegotiation;
- whether to fund third party claims within the existing proceeding, or other proactive steps that may aid in the defence;
- whether the insurer will seek to control the defence of the claim (if the policy gives that option) or, if not, what degree of involvement the insurer will expect in "associating" in the defence (where it does not have the right to actually control the defence);
- whether the insurer will approve the appointment of separate defence counsel for insureds with different interests (such as possible claims for indemnification among the directors);
- what further information the insurer will require from the insureds; and
- whether the insurer will be prepared to enter into early settlement negotiations, before the policy proceeds have been eroded by defence costs.

At the outset of a claim, the first priority of the insureds will typically be to ensure that they have defence counsel in place and that sufficient funding is available for the defence. They may find themselves pressed by the insurer to discuss coverage matters, to accept a reservation of rights or sign a non-waiver agreement, or to enter into a defence funding agreement that might limit their rights against the insurer. Insurers almost always issue a reservation of rights letter or ask the insured to sign a non-waiver agreement, to the effect that the insurer may investigate or even defend the claim without becoming committed to cover it in the event the claim succeeds. Typically the insureds will be dealing with a lawyer on the staff of the insurer, or outside counsel acting for the insurer, who will be very familiar with coverage matters, and will usually have firm views on the coverage issues. The insurer's views on these matters will not necessarily be firmly grounded in the case law, since many of the coverage issues under these policies have not yet been addressed by the courts to any extent, even in the United States. It is not uncommon for insureds to consult independent legal counsel from the outset of a claim to assist them in getting matters off on the right foot with the insurer and in dealing with the insurer as the claim evolves.

> I understand the range of matters that can arise at the outset of a claim, and the availability of independent legal advice for the insureds.

18. Who controls the defence of the director in the event of a claim?

When a claim arises, both the insureds (the corporation, directors and officers) and the insurer have a considerable interest in the conduct and cost of the defence. It is important to clearly establish the insurer's rights and obligations (and their limits) in respect of:

- appointing and instructing defence counsel,
- approving defence expenses,
- reserving the right to deny coverage, and
- paying defence expenses.

Some policies give the insurer the right to appoint and instruct defence counsel, or at least the option to do so. Others reserve these rights to the insured. Larger policies often allow the insured to take charge of his or her own defence. Some require the insurer's consent to the choice of defence counsel. Others contain lists of insurer-approved "panel counsel" for at least some types of claims, particularly securities matters.

Even where the policy does not entitle the insurer to control the defence, it will typically say that the insurer can "associate" in the defence, and give the insurer the right to approve defence expenses in writing before they are incurred, with approval not to be unreasonably withheld. Insurers sometimes argue that these powers entitle them to a high degree of control over the conduct of the claim, just as if the policy gave them an express right to control it. Conversely, for the insured there is also the risk that an insurer who appears not to be very interested in monitoring the defence of a claim in detail will afterwards object that it was not afforded the opportunity to approve expenses in writing. In the course of conducting its defence, the insured should liaise with the insurer sufficiently to prevent these types of problems from emerging.

Dealings with the insurer in the course of a claim are often complicated by the insurer's issuance of a reservation of rights or non-waiver agreement. These are documents which state that the insurer reserves the right to deny coverage, depending on future developments, but still insists on exercising its powers to control or associate in the defence of the claim. These situations often present an obvious conflict of interest between the insurer and the insured. That in turn suggests that the insurer should not be entitled to control or associate in the defence of the claim as fully as it would be able to do if its interests were not in conflict with those of its insured, to whom it owes a duty of good faith. These situations require careful management to protect the insured's interests and, especially, to ensure that the insurer does not misuse its involvement in the defence of the claim to seek out grounds to deny coverage. Both insureds and insurers often retain separate coverage counsel to assist them with these matters.

The funding of defence costs presents another difficult issue. Some insurers take the position that they are not actually required to pay defence costs before the conclusion of the underlying matter at all. More commonly the insurer recognizes some obligation to fund at least some of the defence costs. Insurers are often reluctant to fund all of an insured's defence costs where the insured faces a mix of covered and non-covered allegations, such as a claim that the insured engaged in misconduct that was either fraudulent (excluded) or at least negligent (not excluded). The same reluctance emerges where the insured's defence counsel is also defending other, non-insured parties, such as the company itself, and they are benefiting from the defence expenditures. D&O policies typically contain some form of allocation provision to deal with these matters. Frequently, the policy will say that defence costs are to be allocated between covered and non-covered issues or parties according to fairness, or according to the relative legal exposure on the covered and non-covered allegations.

Some policies also contain a predetermined allocation formula, for some or all types of claims. A formula calling on the insurer to pay 80% of the defence costs is not uncommon. Such formulas offer certainty to the insureds, but at the cost of removing the opportunity to insist on 100% funding where appropriate. Where the policy contains no such formula, the insurer will often seek to negotiate a formula with the insured at an early stage of the claim. An insured entering into an allocation agreement should consider carefully whether the agreement is only provisional (allowing the insurer to claw money back later) or fixed (no claw back).

In order to defend his or her position effectively in the underlying third party claim, an insured will sometimes have to sue someone else. The insured might have a claim for indemnification from another defendant or a non-party, or might want to bring into the lawsuit a non-party who could be liable to the plaintiff. However, D&O insurers are often reluctant to recognize active steps such as these as forming part of the defence, which the insurer must pay for. The case law is mixed on this issue. Disputes about the funding of active defence steps can sometimes be resolved by agreement.

> **I understand the issues related to the control of the defence and payment of defence costs by the insurer and am satisfied that the corporation's D&O policy provides appropriate balance between the interests of the insurer and the directors.**

19. What rules govern the priority of payment?

On some occasions the claims against different directors and officers will threaten to exhaust the policy limits through the payment of judgments or settlements and defence costs, which also erode the policy limits.

At common law, the usual rule in Canada, derived from English law, appears to be that liability insurance proceeds are applied on a first come, first served basis. This can mean that the policy proceeds will be expended on whichever claims happen to mature first, leaving no coverage for the benefit of directors and officers facing claims that mature later. Whether the Canadian courts will continue to apply the English rule without modification is uncertain. There is something of a trend for insurers to seek court approval before making a payment in situations where the total number of claims might exceed the policy limit, and we may see future development in this area of the law.

Some policies contain provisions to deal with the priority of payment among insureds. It is not uncommon for policies to give priority to payment for claims against the individual insureds ahead of claims against the corporation itself that fall within the entity coverage. Priority is also often given to claims against individuals for which the corporation cannot indemnify them (referred to as non-indemnifiable loss), in preference to paying the corporation to reimburse it for having indemnified other directors who face indemnifiable claims.

To reduce the risk that directors will not have enough protection, some corporations buy additional "Difference in Conditions" coverage that does not indemnify the corporation in any respect and only benefits the directors and officers. It is also possible to acquire this coverage solely for the independent directors, so that they do not have to share it with management directors.

> **I am satisfied that, because claims under a D&O policy may exceed the policy limit, the corporation has taken steps to:**
> - **have a provision in the policy that gives priority to claims against individuals for which the corporation has no legal power to indemnify them**
> - **buy higher insurance coverage limits for director indemnification.**

20. Does the D&O insurer owe a duty of good faith to the individual insured?

In principle, third party liability insurers in Canada owe a duty of good faith to their insureds. The main feature of this body of law is that the insurer owes the insured a duty, in some circumstances, to make the whole policy limit available to settle the claim against its insured to spare the insured from the risk of a judgment over the policy limit if the case does not settle. If the insurer turns down an opportunity to settle for the policy limit and the plaintiff gets judgment against the insured for an amount in excess of the limit, the insured can sue the insurer to make it responsible for the entire judgment. The insured can also assign to the plaintiff his right of action against the insurer for bad faith refusal to settle.

Bad faith litigation of this kind against a D&O insurer is rare even in the United States. However it is well established in principle, in Canada and in the United States, that liability insurers can in some circumstances owe their insureds a duty to settle a claim within the policy limit to protect the insured from the risk of a judgment in excess of the policy limit. This principle first emerged in automobile insurance cases, where policy limits are often quite low compared to the amount of the damages that might be awarded against the insured. Similarly, D&O claims often present an exposure exceeding the insurance policy limits. Hence D&O insurers do face a risk of liability over and above the policy limit if they refuse a reasonable opportunity of settlement at or within the limit. That factor assists D&O policyholders in securing the agreement of their insurers to reasonable settlements of claims against them.

> I understand that the insurer's duty of good faith to its insureds may require it to make the whole policy limit available to settle claims that might otherwise go over the policy limit.

Appendix 1—Canada Business Corporations Act Section 124

Indemnification	**124.** (1) A corporation may indemnify a director or officer of the corporation, a former director or officer of the corporation or another individual who acts or acted at the corporation's request as a director or officer, or an individual acting in a similar capacity, of another entity, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation or other entity.
Advance of costs	(2) A corporation may advance moneys to a director, officer or other individual for the costs, charges and expenses of a proceeding referred to in subsection (1). The individual shall repay the moneys if the individual does not fulfil the conditions of subsection (3).
Limitation	(3) A corporation may not indemnify an individual under subsection (1) unless the individual (a) acted honestly and in good faith with a view to the best interests of the corporation, or, as the case may be, to the best interests of the other entity for which the individual acted as director or officer or in a similar capacity at the corporation's request; and (b) in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, the individual had reasonable grounds for believing that the individual's conduct was lawful.
Indemnification in derivative actions	(4) A corporation may with the approval of a court, indemnify an individual referred to in subsection (1), or advance moneys under subsection (2), in respect of an action by or on behalf of the corporation or other entity to procure a judgment in its favour, to which the individual is made a party because of the individual's association with the corporation or other entity as described in subsection (1) against all costs, charges and expenses reasonably incurred by the individual in connection with such action, if the individual fulfils the conditions set out in subsection (3).
Right to indemnity	(5) Despite subsection (1), an individual referred to in that subsection is entitled to indemnity from the corporation in respect of all costs, charges and expenses reasonably incurred by the individual in connection with the defence of any civil, criminal, administrative, investigative or other proceeding to which the individual is subject because of the individual's association with the corporation or other entity as described in subsection (1), if the individual seeking indemnity (a) was not judged by the court or other competent authority to have committed any fault or omitted to do anything that the individual ought to have done; and (b) fulfils the conditions set out in subsection (3).
Insurance	(6) A corporation may purchase and maintain insurance for the benefit of an individual referred to in subsection (1) against any liability incurred by the individual (a) in the individual's capacity as a director or officer of the corporation; or (b) in the individual's capacity as a director or officer, or similar capacity, of another entity, if the individual acts or acted in that capacity at the corporation's request.
Application to court	(7) A corporation, an individual or an entity referred to in subsection (1) may apply to a court for an order approving an indemnity under this section and the court may so order and make any further order that it sees fit.
Notice to Director	(8) An applicant under subsection (7) shall give the Director notice of the application and the Director is entitled to appear and be heard in person or by counsel.
Other notice	(9) On an application under subsection (7) the court may order notice to be given to any interested person and the person is entitled to appear and be heard in person or by counsel. R.S., 1985, c. C-44, s. 124; 2001, c. 14, s. 51.

The following definitions are taken (with permission) from The *Dictionary of Insurance* published by the Insurance Institute of Canada.

Claim—The claim asserted against the director or officer by a plaintiff in a civil proceeding or by a prosecutorial authority.

Claims Made Basis—Trigger of coverage provision in some insurance contracts covering only claims made during term of the insurance policy. One common variant is the claims-made-and-reported policy which also requires that the claim be reported to the insurer during that period.

Conditions—The general terms or requirements upon which the insurance is based. For the mutual understanding of the parties the conditions will commonly state such matters as how the policy can be cancelled or renewed, provisions with respect to change of the insured's interest, provisions as to what an insured should do in the event of a loss, and conditions as to what he should do subsequent to a loss, etc.

Coverage—The nature of protection afforded by a particular policy.

Deductible—An agreed specified sum to be deducted from the amount of loss and assumed by the insured. Also referred to as "retention", or (where the number is large) as "self-insured retention".

Excess Insurance—Insurance which does not participate until underlying layers of insurance covering the same risk are exhausted, or until the loss exceeds a self-insured retention. (See deductible)

Insured—The entity (individual or otherwise) whose risk of financial loss from an insured peril is protected by the insurance policy.

Indemnity—A contract, express or implied, to pay an obligation on behalf of another person. D&O insurance is a type of indemnity.

Insurer—The company or syndicate providing the insurance coverage.

Loss—In D&O policies, "loss" is usually a defined term describing what types of payments are and are not included in the indemnity obligation of the insurer. The scope of the "loss" definition can significantly affect the breadth of coverage.

Policy Limit—The maximum that the insurer is obligated to pay in actual claims under an insurance policy.

Rescind, rescindable—see Rescission.

Rescission—The retroactive, unilateral termination of the insurance policy by the insurer, usually by reason of a material non-disclosure or omission in the application for coverage.

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Additional references

Insurance Institute of Canada, Dictionary of Insurance

*Available for free download at www.rmgb.ca

Notes

Notes

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Richard Berrow is a partner of Fasken Martineau DuMoulin LLP. His risk management practice for corporations, directors and officers includes the preparation of corporate indemnification agreements and the placement and enforcement of directors and officers insurance policies. Richard's practice also includes the enforcement of other forms of insurance coverage on behalf of policyholder clients, class action defence, corporate meeting disputes, and other forms of corporate and commercial litigation. He has appeared before the British Columbia courts and the Supreme Court of Canada, and is a frequent speaker and author at continuing legal education and other seminars.

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