

# Liability Indemnification and Insurance for Directors of Not-for-Profit Organizations

By Brian Rosenbaum, LL.B.

*Supplement to 20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance*

This document is a supplement to the publication *20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance* commissioned by the Risk Management and Governance Board of the Canadian Institute of Chartered Accountants and written by Richard J. Berrow (the "Briefing").

The analysis in the Briefing is principally directed at corporations operated on a for-profit basis. Although much of its content is applicable to directors and officers of non-profit organizations, there are some distinct differences in the manner in which these individuals are statutorily permitted to be indemnified. As well, the typical non-profit directors' and officers' (D&O) liability insurance policy is somewhat different than a for-profit policy.

The Briefing should be read alongside this supplement to fully understand the insurance and indemnification issues non-profit directors and officers face.

## DISCLAIMER

This publication is provided for general information and convenience only, and does not constitute legal advice. The law governing directors' and officers' liability, indemnity and insurance varies from jurisdiction to jurisdiction and is subject to change, and legal advice must always be tailored to the situation at hand. The wordings of directors' and officers' insurance policies vary widely among insurers and are also subject to change, as do insurer practices. Readers should seek appropriate, qualified professional advice about any particular situation before acting or omitting to act based upon any information provided through this publication.

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# Indemnification

## What does Indemnification mean?

**Indemnification** is a legal term which means “to pay the costs of or to reimburse another person for costs incurred”.

In the context of a non-profit corporation, indemnification would involve the payment by the corporation of the legal costs, expenses, settlements and judgments of a director or officer, provided that they:

- arise out of his or her acts or omissions while acting within the capacity of a director or officer, and
- are the subject of actual or threatened legal proceedings.

If, for example, a director was sued along with the corporation by an ex-employee for wrongful termination, the corporation might pay the costs of hiring a lawyer for the director, conducting an investigation on behalf of the director and any other reasonable expenses necessary to adequately defend the director in the lawsuit, depending on any statutory or contractual rights and conditions. If the director was found to be personally liable to pay damages to the ex-employee, the corporation would pay those damages on the director’s behalf, unless the director’s conduct breached a statutory or contractual condition disentitling him or her to that indemnification.

## What determines a director’s right to indemnification?

The legislation under which the organization is incorporated sets out the statutory right of a director or officer to indemnification.

In the case of directors and officers in the for-profit sector, their statutory rights to indemnification are set out in the *Canada Business Corporations Act* (CBCA)<sup>1</sup> or equivalent provincial business corporation statutes.

Directors and officers of non-profit organizations (NPOs) are subject to different legislation in determining their rights to indemnification. The business form the NPO takes and the jurisdiction in which it operates largely determine the applicable statutes. Determining which statutory provisions directors and officers are subject to can be a confusing and difficult process. This document summarizes various federal and provincial statutes.

It must be noted however, that despite any statutory provisions allowing for the indemnification of non-profit directors and officers, many NPO executives and board members may not benefit from such indemnification due to the organization’s limited financial resources.

See questions one through four of the Briefing.

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<sup>1</sup> *Canada Business Corporations Act*, R.S.C. 1985, c. C-44

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## Federal Non-Profit Organizations

### Federal Non-Profit Corporations

National non-profit organizations are often incorporated under the *Canada Corporations Act* (CCA)<sup>2</sup>. Directors of CCA organizations may, with the consent of the organization's members, be indemnified for all costs, charges and expenses incurred as a result of any action, suit or proceeding commenced against them arising in the execution of their duties<sup>3</sup>.

### *Differences between the Canada Corporations Act and the Canada Business Corporations Act*

The standard by which directors of NPOs incorporated under the CCA can be indemnified differs significantly from the standard applicable to for-profit corporations under the CBCA in terms of prohibitions, scope and advancement of funds.

### Prohibitions

Under the CCA, a director may not be indemnified for costs, charges and expenses incurred by such director's own willful neglect or default.<sup>4</sup> In contrast, the CBCA prohibits indemnification if directors and officers have not acted honestly and in good faith with a view to the best interests of the corporation (or in the case of criminal or quasi-criminal proceedings, if the director did not have reasonable grounds for believing his or her conduct was lawful).<sup>5</sup> It is not entirely clear which of the contrasting prohibitions is wider. There may be some instances in which a director's willful neglect is not contrary to the best interests of the organization. Similarly, not every violation of a directors' and/or officers' duty to act honestly and in good faith with a view to the best interests of the corporation involves an act of willful neglect or default. This issue may soon be resolved by new legislation discussed below.

### Scope

Unlike the CBCA, wherein current and former directors and officers have statutory rights to indemnification, the rights to indemnification under the CCA may be limited to current directors.<sup>6</sup> The indemnification provisions in the CCA are permissive in nature allowing the non-profit organization to indemnify its current directors subject to shareholder approval. There does not seem to be any right of indemnification granted to officers or former directors.<sup>7</sup> It may be that officers and former directors of federally incorporated non-profit organizations will have to look to contractual rights or the common law for their indemnification.

<sup>2</sup> *Canada Corporations Act*, R.S.C. 1970, c. C-32

<sup>3</sup> CCA, s.93

<sup>4</sup> CCA, s.93(b)

<sup>5</sup> CBCA, s.124 (3)

<sup>6</sup> CCA, s.93(a)

<sup>7</sup> There is no mention of former directors in the CCA indemnification provision, as there is in the CBCA section. Further, director is defined in s. 3(1) as including "any person occupying the position of director by whatever name he is called". The use of the present tense of the verb "occupy" supports the position that only current directors are entitled to indemnification under the CCA. There is also no express right to indemnification granted to officers, nor does the definition of "director" include officers, as is common in some similar provincial statutes.

### **Advancement of Funds**

The CBCA and a number of provincial statutes allow for the advancement of funds without a director or officer having to wait until some sort of adjudication or ruling is made with regard to the appropriateness of his or her conduct. There are also provisions in many of those statutes that allow for-profit corporations to indemnify their directors and officers for costs and expenses in investigative proceedings.

In contrast, there is no express provision in the CCA permitting payment of funds to a director for costs, charges and expenses incurred prior to a determination that such director's conduct does not disentitle him or her to that indemnification, nor is there any provision permitting indemnification for costs and expenses in investigative proceedings.

### ***Future changes to the provisions of the CCA***

The CCA may undergo some significant changes in the very near future. On January 28, 2009, Bill C-4, *An Act respecting not-for-profit corporations and certain other corporations*,<sup>8</sup> was tabled in the House of Commons. If the Bill in its current form should become law, the indemnification rights of non-profit corporations' directors and officers will closely resemble those of directors and officers of for-profit corporations, in that:

- the standard of conduct prohibiting indemnification under the Bill mirrors that of the CBCA,
- former directors as well as officers will be permitted to be indemnified, and
- non-profit organizations will be entitled to advance costs to their directors and officers prior to a determination in a proceeding.<sup>9</sup>

The broadening of statutory indemnification rights of non-profit directors and officers proposed in the Bill will certainly enhance the ability of non-profit organizations to attract and retain qualified talent for their management teams and boardrooms.

### **Federal Non-Profit Associations**

A federal non-profit organization could alternatively be organized, pursuant to the *Canada Cooperatives Act*<sup>10</sup>, as an association, in which case the indemnification provisions are very similar to those contained in the CBCA.<sup>11</sup>

## **Provincial Non-Profit Organizations**

### **Provincial Non-Profit Corporations**

Non-profit organizations also may be incorporated under provincial legislation. Although there are many similarities under the various provincial statutes with respect to director and officer indemnification, there are also significant differences, some of which are discussed below.

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8 Bill C-4, *An Act respecting not-for-profit corporations and certain other corporations*, 2<sup>nd</sup> Sess., 40<sup>th</sup> Parl., 2009

9 Bill C-4, s.152

10 *Canada Cooperatives Act*, S.C. 1998, c.1

11 *Canada Cooperatives Act*, s.113

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- **Ontario:** In Ontario, the *Corporations Act* (Ontario) (OCA)<sup>12</sup> sets out the indemnification rights of directors and officers.<sup>13</sup> The provision in the OCA is very similar to that in the CCA, except that under the OCA, *officers* are also expressly granted the right of indemnification.
- **British Columbia:** In British Columbia, the *Society Act* (BCSA)<sup>14</sup> permits indemnification of directors and former directors, but is silent as to officers. It also requires court approval prior to indemnification, and that the costs, charges and expenses be reasonably incurred by the director.
- **Quebec:** The *Companies Act* (Quebec)<sup>15</sup> has language similar to Ontario's CCA but the conduct disentitling directors and officers to indemnification is slightly different<sup>16</sup>.
- **Saskatchewan:** Saskatchewan has, perhaps, the most progressive provincial legislation dealing with director and officer indemnification. The *Non-Profit Corporations Act, 1995*<sup>17</sup> permits broad indemnification to directors and officers, similar to that in the CBCA.
- **Alberta and other provinces:** In many provinces, such as Alberta, the legislation is silent as to when, how and to whom indemnification can be granted.<sup>18</sup>

## Provincial Non-Profit Associations and Condominium Corporations

Directors and officers of NPOs incorporated provincially as co-operatives are subject to the indemnification provisions of legislation such as Ontario's *Co-operative Corporations Act*.<sup>19</sup> NPOs can also take the form of condominium corporations, in which case director and officer indemnification could be subject to the provisions of provincial condominium acts.<sup>20</sup>

## Specially-Formed Non-Profit Associations

There are also some non-profit corporations that have come into being pursuant to a special Act of Parliament.<sup>21</sup> The rights to indemnification of directors and officers of these types of NPOs are often determined specifically by the enabling statute.

12 *Corporations Act*, R.S.O. 1990, c. C. 38

13 OCA, s.80

14 *Society Act*, R.S.B.C. 1996, c. 433

15 *Companies Act*, R.S.Q., c. C-38

16 *The Quebec Act* states that directors and officers are entitled to indemnification "except such costs, charges and expenses as are occasioned by his own fault". This is slightly different than the "willful neglect" standard contained in the CCA.

17 *Non-Profit Corporations Act, 1995*, S.S. 1995, c. N-4.2

18 *Companies Act*, R.S.A. 2000, c. C-21 and *Societies Act*, R.S.A. 2000, c. S-14

19 *Co-operative Corporations Act*, R.S.O. 1990, c. C.35

20 *Ontario's Condominium Act, 1998*, S.O. 1998, c. C-19 has indemnification provisions, whereas equivalent legislation in Alberta and British Columbia does not.

21 One such recent example is the *Asia-Pacific Foundation of Canada Act* (R.S.C. 1985, c. A-13) which provides for indemnification of Asia Pacific Foundation directors and officers pursuant to section 16.3

**Note regarding Not-for-Profit Organizations as Trusts**

NPOs may also be organized as trusts. In that case, the powers and duties of trustees are set out in the trust document, provincial trustees' legislation and the common law. Much of this discussion regarding indemnification and insurance will not apply to trustees of charitable trusts.

## Charities

The discussion above has been based on NPOs in a general sense. If an NPO is designated as a charity, additional criteria could apply in determining when indemnification of the NPO's directors and officers is permissible. For example, in Ontario, under the *Charities Accounting Act*<sup>22</sup>, directors and officers may be indemnified only when they have acted honestly and in good faith in performing their duties, and only when such indemnification does not impair a person's right to bring an action against them or unduly impair the carrying out of the non-profit organization's charitable or public purpose. A charity is also not permitted to indemnify its directors or officers if doing so would result in rendering the charitable corporation insolvent.

The charity's board of directors must consider a number of factors before giving an indemnity to or purchasing insurance for a director or officer:

- The degree of risk to which the director or officer is or may be exposed.
- Whether, in practice, the risk cannot be eliminated or significantly reduced by means other than the indemnity or insurance.
- Whether it advances the administration and management of the property held by the charity to give the indemnity or insurance.<sup>23</sup>

## Why is contractual indemnification important?

Due to the fact that indemnification provisions governing directors and officers of NPOs are generally not as broad as those contained in for-profit statutes and merely permit, rather than require, the organization to indemnify its directors and officers, it is vitally important for directors and officers of NPOs to seek contractual indemnification agreements with their organizations. Even where indemnification is required under the organization's by-law provisions, it is prudent to obtain a contractual indemnification agreement since by-law provisions can be amended or repealed without the consent or knowledge of a former director or officer.<sup>24</sup>

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22 *Charities Accounting Act*, R.S.O. 1990, c. C.10

23 *Charities Accounting Act*-Ontario Regulation 4/01 section 2 (5)

24 *Schoon v Troy Corp.*, C.A. 2362-VCL (Del. Ch., March 28, 2008)

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# Insurance

## Typical Coverage

### Entity Coverage

As discussed in question nine of the Briefing, publicly-traded companies often purchase D&O insurance that includes coverage for their own liability with respect to securities claims. However, there is more opportunity for broader entity coverage at a reasonable cost for non-profit organizations. Non-profit D&O insurance policies often include coverage for employment practices liability (EPL) for claims made against “insured persons” and the NPO itself. When purchasing D&O insurance, non-profit organizations must ensure that there is a broad definition of “wrongful act” in the policy that does not unduly limit this EPL coverage.

### Definition of Insured Person

One other significant difference between the non-profit and for-profit D&O insurance policies is the manner in which “insured persons” is defined. As mentioned in question nine of the Briefing, a for-profit D&O policy generally limits insured persons to past, present and future directors and officers. Non-profit organizations often utilize the skills and talents of volunteers, part-time workers and students to achieve their goals. The non-profit policy reflects that reality by containing a broader definition of “insured persons” to typically include employees, volunteers, part-time workers and students within coverage.

## Limits

NPOs generally purchase significantly lower insurance limits than for-profit enterprises. This may be due to a misconception that NPOs face fewer exposures than for-profit companies. Although large, publicly-traded corporations certainly face substantially greater exposures than the typical NPO, and the discussion of limits in question six of the Briefing may not be entirely applicable to NPOs, non-profit corporations generally face the same types of operating risks as many private, for-profit corporations.

Given that NPOs are often not well-funded and may not be in a position to fully indemnify their directors and officers, the purchase of inadequate insurance limits is unwise. If significant claims are made against the NPO, its directors, officers and employees, modest limits could be insufficient to cover defence costs for all covered parties, let alone any settlement amounts or judgments.

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## Deductibles

There is generally no deductible for coverage afforded to insured individuals under a non-profit D&O policy. However, as is the case in private-sector policies, there are generally deductibles for coverage afforded to the NPO itself, both its own separate coverage and for the NPO's obligation to reimburse its directors and officers. The good news for NPOs is that deductibles or retentions in non-profit policies tend to be much lower than those in policies catering to for-profit organizations. Deductible amounts can be as low as \$1000, and in some cases insurers are even prepared to underwrite the policy without any deductibles. This is quite different than in the for-profit situation discussed in question seven of the Briefing.

## Exclusions

Generally speaking, the exclusions present in a non-profit D&O insurance policy are essentially the same as those in a for-profit D&O policy. They include:

- claims made alleging personal misconduct such as fraud, criminal activity, willful breaches of the law and the gaining of illegal profit, and
- claims arising from bodily injury, property damage and pollution.

NPO policies are more likely than for-profit policies to contain professional services exclusions. It is important to consider the impact of such an exclusion when a board member or officer of the NPO holds some sort of professional designation, and as part of his or her duties to the organization, provides supervisory as well as professional advice. In such situations, a broadly drafted personal services exclusion can certainly limit coverage in ways not contemplated by the NPO and its directors and officers when a claim is based primarily on negligent supervision and only incidentally on professional advice.

Professional services exclusions may be triggered when a director who holds a professional designation goes beyond his or her oversight role and provides what could be construed as professional advice to the NPO, for example:

- a lawyer who takes an active role in the management of litigation against the organization
- an accountant who takes an active role in compiling the organization's financial statements

In for-profit policies designed for publicly-traded corporations, a number of exclusions deal with issues arising out of securities claims. Needless to say, this is not a concern for NPOs.

See question ten of the Briefing.

## Control of Defence

**Duty to defend coverage** — under this type of coverage, the insurer must defend claims made against insured persons and the insured organization, and bears the costs of the defence.

**Duty to indemnify coverage** — under this type of coverage, the insured person and/or organization are responsible for mounting their own defence to claims against them, and then seek to recover defence costs from the insurer.

The majority of non-profit D&O insurance policies are written on a duty-to-defend basis and obligate the insurer to defend covered claims made against insured persons and the insured organization. Generally, duty-to-defend coverage is considered broader than duty-to-indemnify insurance (more common in the for-profit sector) because it imposes a higher threshold on the insurer to defend the insured with respect to covered claims.

However, when the policy has duty-to-defend provisions, the insured often gives up much of its rights to appoint or choose counsel as well as instruct counsel during the course of the litigation. For NPOs, especially those without legal departments, this is not a large concern. However, for NPOs that employ experienced general counsel who may wish to play a large role in influencing litigation strategy, duty-to-defend policies can be somewhat restrictive with respect to control of the litigation. In these types of cases, it may be advisable for the NPO to seek coverage on a duty to indemnify policy similar to those procured by for-profit corporations and discussed in question 18 of the Briefing. This will give the NPO more control over the defence, subject to restrictions including the selection of counsel and the insurer's right to associate and participate in the action.

## Where to find more information

CICA Publications on governance

### **The Not-for-Profit Series\***

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## About the Author

Brian Rosenbaum is the Director of the Legal and Research Practice within the Financial Services Group of Aon Reed Stenhouse. His department provides risk transfer solutions to many of Canada's most prominent corporate executives and boards. An authority on insurance matters dealing with management liability, Brian contributes regularly to industry publications such as the Institute of Corporate Directors Newsletter, the CCH Canadian Limited Directors' Manual and the Canadian Compensation and Benefits Reporter published by Thomson Carswell. In addition, he has made numerous presentations to corporate management teams and boards, as well as to organizations such as the Canadian Corporate Counsel Association and the Institute of Corporate Directors. Brian is also a sought after speaker for conferences on issues related to management liability and insurance and is often quoted in publications such as Business Insurance Magazine.

Prior to entering the insurance industry, Brian developed continuing legal education programs with an emphasis on management liability insurance, worked in private practice, and was General Counsel of a Toronto-based group of companies. Brian is a graduate of Osgoode Hall Law School and a member of the Ontario Bar.

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