

INDEMNITY AND INFIDELITY: Advancement of Defence Costs in Actions “By...the Corporation”

Pamela D. Pengelley*

1. INTRODUCTION

Indemnification refers to the financial protection provided by the corporation for its directors.¹ It shields directors from expenses and liability of legal proceedings alleging breaches of their duty to the corporation.² This is of concern for directors because, in addition to the potential liability they face if found blameworthy, the cost of funding an adequate defence can be staggering. To illustrate, since 2003, the Sun-Times Media Group Inc. (formerly Hollinger International Inc.) has paid U.S. \$107.7 million in *legal fees alone* to defend Conrad Black and other former officers in the criminal lawsuit launched by the U.S. government, as well as a bevy of civil suits in Canada and the U.S.³

Corporate pundits rightly regard liberal indemnification provisions as necessary to recruit capable management⁴ and to encourage directors to act on behalf of the corporation in a manner unfettered by fear of “tak[ing] good faith risks in the search for profit”.⁵ They emphasize the increased cost and volume of litigation and portend the grim consequences of limiting directors’ indemnification rights.⁶ Critics of indemnification see it as contributing to corporate malfeasance by permitting directors to waste corporate funds while avoiding personal consequences of misconduct. The high standards of conduct required of directors would be nullified if a company is permitted to relieve its directors from liability for breaches of their duties.⁷ The principle of indemnification strikes a delicate balance between seeking “the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all”.⁸

* B.Sc., LL.B., LL.M (Candidate), Associate, Cozen O’Connor, Toronto, Ontario. The author would like to thank both Lawrence T. Bowman of Cozen O’Connor, Dallas, Texas and the anonymous reviewer for their helpful comments with earlier drafts of this article. Any errors are solely those of the author.

¹ Committee on Corporate Laws, “Changes in the Model Business Corporations Act – Amendments Pertaining to Indemnification and Advance for Expenses” (1994), *49 Bus. Law.* 749 at p. 749. Although this article refers to “directors”, the *CBCA* provisions respecting indemnity include “officers” as well, thus much of this paper is applicable to the indemnification of corporate management generally. Potential distinctions pertaining to the indemnification of officers are beyond the scope of this article.

² *Id.*

³ Tedesco, T., “Left Out to Dry; Hollinger: The Untold Story”, *National Post*, Saturday, December 8, 2007, at p. FP7.

⁴ Wineberg, H. S., “Proposals for the Reform of Provisions of the British Columbia Company Act that Indemnify Directors”, 50 *The Advocate* 523 (1992) at p. 523; Irenas, J.E. & Moskowitz, T., “Indemnification of Corporate Officers, Agents and Directors: Statutory Mandates and Policy Limitations”, 7 *Seton Hall Legis. J.* 117, (1984) at p. 117.

⁵ Johnston, Joseph F. Jr. “Corporate Indemnification and Liability Insurance for Directors and Officers”, 33 *Bus. Law.* 1993 (1978) at p. 1994.

⁶ Wineberg, *supra* note 4 at p. 523.

⁷ British Columbia Ministry of Finance and Corporate Relations, *Company Act Discussion Paper*, (January 1991), at p. 31 [“BCCA Discussion Paper”].

⁸ Johnston, *supra* note 5 at p. 1994. As noted by Iacobucci, J. speaking for the Supreme Court of Canada in *Blair v. Consolidated Enfield Corp.*, [1995] 4 S.C.R. 3 (S.C.C.) (Q.L.) at para. 74 [“Blair”], “Permitting [a director] to be indemnified is consonant with broad policy goals underlying indemnity provisions; these allow for reimbursement for reasonable good faith behaviour, thereby discouraging the hindsight application of perfection.

Legislatures in Canada, Britain and the United States recognize that there is a public interest in regulating the circumstances in which a company indemnifies its directors and officers. Statutory attempts to prescribe the indemnification rights of directors first emerged as short, narrow provisions that simply reiterated common law principles of agency.⁹ Today, they have matured into “one of the most complex and most controversial problems of contemporary corporation law.”¹⁰ The principle common to indemnification statutes is that directors acting in good faith and in the best interests of the corporation should not be liable to third parties and should not bear litigation expenses incurred in their defence.¹¹ Where, however, it is alleged that a director has breached a duty owed *directly* to the corporation, it is the corporation that must pursue its directors, either directly or derivatively.¹² Different indemnity principles will apply in such cases.

The purpose of this article is two-fold. First, to demonstrate that, although it appears that Canada’s current federal statutory indemnification scheme, s.124 of the Canada Business Corporations Act [“CBCA”]¹³, was intended to provide a comprehensive scheme for dealing with indemnification, it does not encompass actions brought *directly* by a corporation against its directors for a breach of duty to the corporation. This is the only section of the CBCA which permits indemnification.¹⁴ If a director is to receive indemnification or advancement of legal expenses for an action brought directly by the corporation, then it must be found here. Although direct actions would seem to fall naturally into subsection 124(4), which authorizes indemnification for actions “by... *the corporation*”, this was intended to apply only to derivative actions. Nor can direct actions be appropriately accommodated by subsection 124(1), which is intended to deal with indemnification in actions brought by third parties.

The second purpose is to review policy issues raised by advancement of defence costs to directors incurred in both derivative actions and direct actions by the corporation. Derivative suits brought by corporate stakeholders, and direct suits brought by the corporation itself, are not the same; in direct suits the corporation and its management are truly adverse. Is the advancement of expenses of litigation in such cases appropriate? It is contended that it is not;

Indemnification is geared to encourage responsible behavior yet still permit enough leeway to attract strong candidates to directorships and consequently foster entrepreneurship. It is for this reason that indemnification should only be denied in cases of *mala fides*. A balance must be maintained.”

⁹ See, e.g., The Canada Joint Stock Companies Act, 1877, 40 Vict., c. 43, (1877), s. 57.

¹⁰ Dickerson, R.V.W., Howard, J.L. & Getz, L., *Proposals for a New Business Corporations Law for Canada*, Vol. 1 Commentary, p. 83, para. 243.

¹¹ Wineberg, *supra* note 4 at p. 523.

¹² The Canada Business Corporations Act, R.S.C. 1985, c. 44 [“CBCA”] provides a statutory derivative action which allows shareholders and others to sue directors on behalf of the corporation for liabilities that directors may owe to the corporation. The proceeds of a successful action are paid to the corporation directly, rather than the plaintiff (ss. 239-240).

¹³ *Id.*, s. 124. Section 136 of Ontario’s *Business Corporations Act* [“OBCA”], R.S.O. 1990, c. B-13, is the same in substance as that of s. 124 of the *CBCA* so that the comments in this article apply equally to the indemnification provisions of the *OBCA*. Although all other provinces have included statutory indemnity provisions in their corporate laws, their analysis is beyond the scope of this article.

¹⁴ Canada Business Corporations Act Discussion Paper: Director’s Liability (Released November 1995), p. 26, para. 90 [“CBCA Discussion Paper”]. Last accessed January 7, 2007 at <http://dsp-psd.pwgsc.gc.ca/Collection/C2-280-7-1995E.pdf>.

judicial inclination to interpret direct actions as falling within the purview of the section should be avoided.

This article begins with s. 124. The historical development of the section is canvassed to demonstrate that direct actions were never considered within its purview. Canadian federal indemnity laws have been heavily influenced by American corporation law, particularly that of Delaware, New York, and the Model Business Corporations Act. The impact of these statutes on the development of s. 124 is considered, concluding with a discussion of the merits of interpreting this section to encompass direct actions.

2. OVERVIEW OF THE CURRENT FEDERAL STATUTORY SCHEME SECTION 124 OF THE CBCA

To be eligible for indemnification under s. 124 of the CBCA, a director must have acted honestly, in good faith and in the best interests of the corporation, and in the case of a criminal or administrative proceeding, the director must also have had reasonable grounds for believing that his or her conduct was lawful.¹⁵ These requirements set minimum standards of conduct that delineate the outer boundaries of indemnification that a corporation may, at its discretion, extend to a director,¹⁶ and reflect the statutory duties imposed on directors by s. 122 of the CBCA.¹⁷ In actions brought other than “by or on behalf of the corporation,”¹⁸ a director who satisfies these minimum standards of conduct has an enforceable right to be indemnified by his corporation, so long as he is not judged by a court to have committed any fault or omitted to do anything he ought to have done.¹⁹ Where a director *is* adjudged liable to a third party, then so long as he has met the minimum standards of conduct owed to the corporation, the statute endows the corporation with the discretion to indemnify the director for all of his or her reasonably incurred costs, charges and expenses, including the amount of any settlement or judgment.²⁰ Court

¹⁵ CBCA, *supra* note 13, s. 124(3). In considering the analogous provision of s. 136(1) of the *OBCA*, *supra* note 14, Iacobucci J., speaking for the Supreme Court of Canada noted that there are three conditions that the director must fulfil in order to receive indemnification for the costs of defending in litigation: (1) the person must have been a party to the litigation by reason of being a director or officer of the corporation; (2) the costs must have been reasonably incurred; and (3) the person must have acted honestly and in good faith with a view to promoting the best interests of the corporation. Persons are presumed to act in good faith unless proven otherwise. *Blair*, *supra* note 8, paras. 35-36. The above criteria appear to set an objective test: See *Catalyst Fund General Partner I Inc. v. Hollinger Inc.*, [2006] O.J. No. 944 (C.A.) (Q.L.) at para. 106, where Cronk J. states: “In the final analysis, given the situation that existed in June 2005, White had no business resisting Hollinger's Removal Motion. That he may have done so in the subjective belief that he was acting in the best interests of Hollinger does not assist him on the Indemnity Appeal. Objectively, that was not the case and he cannot make out a claim for indemnification by relying on an unreasonable subjective belief.”

¹⁶ Committee on Corporate Laws, *supra* note 1 at p. 749.

¹⁷ CBCA, *supra* note 12, s. 122(1).

¹⁸ CBCA Discussion Paper, *supra* note 14, p. 27, paras. 132-133.

¹⁹ CBCA, *supra* note 13, s. 124(5).

(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).

²⁰ *Id.* Section 124(1) provides: “A corporation may indemnify a director or officer of the corporation... 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 or investigative or other proceeding in which the individual is involved because of that association with the corporation or other entity.”

sanction or approval is not required.²¹ Additionally, under s. 120(5) of the CBCA, the granting of indemnity is excluded from the general rule that a director may not vote on a contract in which he or she has a material interest.²² In other words, the director is entitled to vote for contracts which set the terms of his indemnification.

Subsection 124(2) permits advancement of expenses to directors before the final outcome of an action is known.²³ This reflects the view of the legislature that a director who serves a corporation in a representative capacity should not be required to finance his or her own defence. Moreover, given the potentially enormous costs of litigation, responsible individuals may be unwilling to serve as directors unless they have assurance that their corporation will have the power to advance their expenses.²⁴ There is, however, an important distinction between advancement of expenses and indemnification. Indemnification is retrospective, providing reimbursement for expenses *after* the outcome of a proceeding is known. This enables the individuals making the decision to indemnify to do so on the basis of known facts.²⁵ Advancement of expenses is necessarily prospective, so that the individuals making the decision to indemnify generally have fewer facts on which to base their decision.²⁶ For this reason, section 124(2) stipulates that if it is ultimately determined that a director has not fulfilled the minimum standards of conduct necessary for indemnification, the director must repay the money to the corporation.²⁷

The legislation also addresses indemnification in derivative actions.²⁸ Generally speaking, a derivative action is instigated by a stakeholder²⁹ of the corporation, not for the stakeholder's direct benefit, but for the benefit of the corporation. The stakeholder is empowered to bring an action in the name of the corporation, and on the corporation's behalf, against parties who have caused harm to the corporation.³⁰ Often derivative suits are brought against officers or directors of a corporation alleging violations of fiduciary duties owed to the shareholders. The proceeds of a successful action are paid to the corporation rather than to the stakeholder who brings the action.

²¹ *Id.*

²² *Id.*, s. 120(5).

²³ *Id.* Section 124(2) provides: "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 fulfill the conditions of subsection (3)."

²⁴ Committee on Corporate Laws, *supra* note 1 at p. 765.

²⁵ *Id.* at p. 765.

²⁶ *Id.*

²⁷ CBCA, *supra* note 12, s. 124(4).

²⁸ *Id.* Section 124(4) provides: "A corporation may with the approval of the 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)."

²⁹ *Id.* The action is initiated by a "complainant", who is defined at s. 238, to be a shareholder, director, officer, the CBCA director, or any other person who, in the discretion of the court, is a proper person to make an application.

³⁰ *Id.* Section 239 provides for the commencement of a derivative action.

There are policy reasons for refusing indemnity to directors who are found liable to their company in derivative actions. Derivative actions put squarely at issue the question of whether the director has breached his statutory duties to the corporation and its shareholders. It seems unjust to transfer shareholders' money to those who have failed to perform their fiduciary obligations. Additionally, if a company were required to indemnify a director for liabilities incurred by his unsuccessful defence of a derivative action, then indemnification would involve a circularity of payment that would render the derivative action superfluous. This is illustrated by the following example:

A stockholder sues the directors. He says, "You took a million dollars from the corporation." He wins. The court says to these fellows, "Pay that million dollars to the corporation." But [the court] doesn't say that they were grossly negligent or guilty of willful misconduct. He just says that they were negligent or guilty of ordinary misconduct. Usually courts are quite charitable to the insiders in these cases. So they pay the million dollars to the corporation. The corporation, however, doesn't get the million dollars because the court allows the plaintiff's counsel a fee of \$100,000 out of the million dollar recovery. So the corporation has recovered \$900,000. But the defendants are entitled to be indemnified for the amount paid the corporation, so they get back the \$900,000 and they also get back their counsel fees, which we will say are another \$100,000. The net result is that the corporation, having triumphed, is \$200,000 poorer than it was before.³¹

Thus, if a corporation is permitted to reimburse a director for the very amounts paid to the corporation as a judgment, then a "successful" derivative action results in a net loss to the corporation.³² This logic also forecloses indemnification for amounts paid to settle derivative actions.³³ In derivative actions court approval is required as a pre-condition to indemnification, in addition to directors meeting minimum standards of conduct.³⁴

The implied premise of subsection 124(4) is that, if a derivative action in the name of the corporation has been brought against a director, then the director has probably not been acting in the interests of the corporation and therefore his conduct should be scrutinized.³⁵

Section 124 of the CBCA does not contemplate indemnity for actions brought *directly* by a corporation against its directors for a breach of duty to the corporation although this would appear to be authorized under s. 124(b), on the basis of the reference to actions "*by... the corporation*". This section was intended to apply only to derivative actions, as evidenced by the

³¹ Bishop, J.W. "Indemnification of Corporate Directors, Officers and Employees", 20 Bus. Law. 835 (1965) at p. 841.

³² Notes; Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation", 76 Harvard L.R., 1403 (1963) at p. 1403.

³³ *Wood v. Noma Elec. Corp.*, 96 N.Y.L.J. 1121 (N.Y. City Ct. 1936). Some academics have pointed out, however, that there may be less objection to a corporation indemnifying settlement payments because a corporation can derive tangible benefits from the prompt resolution of the action, and to encourage rapid disposition of refractory litigation. See, for example, Pillai, J. & Tractenberg, C., "Corporate Indemnification of Directors and Officers: Time for Reappraisal", 15 U. Mich. L.J. Reform 101 (1982), p. 105; Kuykendall, M., "A Neglected Policy Option: Indemnification of Directors for Amounts Paid to Settle Derivative Suits – Looking Past "Circularity" to Context and Reform", 32 San Diego L. Rev. 1063 (1995).

³⁴ CBCA, *supra* note 12, s. 124(4).

³⁵ Dickerson, *supra* note 10, at p. 84, para. 247.

marginal caption, “*Indemnification in derivative actions*”. The text of the subsection refers to a derivative suit as an action “by or on behalf of the corporation,”³⁶ being an action *by* the corporation in the sense that the action is commenced for the corporation, and *on behalf* of the corporation because it is commenced by a stakeholder for the corporation’s benefit. Derivative actions have been variously referred to as “actions ‘in the right of the corporation’, ‘secondary actions by shareholders’, or ‘actions to enforce a secondary right on the part of shareholders,’”³⁷ and the usual definitions of the word “derivative” do not encompass the direct action by the corporation. While indemnification may be appropriate in certain direct suits, particularly when the director’s defence is successful, the advancement of defence costs to directors in such suits may never be appropriate and is not provided for by statute, as demonstrated by the following historical review of Canadian statutory indemnification law.³⁸

3. HISTORICAL DEVELOPMENT OF CANADIAN INDEMNIFICATION LAW

a) Indemnification at Common Law

The notion that a director should be reimbursed by the company for liability that he incurs in service to it derives from the common law of agency. The common law holds that an agent should not bear liability arising from simply carrying out his principal’s instructions; those losses more appropriately rest with the principal who gives the instructions.³⁹ There are two exceptions. First, an agent is not entitled to seek indemnity from his principal where he carries out instructions that he *knows* to be unlawful.⁴⁰ Second, an agent may not seek indemnification if the loss is attributed to his “fault” or lack of skill in carrying out the task.⁴¹

³⁶ *Id.*

³⁷ Comment, “The Right of Directors to Indemnification in Actions Brought Directly by the Corporation: A Study of BCL Sections 722 and 723”, 39 *Fordham L. Rev.* 743 (1971) at p. 744; H. Henn, *Law of Corporations* § 358, at 751 (2d ed. 1970).

³⁸ Mazur, D. “Indemnification of Directors in Actions Brought Directly by the Corporation: Must the Corporation Finance its Opponent’s Defence?” 19 *J. Corp. L.* 201 (1994).

³⁹ McGuiness, K.P., *Canada Business Corporations Law* (Markham, Ontario: LexisNexis, 2007), p. 1091, s. 11.298; *Adams v. Morgan & Co.*, [1924] 1 K.B. 751; *Re Hollebone’s Agreement* [1959] 2 All E.R. 152.

⁴⁰ *The Koursk*, [1924] P. 140 at 155; *Weir v. Bell* (1878), 3 Ex. D. 238 at 248 (C.A.). Note that this is a separate and distinct issue from that of the right of contribution under Ontario’s Negligence Act, R.S.O. 1990, c. N.1.

⁴¹ McGuiness, *supra* note 39. This was decided by Neville, J., in *In Re Brazilian Rubber Plantations and Estates Limited*, [1911] 1 Ch. 425 [“*Brazilian Rubber*”] which was followed by Romer, J., at first instance in *In Re City Equitable Fire Insurance Company Limited*, [1925] Ch. 407 [“*City Equitable*”]; see also *New Zealand Farmers’ Co-operative Distributing Co. v. National Mortgage Agency Co. of New Zealand*, [1961] N.Z.L.R. 999. In such cases, the principal would remain liable to third persons in a civil suit for the torts of his agent, even if the principal did not authorize or know of such misconduct, or even if he forbade the acts, or disapproved of them, so long as they were committed within the scope of an agent’s extensive authority. Moreover, if the principal were held to be vicariously liable for damages caused by the agent’s negligence, then the agent would be subject to an implied obligation to indemnify his principal – a logical consequence of the duty of care that an agent owes to his principal in carrying out the principal’s instructions. See, for example, *Keppel v. Wheeler*, [1927] 1 K.B. 577 (C.A.); *Hillcrest General Leasing Ltd. v. Guelph Investments Ltd.* (1970), 13 D.L.R. (3d) 517 at 522 (Ont. C.A.), *per* Grossberg Co. Ct. J. See also *McGowan & Co. v. Dyer* (1873), L.R. 8 Q.B. 141 [“*McGowan*”].

The traditional principal-agent relationship does not perfectly analogize to the relationship of a director and corporation, however. Directors are not agents in the strict technical sense; a traditional agency relationship arises primarily in contract, whereas a director's powers derive from statute rather than by a contractual delegation of authority from the corporation or the stockholders who elect them.⁴² Nonetheless, as writers have pointed out, directors are agents acting on behalf of both the corporation and its shareholders in all practicality, and it is by so doing that they are exposed to liability.⁴³ The courts of Britain and Canada share a pragmatic view of the unique capacity of directors, holding that they *are* properly conceived to be agents for a corporation,⁴⁴ but not *only* as agents. For instance, directors should also be thought of as trustees for a company with respect to the exercise of their powers, since they cannot lawfully use their powers except for the company's benefit, or intended benefit.⁴⁵ It follows, then, that directors should also be entitled to indemnification, as agents, against losses incurred by them in carrying out their duties on behalf of the corporation.⁴⁶ A test for determining whether a director's impugned act is made on behalf of the corporation is to examine whether the act is allegedly for the director's own benefit or for the benefit of the corporation.⁴⁷

Thus, directors in England and Canada were owed indemnity from a corporation in accordance with common law principles.⁴⁸ Through a certificate of incorporation, the by-laws, a resolution, or an agreement approved by shareholder majority, a corporation could indemnify its directors at common law. This power would become an obligation if the corporation agreed to pay the legal expenses of the directors. Further, an agent could contract with his principal for indemnification rights that were more or less extensive than those provided by the common law.⁴⁹

b) The Rise of Statutes Limiting Indemnity Rights

In 1845, British legislation codified these common law principles. The first statutory indemnification clause, found in Britain's Companies Consolidation Act⁵⁰ stated, in substance, that a director executing any contract on behalf of a company or otherwise acting on his

⁴² White, W. J. & Ewing, J.A. (1901), *A Treatise on Canadian Company Law*, (Montreal: C. Theoret), p. 283. The authors note, however, that they are agents in the fact that in many cases their acts, otherwise voidable, become valid by the ratification of the stockholders. See for example, *Charitable Corporation v. Sutton*, 2 Atk. 400; *Bank v. Rutland Ry. Co.*, 30 Vt. 159, 169; *Grant v. United Switchlock Rail Co.*, 30 C.D. 135.

⁴³ White, *Id.*; McGuiness, *supra* note 39 at p. 1091, s. 11.300.

⁴⁴ See, for example, *Halsbury's Laws of England*, Vol. V (1910), para. 358, which states: "The true position of directors is that of agents for the company. As such they are clothed with the powers and duties of carrying on the whole of its business, subject, however, to the restrictions imposed by the articles and any statutory provisions. See also *Re Faure Electric Accumulator Co.* (1888), 40 Ch. D. 141. But note that the director is not an agent of the shareholders: *Gramophone and Typewriter, Ltd. v. Stanley*, [1908] 2 K.B. 89, 106, C.A.

⁴⁵ *Halsbury* (1910), *Id.*, para. 360.

⁴⁶ *Halsbury, Id.*, para. 477.

⁴⁷ *Halsbury* (1910), *supra* note 45, para. 480. See also *McGowan, supra* note 41; *Northern Life Assurance Co. of Canada v. McMaster, Montgomery, Fleury & Co.*, [1928] S.C.R. 513 (Q.L.) at p. 4 of 5 ["*Northern Life*"].

⁴⁸ McGuiness, *supra* note 39, at p. 1093, s. 11.301.

⁴⁹ *Id.*

⁵⁰ No abbreviated title is indicated for this Act. The Act is formally titled "An Act for consolidating in One Act certain Provisions usually inserted in Acts with respect to the Constitution of Companies incorporated for carrying on Undertakings of a public Nature", 8 Vic. cap. 16 (1845) ["Companies Consolidation Act"].

directorial powers was not to be held legally responsible, and was entitled to be indemnified by the company for all payments made or liability incurred in execution of his powers.⁵¹ As time passed, it became clear that the seemingly trivial distinction between directors, whose powers derived from statute, and “true” agents, whose powers derived from contract, could be problematic. Since “true” agency relationships were a product of contract, agents who sought indemnification rights that were more extensive than those at common law had to *bargain* with their principals for those rights.⁵² Conversely, the corporation’s contractual indemnification obligations were being created by the very people who would benefit from them,⁵³ so that there were no effective controls on the scope of the rights that directors could choose to allocate to themselves. This resulted in company articles containing extremely generous clauses purporting to indemnify directors against the consequences of, not just their negligence or breach of duty, but even breach of trust.⁵⁴ The sweeping scope of indemnification rights that companies were granting their directors provoked a reaction from British and Canadian legislatures, causing them to revise the statutes to set minimum standards of conduct for directors to fulfill in order to attain corporate indemnification.⁵⁵

Britain’s ‘Companies Act, 1929’⁵⁶ implemented a provision that prohibited indemnification “in respect of any negligence, default, breach of duty or breach of trust.” An exception was carved out for a director’s defence costs arising from civil or criminal liability “in which judgment is given in his favor or in which he is acquitted.”⁵⁷ Similarly, Canada’s first statutory indemnification clause, s. 57 of The Canada Joint Stock Companies Act, 1877,⁵⁸ and Ontario’s first statutory indemnification clause, s. 72 of The Corporations Act, 1953,⁵⁹ both provided that a director could be indemnified out of company funds for costs, charges and expenses incurred in the execution of his duties as a director, unless they were “occasioned by his own *willful* neglect or default”.⁶⁰

⁵¹ *Id.* Section 100.

⁵² *Id.*

⁵³ McGuiness, *supra* note 39, at p. 1093, s. 11.302.

⁵⁴ *Tomlinson v. Liquidators of Scottish Amalgamated Silks Limited*, [1934] S.L.T. 101 (HL) at 104 *per* Lord Clyde.

⁵⁵ Notes, *Halsbury’s Statutes of England* (2 Ed.), Vol. 3 (1949), p. 624.

⁵⁶ 19 & 20 Geo. V. cap. 23 [“Companies Act, 1929”].

⁵⁷ *Id.*, s. 152. See also: *Halsbury’s Statutes (1949)*, *supra* note 55 at p. 624 (Notes).

⁵⁸ The Canada Joint Stock Companies Act, 1877 *supra* note 9. Section 57 provides: “Every Director of the Company, and his heirs, executors and administrators and estate and effects respectively may, with the consent of the Company, given at any general meeting thereof, from time to time, and at all times, be indemnified saved harmless out of the funds of the Company, from and against all charges, costs and expenses whatsoever which he shall or may sustain or incur in or about any action, suit or proceeding which shall be brought, commenced or prosecuted against him, for or in respect of any act, deed, matter or thing whatsoever, made, done or permitted by him, in or about the execution of the duties of office; and also from and against all other charges, costs and expenses which he shall sustain or incur, in or about, or in relation to the affairs thereof, except such costs, charges or expenses as shall be occasioned by his own willful neglect or default.” This wording was adopted in The Companies Act, 1902, E. II, c. 15, s. 67 (1902), and subsequent Federal corporation statutes, remaining essentially unaltered in Canada for over 100 years, until 1975 with the enactment of the Canada Business Corporations Act, R.S.C. 1975, c. 44, s. 124 [“CBCA (1975)”].

⁵⁹ S.O. 1953, c. 19, s. 72.

⁶⁰ *Id.* (emphasis added); In *City Equitable*, *supra* note 41, the Court of Chancery determined that “willful neglect or default” is an act, or an omission to do an act, where the person who acts, or omits to act, knows what he is doing. Accordingly, if that act or omission amounts to a breach of that person’s duty, and therefore to negligence, he is not guilty of willful neglect or default unless he knows that he is committing, and intends to commit, a breach

c) Influential Developments in the United States: The *McCollum* Case

Directors' indemnification rights were codified in Canada and Britain much earlier than in the United States where there was no clear common law basis for indemnification. The existence of the right seemed to depend upon the benefit which accrued to a corporation as a result of director's defence.⁶¹ Although there were few cases on the subject,⁶² a successful defence of an action seemed to play a major role in the determination of the existence of a benefit to the corporation.⁶³ The mere fact that the director was unsuccessful, however, did not preclude the courts from finding that a benefit existed, thus permitting indemnification.⁶⁴

Following the 1929 stock market crash, Senate hearings on stock exchange practices raised the issue of director malfeasance into national visibility.⁶⁵ The U.S. Securities Act of 1933, the Securities Exchange Act of 1934 and other antitrust laws⁶⁶ were enacted to address director misconduct and to bring about substantial changes in the general behavior of directors.⁶⁷ The financial environment of the 1930s made directors fearful of unfounded derivative suits.⁶⁸ In tandem with new exposures of American directors to personal liability, indemnification clauses became increasingly common in corporate charters and bylaws.⁶⁹ The common law was that directors held liable in derivative actions for breaching their duty to the corporation were not

of his duty, or is recklessly careless in the sense of not caring whether his act or omission is or is not a breach of his duty. See also *Brazilian Rubber*, *supra* note 41.

⁶¹ See, e.g., *Wickersham v. Crittenden*, 106 Cal. 329 (1895); *Godley v. Crandall & Godley Co.*, 181 App. Div. 75 (1st Dep't 1917) ["*Godley*"].

⁶² See Comment, "Corporations – Indemnification of Management for Litigation Expenses", 52 Mich. L. Rev. 1023 (1954) at p. 1025.

⁶³ G. Washington, *Corporate Executives Compensation* 334 (1942). For example, in the 1906 decision of *McCourt v. Singers-Bigger*, 145 F. 103 (8th Cir. 1906), unsuccessful directors were denied indemnification because, at p. 114, "[t]hey did nothing to recover or save a trust fund, or to prevent its waste or dissipation, but everything in their power to prevent its recovery or restitution to the original owner. Their proceedings, while in the name of the old company...were adversary to its equitable rights".

⁶⁴ See, e.g., *Kanneberg v. Evangelical Creed Congregation*, 146 Wis. 610 (1911); *Godley*, *supra* note 61 at p. 78.

⁶⁵ *Stock Exchange Practices, Hearings on S. Res. 84 Before the Senate Committee on Banking and Currency*, 72d Cong., 1st Sess. (1932); *Stock Exchange Practices, Hearings on S. 84 and S. 239 Before a Subcommittee of the Senate Committee on Banking and Currency*, 72d Cong. 2nd Sess. (1933); *Stock Exchange Regulation, Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852*, 73d Cong., 2d Sess. (1934).

⁶⁶ Section 14 of the Clayton Act, 38 Stat. 736 (1914), 15 U.S.C. § 24 (1955) recognized the director's responsibility for corporate violations and provided a variety of sanctions which could be used against him.

⁶⁷ Notes, *supra* note 32 at p. 1412. Although compensatory relief was one aim of the civil remedies, it was clear that Congress looked upon them as a means whereby private actions might enforce adherence to standards and requirements embodied in the acts. As one commentator wrote in 1935, "Since the Acts are partial substitutes for a comprehensive system of control over finance, compensation must assume secondary importance". Comment, "Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act", 44 Yale L.J. 456 (1935), p. 457.

⁶⁸ See Hanks J. & Scriggins, L. "Protecting Directors and Officers from Liability – The Influence of the Model Business Corporation Act", 16 Bus. Law. 3 (2000) at p. 5.

⁶⁹ Bates, G. E., & Zuckert, E. M., "Directors' Indemnity: Corporate Policy or Public Policy", 20 Harv. Bus. Rev. 244, (1942) at p. 244.

entitled to indemnification. Yet where a director *successfully* defended a derivative action, it was unclear whether a right to indemnification could arise under agency law.⁷⁰

Then came the sour decision in *New York Drydock Company v. McCollum*⁷¹ in 1939, a case so notoriously unpopular that its backlash extended beyond the United States, spurring the development of Canada's modern indemnification statutes. In *McCollum*, directors of the New York Drydock Company were sued by a disgruntled stakeholder in a derivative suit that alleged losses to the corporation of \$11 million. The directors successfully defended the action on the merits,⁷² and an appeal was subsequently dismissed for lack of prosecution.⁷³ The directors asked the corporation for over \$86,000 in legal fees and related costs. The corporation, unsure of whether it had the power to make the payment, sought a declaratory judgment in the Supreme Court for Onondaga County, New York. The case was referred by consent⁷⁴ to a distinguished former judge of the Court of Appeals of New York, Leonard B. Crouch, as an "Official Referee".⁷⁵ At the hearing, the directors argued, first, that the corporation had an implied obligation to pay their legal expenses in successfully defending the derivative action,⁷⁶ second, that their successful defence of a shareholder's derivative action served "in a substantial way to benefit the corporation" so that payment of their reasonable legal expenses were justified,⁷⁷ and finally, that there was a social necessity for indemnification because it would otherwise be difficult to induce responsible men to act as directors.⁷⁸

In considering whether the corporation had an implied legal obligation to indemnify the directors, Judge Crouch acknowledged the common law principle that agents, trustees and receivers were entitled to indemnity for their legal expenses at common law, but he rejected the application of these analogies to the director-corporation relationship.⁷⁹ Contrary to the conclusion reached by Canadian and British courts, Judge Crouch stated:

So far as the case of principal and agent is concerned, the analogy is not close enough to prevail alone...[A] director of a corporation is not an agent either of the corporation or of its stockholders, except in a convenient rhetorical sense, though he may sometimes act in the nature of an agent in dealing with third parties. He derives his power and authority neither from the stockholders nor from the corporation. His status is *sui generis*. His office is a creature of the law.⁸⁰

⁷⁰ For example, in *Figge v. Bergenthal*, 130 Wis. 594, 109 N.W. 581 (1906), the Wisconsin Supreme Court implied that success, not benefit, was the criterion in saying, at 625, that "if not case is made against defendants, it is not improper or unjust that the corporation should pay for the defence of the action". Conversely, in *Griesse v. Lang*, 37 Ohio App. 553, 175 N.E. 222 (1931), payment was denied by the Ohio Court of Appeals after the successful defence of a stockholder's derivative action because the court was of the opinion that the corporation had received no benefit from the legal services.

⁷¹ 16 N.Y.S.2d 844 (Sup. Ct. 1939) [*McCollum*].

⁷² *Id.* With the exception of one issue which was dismissed for lack of evidence.

⁷³ *Id.* at p. 845.

⁷⁴ See Hanks & Scriggins, *supra* note 68 at p. 5.

⁷⁵ *Id.*

⁷⁶ *McCollum*, *supra*, note 71 at p. 847.

⁷⁷ *Id.*

⁷⁸ *Id.* at p. 850.

⁷⁹ *Id.* at p. 846.

⁸⁰ *Id.* at p. 847.

Judge Crouch concluded that “there is no legal obligation in the strict technical sense contended for by the defendants”.⁸¹ He then went on to explore whether corporations could have a legal obligation to indemnify their directors in the wider ‘equitable’ sense.⁸² He found that the case law on reimbursement of successful directors was scarce,⁸³ and cited a Yale Law Journal note⁸⁴ which posited that directors voluntarily assumed the risk of being sued when they agreed to act as directors.⁸⁵ Judge Crouch concluded that if a director could clearly demonstrate to the court that, in conducting his own defence, he brought some *definite benefit* to the corporation or otherwise conserved some substantial interest of the corporation, the court could authorize the reimbursement.⁸⁶ The fulcrum of Judge Crouch’s decision was that the corporation had not received any benefit from the expenditure. Judge Crouch was of the opinion that, because a derivative action is brought for the corporation’s benefit, a corporation only stands to benefit when the plaintiff wins. He concluded, “there was nothing to show that any interest of the corporation had been conserved or that the corporation had received any benefit from the expenditure, so that indemnification was unauthorized and illegal.”⁸⁷ Judge Crouch apparently reasoned that, since the directors were not liable, there was no recovery for the corporation and therefore, there could be no accompanying benefit to the corporation.⁸⁸ Although unstated, the essence of Judge Crouch’s position was that it would be up to the legislature or a higher court to fashion what he believed to be a new rule requiring indemnification for legal expenses incurred by directors in the successful defence of a derivative suit.⁸⁹

d) Reaction to *McCullum*: The Rise of Statutes Extending Indemnity Rights to Successfully Defended Derivative Actions

The financial environment in the 1930s made directors fearful of “blackmail suits”⁹⁰ by stakeholders. As noted by one commentator, “there seemed to be no action which a director could take that was not surrounded with the risk of financial loss, notoriety and all the annoyances possible from a long and bitterly fought law suit”.⁹¹ *McCullum* created a ‘Catch-22’ for directors seeking indemnity in the context of derivative lawsuits. If the director proved that he had not harmed the corporation and won the lawsuit, then no benefit would be seen as being conferred to the corporation because it would not collect a judgment from the director. Conversely, if the director lost the suit, then he had been adjudged to have violated his duty to the corporation and could not then show a benefit from his failed conduct.⁹² In describing the

⁸¹ *Id.* at p. 847.

⁸² *Id.*

⁸³ *Id.* at p. 848.

⁸⁴ Note, “Defence of Directors by Corporation Against Suit Brought in its Behalf”, 43 Yale L.J. 661 (1934).

⁸⁵ *Id.* at p. 663.

⁸⁶ *Id.* at p. 849.

⁸⁷ *McCullum*, *supra* note 71 at p. 849.

⁸⁸ Hanks & Scriggins, *supra* note 68 at p. 7.

⁸⁹ *Id.* at p. 8.

⁹⁰ Generally speaking, the term “blackmail suit”, also referred to as a “strike suit” or “hold-up suit”, referred to a derivative suit brought primarily for its nuisance value by a small shareholder whose interest in the corporation is insignificant. Knowing that the cost of defending such a suit is high, the shareholder sued in the hope of attaining a private settlement, and with no intention of benefiting the corporation on whose behalf the suit was theoretically brought See Henn & Alexander, *The Law of Corporations* § 358 (3d ed. 1983).

⁹¹ Hanks & Scriggins, *supra* note 68 at p. 12; Bates & Zuckert, *supra* note 69 at p. 265.

⁹² Mazur, *supra* note 38.

state of the law at the time, one author observed that the *McCollum* decision turned “into hopeless confusion a field of law where ample bewilderment already existed.”⁹³

The reaction to *McCollum* was, first, a spate of bylaws which empowered corporations to indemnify their directors for legal expenses incurred in successfully defended derivative actions⁹⁴ and shortly thereafter, the enactment of state legislation authorizing the same. In 1941, New York became the first state to enact a statutory indemnification clause: s.27-a⁹⁵ of the General Corporation Law (“GCL”). The wording of this clause is so substantially similar to that of the Canadian indemnity provision then in existence⁹⁶ that it must have served as a template for New York’s provision. Yet the Canadian codification was intended to *limit* what was perceived as overly broad attempts by corporations to indemnify their directors, whereas New York’s legislature intended its statutory provision to deal with the problem immediately confronting it - to assure directors of a right to be indemnified for the costs of successfully defending a derivative action.⁹⁷ Section 27-a was intended to reverse the holding of the *McCollum* case and nothing more.⁹⁸ Thus the law of indemnification in the United States was developed specifically to deal with derivative actions.

The New York drafters did seem to recognize that all of their indemnity problems could not be solved by simply importing a foreign indemnity clause into their GCL.⁹⁹ Thus, New York made a substantive addition to section 27-a, setting out that indemnification would “*not* be deemed exclusive of any other rights to which those indemnified may be entitled, under any by-

⁹³ Hanks & Scriggins, *supra* note 68 at p. 12; Bates & Zuckert, *supra* note 69 at p. 246. As stated by Professor Joseph Bishop, one of the foremost authorities on the issue of indemnification: “The decision was nonsense. A corporation will practically never benefit directly from defeating its’ own cause of action. It is hard to think of cases in which it would. But what the court didn’t understand was that the benefit to the corporation comes from inducing valuable executives to serve it by promising them protection against unjustified litigation. It is like paying them their salary....But the judge didn’t see that. New York was stuck with the so-called “benefit rule”, that a corporation had no power to indemnify individual executives, no matter how innocent they were, unless there is some direct benefit to the corporation”. Bishop (1965), *supra* note 31, p. 839.

⁹⁴ Bates & Zuckert, *supra* note 69; Hanks & Scriggins, *supra* note 68, p. 12.

⁹⁵ Law of April 2, 1941, ch. 209, § 1 [1941] N.Y. Laws 164th Sess. 813. Section 27(a), ch.209, 1941 N.Y. Laws 813, gave corporations the power to grant indemnification rights to their directors through a certificate of incorporation, bylaw or resolution, except no indemnification could be made to a director adjudged liable for negligence or misconduct. Section 27-a states: The certificate of incorporation...or the bylaws...or a resolution in a specific case...may provide that each director of the corporation shall be indemnified by the corporation against expenses actually and necessarily incurred by him in connection with the defence of any action, suit or proceeding in which is made a party to by reason of his being or having been a director of the corporation, except in relation to matters as to which he shall be adjudged in such action suit or proceeding to be liable for negligence or misconduct in the performance of his duties as such director... (Act of April 2, 1941).

⁹⁶ *E.g.*, Companies Act, R.S.C. 1927, c. C.27. Section 107 provides: “Every director of the company...may, with the consent of the company, may...be indemnified and saved harmless out of the funds of the company against; (a) all costs, charges and expenses whatsoever which such director sustains or incurs in or about any action, suit or proceeding which is brought, commenced or prosecuted against him, for or in respect of any act, deed, matter or thing whatsoever, made, done or permitted by him, in or about the execution of his duties of office; (b) all other costs, charges and expenses which he sustains, or incurs, in or about or in relation to the affairs thereof, except such costs, charges or expenses as are occasioned by his own willful neglect or default.”

⁹⁷ Notes, *supra* note 32 at pp. 1406-7.

⁹⁸ Mazur, *supra* note 38 at p. 207.

⁹⁹ Notes, *supra* note 32 at pp. 1406-7. Del. Code Ann. tit. 8, §122(1) (1943); N.Y. Laws, ch. 231 (1941), s. 27(a).

law, agreement, vote of stockholders, or otherwise”.¹⁰⁰ The New York draftsmen believed that their courts would be guided by public policy considerations in deciding whether to enforce an indemnification contract or bylaw that extended beyond a statute’s scope.¹⁰¹ This type of catch-all phrase, known as a “non-exclusivity” clause, has become standard in statutory indemnity provisions in the United States although they are not seen in Canada.

Shortly after enacting section 27-a, New York enacted section 61-a,¹⁰² a procedural clause that buttressed section 27-a by endowing courts with the discretion to assess a director’s expenses in a successful derivative action as ‘special costs’ against the corporation. It was in New York’s section 61-a that the origins of a derivative suit being described as an action “*by the corporation, or in the right of the corporation*” first appeared.¹⁰³

61(a) In any action, suit or proceeding, against one or more officers or directors...*brought by the corporation, or brought by or on behalf of one or more stockholders...*, the reasonable expenses, including attorneys [sic] fees, of any party plaintiff or party defendant incurred in connection with the successful prosecution or defense of such action, suit or proceeding shall be assessed upon the corporation...¹⁰⁴

Although section 61-a specifically referred to actions “*brought by the corporation,*” this wording is misleading and imprecise because the New York legislature did not actually include direct actions by a corporation against its directors. This is evidenced not only by the purpose of the clause itself, but also by the official commentary and judicial interpretation.¹⁰⁵ First, as Professor Mazur has noted, the purpose of section 61-a, in and of itself, precluded any application to direct actions by a corporation. “Any party plaintiff or party defendant” was permitted to recover expenses from the corporation, as assessed by a court. The term “party plaintiff” could only refer to a *derivative* stakeholder since the “party plaintiff” in a *direct* action will be the corporation. The section could not refer to direct actions, because there would be no reason for a court to assess a corporation’s costs against itself. Notwithstanding the reference to

¹⁰⁰ Del. Code Ann. tit. 8, §122(1) (1943); N.Y. Laws, ch. 231 (1941), s. 27(a).

¹⁰¹ See, for example, Bishop, J. “Sitting Ducks and Decoys: New Trends in the Indemnification of Corporate Directors and Officers”, 77 Yale L.J. 1078 (1968). As stated by Oosterle, D.A., “Limits on a Corporation’s Protection of its Directors and Officers From Personal Liability”, (1983) Wis. L. Rev. 513 at 539: “[T]he statutes establish a minimum permissible level of indemnification and allow courts to expand that level if they are so inclined. The draftsmen thus attempted to cut off budding restrictive judicial precedent while saving whatever liberal treatments could be coaxed out of the courts”. In the interim, a number of courts had rejected the reasoning in *McCollum* and abandoned the benefit theory, based upon the same public policy considerations as was intended the statutory provisions. For example, the New Jersey court in *Solimine v. Hollander* 129 N.J. Eq. 246, 19 A.2d. 344 (Ch. 1941) and the Supreme Court of Minnesota in *In re Dissolution of E.C. Warner Co*, 232 Minn. 207, 45 N.W.2d, 388 (1950) emphasized that the directors’ successful defences had aided the corporation by defending the “corporate image” and retaining in office the chosen representatives of the shareholders. Recognition was also given to the necessity for insulating directors from the risk of sizable litigation expenses if the corporation were to attract qualified persons. Moreover, a public purpose was thought to be served by indemnification, particular emphasis being placed on encouraging directors to contest “strike suits” brought for the sole purpose of coercing settlements.

¹⁰² Law of April 14, 1941, ch. 350, § 1 [1941] N.Y. Laws 164th Sess. 1034 (repealed 1945).

¹⁰³ Mazur, *supra* note 38 at p. 207.

¹⁰⁴ Section 61-a of the New York General Law, ch. 350, 1941 N.Y. Laws 1034 (Act of April 14, 1941). (emphasis added).

¹⁰⁵ Mazur, *supra* note 38 at p. 207.

actions “*by a corporation*”, direct suits by the corporation against its directors were not contemplated.¹⁰⁶

That the legislature did not intend these laws to protect directors sued directly by their corporations is further evidenced by the amendments to New York’s indemnity provisions four years later.¹⁰⁷ In 1945, pursuant to recommendations by New York’s Law Revision Commission, the phrase “*brought by the corporation or brought on its behalf*” in section 61-a was replaced with the words “*action suit or proceeding*” (a phrase that was first utilized in Canada’s *Joint Stock Companies Act, 1877*).¹⁰⁸ Since New York’s section 27-a used the phrase “*action, suit or proceeding*”, the Law Revision Commission proposed that the wording in section 27-a and 61-a be made consistent. These sections were renumbered as sections 63 and 64 of the GCL. The Commission proposed that former section 61-a be expanded to set up better procedural machinery for enforcing reimbursement by a corporation of litigation expenses of its directors and officers in derivative actions. These new clauses dealing with the procedural aspects of indemnification were inserted as sections numbered 65, 66, 67 and 68.¹⁰⁹ The 1945 amendments were codified as a new “Article 6A” of New York’s general company law. Article 6A was inserted as an addendum to the section of company law dealing solely with derivative suits, “Article 6.”¹¹⁰

Notwithstanding that “*action, suit or proceeding*” is seemingly broader than the wording of the former section 61-a, “*brought by the corporation or brought on its behalf*”, the New York legislature did not intend the change to extend the scope of the new Article 6A beyond *derivative* actions.¹¹¹ The official commentary to the GCL stated that “[a]ll essential provisions of section 61-a which regulate the granting of allowances in actions *brought on behalf of a corporation* are incorporated in new sections 64 - 67, inclusive...”,¹¹² and further, that :

This section embodies the essential provisions of the present section 61-a providing for the assessment of certain litigation expenses as “special costs” of a *derivative action* in so far as that section applies to defendant officers and directors. It broadens the scope of that section in several respects in order to make it consistent with section 27-a, amended and renumbered as section 63 by these amendments.¹¹³

The New York courts concluded that the phrase “*by or on behalf of a corporation*” refers only to *derivative* actions.¹¹⁴ In *Schwartz v. General Aniline & Film Corp.*,¹¹⁵ the New York Court of Appeal was asked to determine whether the Article extended indemnity rights to directors charged by the government with criminal antitrust violations. The court held that indemnification provisions under Article 6A could not encompass the costs of a criminal

¹⁰⁶ *Id.* at p. 207.

¹⁰⁷ *Id.* at p. 208.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Schwartz v. General Aniline & Film Corp.*, 113 N.E.2d 533 (N.Y. 1953) [“*Schwartz*”], at p. 536.

¹¹¹ Mazur, *supra* note 38 at p. 208.

¹¹² *Id.* at p. 208. Act of April 18, 1945, ch. 869, 1945 N.Y. Laws 1971 (emphasis added).

¹¹³ Act of April 18, 1945, *Id.* at 1973 (emphasis added).

¹¹⁴ *Id.*

¹¹⁵ *Schwartz*, *supra* note 110.

defence. The court reviewed the history of New York's indemnity legislation and affirmed that the provisions were adopted in response to *McCullum*, a derivative suit, and were only intended to cover derivative suits. Article 6-A was a supplement to Article 6, which authorized derivative suits, so that the two articles were required to be considered in conjunction.¹¹⁶ In *Schwartz*, suits brought "by or on behalf of a corporation" referred to derivative suits under New York's Article 6. No expanded scope was intended from the wording "by".¹¹⁷

The *Schwartz* court speculated as to why the legislature used the term "*action, suit or proceeding*" in the former section 27-a and in amended sections 63 and 64 if it did not mean *all* actions, suits or proceedings instead of just derivative actions. The court concluded that, although the legislature was only considering derivative suits, the phrase "*any action suit or proceeding*" was intended to cover all procedural bases for bringing derivative suits.¹¹⁸

Notwithstanding the original reference to actions "*by the corporation*" in New York's indemnity law, there is substantial evidence that direct actions by the corporation were not contemplated: first, the fact that New York's indemnity provisions were enacted specifically to deal with the problem of *McCullum*, a derivative action; second, the fact that the purpose of the clause in which that wording arose could not apply to direct actions in any event; third the nature of the subsequent amendments and commentary to the GCL, which speak to the fact that "*by the corporation*" referred only to derivative actions, not to direct actions by the corporation against its directors; and fourth, the fact that the reasoning of New York's judiciary is consistent with this conclusion.

In 1943, two years after the enactment of New York's original indemnification statute, Delaware adopted its first statute authorizing corporations to indemnify directors for successful derivative actions. It was modeled on the New York indemnification provisions and included the phrase "*action, suit or proceeding*".¹¹⁹ In 1946, the Committee on Corporate Law submitted a "Draft of Suggested Form of Business Corporation Act" which it posited could be helpful to the states in amending their various business corporation laws.¹²⁰ Four years later, in 1950, the Committee presented its first version of the Model Business Corporations Act ("MBCA").¹²¹ Section 3, dealing with indemnity, had been heavily influenced by the 1943 Delaware statute,¹²² which had in turn been influenced by New York's statute. Each of them purported to indemnify directors for expenses in defending an "*action suit or proceeding*" as a result of his service to the corporation, absent a judgment of negligence or misconduct. Thus, the first statutory indemnification schemes appearing in the United States, including that of New York, Delaware and the MBCA were all intended to assure indemnification exclusively for directors sued in *derivative* actions, and who were not held liable for negligence or misconduct.

¹¹⁶ *Id.* at p. 535.

¹¹⁷ Mazur, *supra* note 38 at p. 208.

¹¹⁸ *Schwartz*, *supra* note 113.

¹¹⁹ 44 Del. Laws ch. 125 (1943), s. 122(1)

See also Arsht, S.S. "Indemnification Under Section 145 of the Delaware General Corporation Law", 3 Del. J. Corp. L. 176 (1978); Hanks & Scriggins, *supra* note 68 at p. 14.

¹²⁰ Hanks & Scriggins, *Id.* at p. 15.

¹²¹ Model Business Corporations Act (Revised), 6 Bus. Law. 1 app. (1950); *Id.*

¹²² Hanks & Scriggins, *supra* note 68 at p. 15.

e) **The Rise of Statutes Expressly Extending Indemnity Rights to Actions Brought by Third Parties**

The state statutes were intended only to address indemnification in derivative actions; they did not settle questions about the propriety of indemnification in third-party proceedings.¹²³ Although there were good policy reasons to deny indemnity in derivative actions where directors were found to breach a duty to the corporation, in proceedings brought against a director by the government or by private third parties the question of whether a director had properly discharged his duty to the *corporation* was usually not in issue. Actions brought by third parties might not be based on any wrongdoing to the corporation at all, but rather on something which the director may have done on the corporation's behalf or for its benefit, but which was alleged to have harmed a third party.¹²⁴ In such cases, the issue of whether the director was found liable for negligence or misconduct to the third party would not trigger the same policy concerns.¹²⁵ Yet, there was a general concern that the broad reference to the "*action, suit or proceeding*" used in most state indemnity statutes might nonetheless be interpreted by courts to include actions by third parties, thereby limiting a corporation's ability to indemnify its directors in those cases, based on the overly-restrictive statutory criteria intended specifically for derivative suits.¹²⁶

In 1961, in response to these concerns, New York revamped its statutory indemnification scheme to deal expressly with actions brought against directors by third parties, by standards that were different and more lenient than in the case of derivative suits.¹²⁷ Sections 63 through 68, comprising Article 6A of New York's GCL were renumbered once again as sections 721 through 727. These amendments revived the clumsy reference to a derivative action first seen in the old section 61-a, and which persists in modern Canadian indemnification legislation. Section 722 addressed indemnification where a director was faced with a derivative action, which the statute referred to as an action "*by or in the right of the corporation.*" As noted by the official comment to section 722: "[t]his section is a substantial re-enactment of General Corporation Law §63, modified to the extent that it has been made applicable to *derivative actions only*".¹²⁸ Under this section, a corporation could not indemnify a director who had been adjudged liable to his corporation in a derivative suit, either for legal expenses or for the amount of the judgment.¹²⁹

Section 723 dealt with actions brought by the government or third parties, referred to as actions "*other than one[s] by or in the right of the corporation.*"¹³⁰ The only requirement for indemnification in third party suits was the finding by the director that the corporation acted in good faith and in the corporation's best interests. The more lenient standard for indemnification in third-party suits was justified by the legislature on the basis that the director had not breached

¹²³ Notes, *supra* note 32 at p. 1403.

¹²⁴ Tomlinson, *supra* note 54.

¹²⁵ As noted by Bishop, J., "Current Status of Corporate Directors' Right to Indemnification", 69 Harv. Law. Rev. 1057 (1956) at p. 1058. See also Notes, *supra* note 33 at p. 1403.

¹²⁶ Bishop, *Id.* at p. 1073; Notes; Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation", 76 Harvard L.R., 1403 (1963) at p. 1403.

¹²⁷ N.Y. Bus. Corp. Law §§ 721-27 (McKinney 1963).

¹²⁸ *Id.*, §723 CMT.

¹²⁹ Mazur, *supra* note 38 at p. 211, fn. 55.

¹³⁰ N.Y. Bus. Corp. Law, *supra* note 127 §§ 721-27.

any fiduciary duty owed to his corporation.¹³¹ As explained by the official comment to section 723:

The purpose of this section is to codify the common law principle that directors or officers are reimbursable by the corporation for expenses incurred and amounts paid in defense of actions or proceedings *other than derivative actions*...In contrast with indemnification in *derivative actions*, indemnification is permissible under this section for expenses incurred and amounts paid in settling threatened as well as pending *non-derivative actions* or proceedings.¹³²

In addition to sections 722 and 723, the revisions to the New York statutory scheme in 1961 included other sections dealing with the procedural aspects of indemnification rights.¹³³ In 1967, the drafters of the Delaware corporation law and the Committee on Corporate Laws, joined together, using at least one common drafter, to revise their indemnification provisions by using the New York model as a guide.¹³⁴ After the collaboration, the Delaware indemnification provisions and the MBCA were almost identical.¹³⁵ Like the New York statutes, both the Delaware statute and the MBCA granted indemnification rights in two general categories of litigation, derivative suits and third party suits. As a result, almost every indemnification statute in the United States, whether modeled on the indemnity law from New York, Delaware or the MBCA, ultimately is rooted in the New York model.¹³⁶ The phrase “*by or in the right of the corporation*” found its way into the indemnification statutes of forty-six of the fifty states.¹³⁷ Both Delaware and the MBCA copied the phrase verbatim from the 1961 New York sections 722 and 723, even though they, like New York, never intended that indemnification rights apply to suits actually brought directly *by* a corporation against a director for breach of fiduciary duty.¹³⁸

In the more than 50 years since the enactment of the original New York indemnification statute, not one reported decision considered whether direct actions by the corporation had been contemplated by the statute,¹³⁹ and only one law review article addressed the issue. The article was written by a student in 1971, who concluded that director suits were within the scope of the New York indemnification statute based entirely on the word “*by*” in “*by or in the right of the corporation*”. Instead of questioning the precision of this phrase in light of the legislative history

¹³¹ Cheek, J.H. “Control of Corporate Indemnification: A Proposed Statute”, 22 Vand. L. Rev. 255 (1969) at p. 278; Bishop, *supra* note 125 at p. 1073.

¹³² N.Y. Bus. Corp. Law, *supra* note 127, §723 cmt. (emphasis added).

¹³³ Mazur, *supra* note 38.

¹³⁴ Hanks & Scriggins, *supra* note 68 at p. 16; Mazur, *Id.* at p. 212.

¹³⁵ Hanks & Scriggins, *Id.* at p. 17; Mazur, *Id.*

¹³⁶ Mazur, *Id.*

¹³⁷ See Bishop, J., “The Law of Corporate Officers and Directors: Indemnification and Insurance”, §§6.08-.58 (1981 & Supp. 1992); Mazur, *Id.*

¹³⁸ Mazur, *Id.* As noted by the author, there is no indication that the drafters ever intended the acts to apply to direct suits by the corporation. The official comments to the MBCA repeatedly refer to subsection (b) – suits “*by or in the right of the corporation*” – only in terms of derivative actions: “[S]ubsection (a) deals with third party suits; subsection (b) with derivative actions...Under (b), which pertains to derivative actions, indemnification is permitted only for expenses...A new standard of conduct is applicable both in third party suits and in respect of derivative actions...In respect of a derivative action it is provided in subsection (b)...”, Model Business Corp. Act § 5 cmt. (1969).

¹³⁹ Mazur, *Id.* at p. 214.

and official comment, the author took the phrase at face value and decided that the official comment must have been misguided and incorrect.¹⁴⁰

f) Changes to Canada’s Federal Indemnification Laws: Section 124 of the CBCA

Throughout the development of indemnification statutes in the United States, Canada’s indemnity legislation persisted in the form first enacted in the Joint Stock Companies Act, 1877.¹⁴¹ In 1974, a three-man committee led by Robert Dickerson recommended an overhaul of Canada’s corporation law.¹⁴² Dickerson’s committee proposed a Draft Act that radically changed Canadian company law by following the enabling philosophy behind the company law of New York, Delaware and the MBCA.¹⁴³ Among the committee’s numerous proposed changes were indemnity provisions and the creation of a statutory derivative action along American lines.¹⁴⁴ Dickerson acknowledged that his amendments were “much influenced by the New York model”,¹⁴⁵ on the basis that:

[p]robably the most comprehensive statutory provisions are those set out in ss. 721 and 726 of the New York Business Corporation Law. In addition to being far more detailed than English and Canadian law, they create an exclusive regime that applies to every New York business corporation irrespective of any other provisions contained in the corporation’s articles or by-laws.¹⁴⁶

Dickerson’s proposed indemnity statute closely followed the New York regime in particular, distinguishing between derivative actions, which he referred to as actions “*by or on behalf of the corporation*”, and third party actions.¹⁴⁷ There is no suggestion in Dickerson’s report that direct actions were contemplated by the wording “*by...the corporation*”. With respect to indemnification for derivative actions, his report states:

Subsection (2), which refers to a *derivative action in the name of the corporation* against its directors and officers, sets up several tests in addition to the general standards of subsection (1). Note that indemnification here does not include amounts paid to settle an action or to satisfy a judgment. The implied premise of this subsection is that if a *derivative action* in the name of the corporation has been brought against a director or officer, he has probably not been acting in the interests of the corporation and therefore his conduct should be more closely scrutinized. This is particularly true in respect of settlements of actions where directors, having in their own interests profited from dealings that were prejudicial to the corporation, then seek indemnity from the corporation because they are compelled to settle a *derivative action* alleging that

¹⁴⁰ Mazur, *Id.*; Comment, *supra* note 37.

¹⁴¹ See, e.g., The Companies Act, 1902, 2 Ed. II, c. 15, s. 67; The Companies Act, R.S.C. 1906, C. 79, s. 79; Companies Act, R.S.C. 1952, c. 33, s. 92; Canada Corporations Act, R.S.C. 1970, c. C. 32, s. 93;

¹⁴² Dickerson, *supra* note 10.

¹⁴³ Committee Law Review Steering Group, “Modern Company Law for a Competitive Economy: The Strategic Framework”, *Consultation Document* (February 1999, UK) at p. 24, para. 4.3. [“Committee Law Review”].

¹⁴⁴ *Id.* at p. 25, para. 4.5.

¹⁴⁵ Dickerson, *supra* note 10, p. 82 at para. 244.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*, p. 84 at paras. 246-47.

misconduct, a practice that has appropriately been castigated as “double looting” in some U.S. jurisdictions. Subsection (2) also requires court approval as a pre-condition to payment.¹⁴⁸

The federal government closely followed Dickerson’s recommendations with respect to s. 124 of the CBCA¹⁴⁹, first enacted in 1975.¹⁵⁰ The original subsection 124(1) endowed corporations with the general authority to indemnify a director for all reasonable “costs, charges and expenses, including amounts paid to settle an action or satisfy a judgment” in respect of any “civil, criminal or administrative action or proceeding” to which the director was made a party by reason of his being a director, so long as “he acted honestly and in good faith with a view to the best interests of the corporation”, and in the case of a criminal or administrative proceeding, “he had reasonable grounds to believe that his conduct was lawful.”¹⁵¹ A separate category dealing specifically with indemnification in derivative actions was prescribed in subsection 124(2), under the caption “*Indemnification in derivative actions*”, with the text referring to the derivative proceeding “*by or on behalf of the corporation*” in the same manner as in the US state legislation.¹⁵² This phrase has continued through to the current version in s. 124(4). The plain language of the statute may be interpreted in a manner almost “perfectly opposed to almost every indication of what the language was intended to mean”.¹⁵³ Contrary to its apparent meaning, the phrase “*by or in the right of the corporation*” in section 124(4) of the CBCA was never intended to include a direct suit brought by a corporation against its directors for breach of their fiduciary duty.

g) Canadian Judicial Interpretation of the Phrase “*By or In the Right of the Corporation*”

The words of an Act “are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament.”¹⁵⁴ Upon determining the “ordinary meaning”¹⁵⁵ of the words, the court must go

¹⁴⁸ *Id.* at para. 244 (emphasis added).

¹⁴⁹ CBCA (1975), *supra* note 59, s. 124.

¹⁵⁰ Committee Law Review, *supra* note 143 at p. 24, para. 4.3.

¹⁵¹ CBCA (1975) *supra* note 59, s. 124(1) provides: “Except in respect of an action by or on behalf of the corporation or body corporate to procure a judgment in its favour, a corporation may indemnify a director or officer of the corporation...against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by him in respect of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of such corporation or body corporate, if

(a) he acted honestly and in good faith with a view to the best interests of the corporation; and

(b) in the case of a criminal or administrative proceeding that is enforced by a monetary penalty, he had reasonable grounds for believing that his conduct was lawful.”

¹⁵² *Id.*, s. 124(2), which states: “A corporation may, with the approval of a court indemnify a person referred to in subsection (1) in respect of an action by or on behalf of the corporation or body corporate to procure a judgment in its favour, to which he is made a party by reason of being or having been a director or officer of a corporation or body corporate, against all costs, charges and expenses reasonably incurred by him in connection with such action if he fulfils the conditions set out in paragraph (1)(a) and (b).

¹⁵³ Mazur, *supra* note 38 at p. 215.

¹⁵⁴ *York Condominium Corp. No. 382 v. Jay-M Holdings Ltd.*, [2007] O.J. No. 240 at para. 2 (Ont. C.A.) [“*Jay-M*”]. *per* K.M. Weiler, J.A., citing Driedger, E.A., *The Construction of Statutes*, 2nd ed. (Toronto: Butterworths, 1983) at 87. The Court further notes, at para. 2, that this approach has been widely endorsed by the

on to consider the context of the provision, the purpose and scheme of the legislation as well as the consequences of adopting the ordinary meaning and any other relevant indicators of legislative meaning.¹⁵⁶ As noted by Weiler J.A. of the Ontario Court of Appeal, speaking for the Court:

Having determined the ordinary meaning, the court must adopt an interpretation that best fulfils the objects of the legislation...Having regard to this broader context, the court may modify or reject the application of the presumption that favours an interpretation in accordance with the ordinary meaning. However, the interpretation adopted must be plausible in the sense that it is one that the words are reasonably capable of bearing.¹⁵⁷

Case law on the CBCA's indemnity provisions is sparse. Only one case in Canada has considered the application of the indemnity provisions of the CBCA to a direct action. In *Amirault v. Westminer Canada Holdings Ltd.*,¹⁵⁸ an Australian mining company, the Western Mining Company ("WMC"), took over a Nova Scotia gold mining company, Seabright, based on reports about ore mining prospects. After the closing date for the acquisition of Seabright, it was discovered that the ore was of too low a grade to support a mine.¹⁵⁹ WMC and Seabright brought an action in Ontario against Seabright's former directors on the basis of fraud, conspiracy, breach of duty, negligence, negligent misrepresentation, and insider trading. After receiving the statement of claim, the directors made it known that they were seeking funding arising out of Seabright's indemnity by-laws and insurance. Before any defences were filed in that action, WMC and Seabright amended their statement of claim against the directors by removing all allegations of negligence and substituting allegations of willful misrepresentation in an effort to eliminate any opportunity for funding. The former directors countered with their own actions in Nova Scotia, claiming damages for Seabright's refusal to indemnify them for losses resulting from the claim against them under Seabright's by-laws.¹⁶⁰ As a defence, the mining companies averred dishonesty on the part of the directors and attached the statement of claim from their Ontario action.¹⁶¹

At the trial of the indemnity action in Nova Scotia, the judge concluded that the Ontario action brought by the mining companies against the former directors was entirely unfounded, and had been commenced solely for the purpose of causing injury to the directors and to detract attention from the failed mining investment.¹⁶² The court found that the WMC set out deliberately and intentionally to "crush" the directors; the mining companies acted together in concert for the predominant purpose of causing them injury.¹⁶³ The trial judge found the mining

Supreme Court. See *Bell ExpressVu Limited Partnership v. Rex*, [2002] 2 S.C.R. 559 at para. 26 ["Bell"]. Note that the interpretative factors set out by Driedger need not be canvassed separately in every case: *Bell* at para. 31.

¹⁵⁵ The ordinary meaning of legislation has been judicially defined as "the natural meaning which appears when the provision is simply read through: *Canadian Pacific Airlines v. Canadian Air Line Pilots Assn.*, [1993] 3 S.C.R. 724 at 735.

¹⁵⁶ *Bell supra*, note 154 at paras 29-30.

¹⁵⁷ *Jay-M, supra* note 154 at paras. 13-14.

¹⁵⁸ [1994] N.S.J. No. 12 (N.C.C.A.), *aff'g* [1993] N.S.J. No. 129 (N.S.S.C.). ["*Amirault*"].

¹⁵⁹ *Id.* (C.A.) at para. 11.

¹⁶⁰ *Id.* at paras. 14-15.

¹⁶¹ *Id.* at para. 16.

¹⁶² *Supra*, note 158 (S.C.), p. 114 of 125.

¹⁶³ *Id.* at, p. 115 of 125.

companies liable for the tort of conspiracy in addition to being liable to the directors for indemnity.¹⁶⁴ Only one short paragraph of the judge's 125 page decision was devoted to the issue of whether section 124 of the CBCA permitted indemnification of the directors in the context of actions brought against them directly by their corporation:

[S]ection 124 excepts actions by the corporation itself against former directors while the by-law does not. However, again there is another plaintiff besides the corporation and in my view that guarantees the application of the indemnity corporations to the favor of the plaintiff.¹⁶⁵

The judge thus implicitly but without discussion regarded direct actions by the corporation as falling within the subsection dealing with derivative actions. The judge further concluded that the fact that one of the plaintiffs to the Ontario action was WMC, a third party, was sufficient to negate the statutory restrictions applied to indemnity in the case of derivative actions. This decision was upheld on appeal without any further consideration of s. 124.¹⁶⁶

4. POLICY RATIONALE FOR DIFFERENT TREATMENT OF DIRECT AND DERIVATIVE ACTIONS: ADVANCEMENT OF DEFENCE COSTS

a) Advancement of defence costs under s. 124(4) of the CBCA

At first glance, the similarities between direct and derivative suits may appear to provide justification for treating these actions identically with respect to subsection 124(4). Both types of suits are intended to benefit the corporation, and if the actions are successful, the judgment is paid to the corporation directly.¹⁶⁷ Yet, if courts are to interpret “by or in the right of the corporation” to include direct suits, the question of whether expense advances are appropriate in that context must be considered.¹⁶⁸ With respect to derivative suits and third party suits the interests of the corporation's management are, for the most part, aligned. However, these considerations clearly do not apply to direct suits:

Perhaps a better way to look at indemnification rights is in terms of “us” and “them”. Corporate management is “us”; anyone outside management is “them”. From the time of the first indemnification statutes, corporations have looked for ways to insulate their directors from suits by “them”. Third-party suits are clearly brought by “them,” persons outside management. To a public corporation, *every* shareholder derivative suit is a strike suit, a nuisance, and something to get rid of. Indemnification is the system of statutory rights designed to discourage suits by outsiders and to help the corporation defeat them if they are brought.¹⁶⁹

¹⁶⁴

Id.

¹⁶⁵

Id. at p. 111 of 125.

¹⁶⁶

Supra, note 159 (C.A.).

¹⁶⁷

Mazur, *supra* note 38 at p. 215.

¹⁶⁸

Id.

¹⁶⁹

Id.

One of the primary goals of indemnification is to encourage competent people to serve as directors. A policy goal of indemnification is to “promote the desirable end that corporate officials will resist what they consider to be unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation they have served if they are vindicated”.¹⁷⁰ A corporation’s definition of “unjustified suits and claims” does not contemplate the corporation’s *own* direct suits and claims. Derivative suits, which are brought by corporate stakeholders, and direct suits brought by the corporation itself, are fundamentally different. Only in direct suits are the corporation and its management true adversaries.¹⁷¹ Since directors will stipulate the indemnification rights to which they are entitled and their interest is to maximize indemnification in all possible circumstances, the tendency is for corporations to adopt unconditional and mandatory advancement rights.¹⁷² The typical corporate indemnification by-law purports to endow directors with indemnification and advancement rights “to the maximum extent permitted by law”.¹⁷³ It is therefore up to the courts and legislature to set appropriate policy limits on indemnification.¹⁷⁴

While indemnification and advancement are closely related concepts, they are not identical. Advancement often works in concert with indemnification, but unlike indemnification, advanced funds are “contingent” funds. “[A]dvancement can be thought of as an extension of credit, the final repayment of which is conditioned on whether a corporate official is ultimately entitled to indemnification”.¹⁷⁵ Since advanced funds are necessarily forwarded to a director before the outcome of litigation is known, a director is required to repay advanced amounts if it is ultimately determined that he or she has not met the standard of conduct required for indemnification in connection with the proceeding.¹⁷⁶

Prior to 2001, s.124 of the CBCA did not expressly permit corporations to advance defence costs to their directors before the outcome of litigation was known, although the issue of whether a corporation could nonetheless do so was considered in two cases involving federal

¹⁷⁰ *Id.* at p. 216.

¹⁷¹ *Id.*

¹⁷² Bishop, J., *supra* note 101 at p. 1079: “With a few honorable exceptions, the object of the draftsmen of the first generation of by-laws seemed to be to virtually immunize management from personal liability. The most brazen of these older by-laws purported to permit executives adjudged guilty of breaching their duty to the corporation to be indemnified not only for their counsel fees but also for the very sums they had been ordered to pay the corporation. The recent trend amount sophisticated counsel has been to eschew such naively hoggish attempts to nullify the stockholder’s judicial remedy, which courts would in any case be likely to invalidate as against public policy.”

¹⁷³ Another way to describe this by-law is to say that it makes mandatory all indemnification that the statute permits but does not require. See, e.g., *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A. 2d. 138, 142 (Del. Sup. Ct. 1974).

¹⁷⁴ These legal boundaries were considered in the federal discussion paper on indemnification prepared in 1995: “Although the issue does not appear to have been judicially considered, most commentators have argued that the intention of the legislature in spite of the silence of the law is that CBCA indemnification provision is not exclusive. This would mean that a corporation may provide for indemnification of its directors and others through contracts, articles, bylaws, directors resolutions, etc. in situations which are not covered in s.124, but are not contrary to public policy nor prohibited by statute.” CBCA Discussion Paper, *supra* note 14, p. 36, para. 128.

¹⁷⁵ *Fasciana v. Elec. Data Sys. Corp.*, 829 A. 2d. 178 at 182-83 (Del.Ch. 2003).

¹⁷⁶ Pierce, M W., “Indemnification of Directors and Officers: Delaware and Tennessee”, 6 Transactions Tenn. J. Bus. L 395 (2005).

legislation. In *Canada Deposit Insurance Corporation v. Canadian Commercial Bank*¹⁷⁷ the liquidator of the Canadian Commercial Bank sued the bank's directors, officers and senior managers for various acts of negligence relating to the bank's management. The officers and senior managers sought full funding, in advance, of their litigation expenses, by relying on the indemnity provisions of the federal *Bank Act*, which indemnity provisions paralleled the CBCA. The Court of Appeal affirmed the decision of the trial judge, that "the right to indemnity was triggered by the result of the action",¹⁷⁸ so that the statutory indemnity provisions did not entitle the officers and managers to immediate funding.

In *Chromex Nickel Mines Ltd. v. British Columbia Securities Commission*,¹⁷⁹ the Securities Commission had begun hearings into the conduct of the President of Chromex. The company's Board of Directors passed a resolution that the President had, to its satisfaction, acted honestly and in good faith with a view to the best interests of the corporation and had reasonable grounds to believe that his conduct was lawful, thus fulfilling the CBCA's requirements for indemnification. The Board then sought a declaration that it was authorized to advance the President his legal expenses prior to the hearings' conclusion. Enrico J. held that the CBCA leaves the decision of compliance with the good faith requirements entirely up to the directors, who remain personally liable if they fail to ensure that those requirements are met, but that "[t]his does not suggest that they must await the outcome of the proceeding to grant indemnity, although it might be prudent for them to do so".¹⁸⁰ In holding that the Board could provide advance costs to the President, Enrico J. distinguished the *Canada Deposit* case on the basis that it applied only to derivative actions.¹⁸¹

The advancement of defence costs was considered in a 1995 federal discussion paper considering proposed amendments to s. 124. The discussion paper considered the competing policy considerations underlying advancement: "If the corporation will not provide advance funding, directors may find themselves unable to finance their own defence",¹⁸² and yet "the director should be required to satisfy from his or her personal assets not only any adverse judgment but also legal expenses incurred in connection with the proceeding. Any other rule could encourage socially undesirable conduct".¹⁸³ The discussion paper recognized that "*during the early stages of legal proceedings, neither the corporation nor the court is likely to be in a position to determine the ultimate propriety of indemnification.*"¹⁸⁴ The corporation should be able to extend funds to the director for his legal fees, subject to repayment if it was determined that he or she was ultimately disentitled to the funds. These conclusions instigated the most recent amendments to s. 124 of the CBCA, enacted on November 23, 2001. Subsection 124(2) expressly permits corporations to advance funds to their directors sued in third party actions to cover the director's legal costs. The advanced funds are only for the costs, charges and expenses of legal proceedings,¹⁸⁵ and must be repaid if the director ultimately does not satisfy the

¹⁷⁷ (1989), Alta. L.R. (2d) 194 (Alta. C.A.) [*"Canada Deposit"*].

¹⁷⁸ *Id.* at p. 202.

¹⁷⁹ [1991] B.C.J. No. 2347(B.C.S.C.) [*"Chromex"*].

¹⁸⁰ *Id.* at p. 9.

¹⁸¹ *Id.*

¹⁸² CBCA Discussion Paper, *supra* note 14 at p. 28, para. 96.

¹⁸³ *Id.* at p. 26, para. 91.

¹⁸⁴ *Id.* at, p. 28, para. 96 (emphasis added).

¹⁸⁵ CBCA, *supra* note 12, s. 124(2).

minimum standards of conduct. The obligation to repay need not be secured, nor is the corporation required to take into account the director's financial ability to repay before it begins to pay the director's legal bills.

With respect to derivative actions, advancement is permitted but under more restrictive conditions than apply in the case of third party actions. Section 124(4) states: "[a] corporation may with the approval of the court...advance moneys... in respect of an action by or on behalf of the corporation... if the individual [acts honestly in good faith with a view to the best interests of the corporation]"¹⁸⁶ Accordingly, two preconditions must be satisfied in order for a director to qualify for advancement of his defence costs in derivative actions. The first precondition is that of court approval. The second precondition is that the director must have acted honestly and in good faith with a view to the best interests of the corporation. On its face, this precondition creates a dilemma since, as noted above, the corporation will generally have an insufficient basis for determining whether a director has satisfied the statute's conduct requirements at the outset of litigation. This is the very reason that the statute requires repayment of the defence costs if the director is ultimately found to have breached his fiduciary obligations.

The solution to this dilemma may be found in *Blair v. Consolidated Enfield Corp.*¹⁸⁷ In that case, the Supreme Court of Canada considered a director's claim for indemnification of expenses incurred in defending a shareholder's derivative action. The director relied on the provisions of the OBCA mirroring those of s. 124, as well as a by-law enacted by the corporation that provided for mandatory indemnification if the director acted honestly and in good faith with a view to the best interests of the corporation. The Court stated:

What I do find persuasive is that *persons are assumed to act in good faith unless proven otherwise...*In this respect, contrary to the appellant's submissions before this Court, I believe that a proper construction of the statute and the law related to good faith issues reveals that [a director] is not required to prove his good faith, although he may certainly call evidence in this regard to counter evidence of bad faith adduced against him. To a large extent, the corporation must establish, to the satisfaction of the court, exactly what [the director] did that was inimical to its best interests.¹⁸⁸

In a derivative action, it is a *complainant* rather than the corporation directly, who is alleging that a director has committed a wrong. When a director brings an application for advance funding of his defence costs as soon as a derivative suit is filed, the corporation itself is unlikely to have cause to challenge the good faith presumption as described in *Blair* and thus, the propriety of the advancement.¹⁸⁹ The practical effect is that the precondition in s.124(4) that a director act honestly and in good faith in order to qualify for advancement is unlikely to present a significant obstacle for the director seeking advancement. The views of the corporation and the director regarding the advancement will, generally speaking, be aligned.¹⁹⁰

¹⁸⁶ *Id.* s. 124(4).

¹⁸⁷ *Blair, supra* note 8.

¹⁸⁸ *Id.* at para. 35 (emphasis added).

¹⁸⁹ *Id.*

¹⁹⁰ Mazur, *supra* note 38 at p. 238.

Conversely, where a corporation initiates a direct action against its director, it possesses evidence of directorial misconduct sufficient to prompt litigation against one of its own. Corporations probably did not intend their indemnification rights to apply where they believe that directors have lined their pockets at the expense of the corporation. The policy rationale underlying advancement, that a corporation lacks sufficient information to draw a conclusion about the director's conduct at the outset of litigation, is not applicable since the corporation has already had the opportunity to investigate the allegations in its own suit, and will not file suit unless it believes the allegations have merit.¹⁹¹ The corporation then will be of the opinion that the director is no longer entitled to the benefit of the doubt.¹⁹² The corporation would not wish to put itself in the highly undesirable position of financing its opponent's defence.¹⁹³ An unfaithful director who might otherwise have settled the action would be encouraged to litigate almost endlessly, thereby inflicting delay and expense on the corporation in order to defeat an otherwise meritorious claim.¹⁹⁴ Further, since the obligation to repay need not be secured, it is unlikely that the corporation would be able to recover the advanced funds if the director is ultimately disentitled to them.¹⁹⁵

!

On an action or application by a director seeking advancement, the corporation will be highly motivated to rebut any presumption that its director, whom it has chosen to sue, has somehow acted in good faith or in its best interests. The inevitable result will be a full-blown trial of the director's conduct at the advancement proceedings, superseding the corporation's direct action. This places the director in the position of plaintiff, since it is the director who will have the effective control over the forum and method of litigation. This was the result in *Amirault*,¹⁹⁶ where the plaintiff companies had initiated a direct action in Ontario against the directors, and the directors subsequently initiated an action for indemnity in Nova Scotia. Although *Amirault* was unusual in that the corporations' direct actions were found to have been initiated for an improper purpose, it nonetheless illustrates potential procedural complications that may arise in treating direct actions as falling within the scope of s. 124(4).¹⁹⁷ Effective control of the litigation is wrested from the corporation and placed in the hands of its opponent with no corresponding benefit to the director since he will have to litigate the issues raised in the main action to conclusion in the advancement proceeding, all without the benefit of the advancement. The benefit to the director of the advancement is undermined, since: "[t]he value of the right to advancement is that it is granted or denied while the underlying action is pending".¹⁹⁸

b) Advancement Rights in Other Jurisdictions: Lessons from Delaware

¹⁹¹

Id.

¹⁹²

Id.

¹⁹³

Id.

¹⁹⁴

Id.

¹⁹⁵

Id.

¹⁹⁶

Supra note 158.

¹⁹⁷

Id. (S.C.) at p. 112 of 125.

¹⁹⁸

Morgan v. Grace, No. Civ. A. 0430, 2003 WL 22461915, at p. 1 (Del. Ch. 2003) [*"Morgan"*].

Insight may be gleaned from other jurisdictions. Delaware removes any conduct requirement from provisions authorizing advancement to directors.¹⁹⁹ If a corporation has undertaken to provide its directors with mandatory advancement rights, those advancement provisions can be “enforced as a contract”²⁰⁰ in proceedings of a *summary* nature.²⁰¹ The rationale is articulated by Delaware’s Supreme Court as follows:

The express purpose of 8 *Del. C.* § 145, which provides advancement and indemnification rights to officers and directors, is to “promote the desirable end that corporate officials will resist what they consider unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation they have served if they are vindicated.”...Clearly to be of any value to the executive or director, advancement must be made promptly, otherwise its benefit is forever lost because the failure to advance fees affects the strategy that the executive or director will be able to afford. To [do otherwise] would be to allow [the corporation] to be derelict in its contractual protection of directors/officers to compromise their own litigation in the face of cost concerns, a result that is clearly against Delaware’s policy of resolving advancement issues as clearly as possible.²⁰²

As a result, “the scope of an advancement proceeding under Section 145(k)...is limited to determining ‘the issue of entitlement according to the corporation’s advancement provisions and not to issues regarding the movant’s alleged conduct in the underlying litigation.’”²⁰³ For this reason, most advancement proceedings take place by way of an application on a paper record; the detailed analysis required to evaluate a director’s conduct is seen as being both premature and inconsistent with the purpose of the summary proceeding.²⁰⁴ The method employed by Canada’s s. 124(4), of trying the issue of advancement “simultaneous with the trial of the same lawsuits for which the corporate official is seeking provisional payment of his litigation expenses” has been rejected on the basis that it “results in an unacceptable cost; the effective elimination of the separate right of advancement.”²⁰⁵

The difficulty created by Delaware’s summary method is that all evidence of whether indemnification will be permitted at the end of the case is “irrelevant” to the right to

¹⁹⁹ Del. Code. Ann. tit. 8 §§ 145(e) (1991): Expenses (including attorney’s fees) incurred by an officer or director in defending any civil, criminal, administrative or investigative action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the corporation as authorized in this section.

²⁰⁰ *Gentile v. SinglePoint Fin., Inc.*, 787 A. 2d 102, 106 (Del. Ch.), *aff’d*, 788 A. 2d 111 (Del. 2001). See also *In re Delta Holdings, Inc.*, No. Civ. A 18604, 2004 WL 1752857, at p. 7 (Del. Ch. July 26, 2004) [“*Gentile*”] stating that rights to advancement “contained in a mandatory, expansive indemnification provision, are present contractual rights”.

²⁰¹ Del. Code. Ann. tit. 8 §§ 145(k) (1991): “The Court of Chancery is hereby vested with exclusive jurisdiction to hear and determine all actions for advancement of expenses or indemnification brought under this section or under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise. The Court of Chancery may summarily determine a corporation’s obligation to advance expenses (including attorney’s fees).”

²⁰² *Homestore, Inc. v. Tafeen*, 886 A 2d 502 at p. 505 (Del. 2005), *aff’g* 888 A. 2d 204 (Del. 2005).

²⁰³ *Kaung v. Cole National Corp.* 884 A. 2d 500 at p. 509 (Del. 2005) quoting *Homestore, Id.* at p. 503.

²⁰⁴ *Homestore, Id.* at p. 510.

²⁰⁵ *Reddy v. Elec. Data Sys. Corp.* No. Civ. A 19467, 2002 WL 1358761, at p. 8 (Del. Ch. 2002).

advancement.²⁰⁶ Thus, charter, bylaw or indemnification provisions mandating advancement have been enforced in numerous cases brought directly by corporations against their former directors for breaches of fiduciary duty, fraud and the like, in cases where the corporation was confronted with very strong evidence of the director's malfeasance.²⁰⁷ As the courts of Delaware have explained, "[t]he public policy of Delaware is to allow advancement...even in cases in which...the claims are for breach of fiduciary duty,"²⁰⁸ the fact that a corporate officer "engaged in misconduct...has nothing to do with the agreement" to advance expenses,²⁰⁹ and any argument to the contrary "blurs the distinct purpose of advancement provisions".²¹⁰ As stated in *Reddy v. Electronic Data Systems Corp.*,²¹¹ "[b]y its own scrivener's hand, [the corporation] has bound itself to advance funds to [its director] so long as the [Delaware General Corporation Law] allows it to do so,"²¹² and "[h]aving been accorded the freedom to craft its bylaws as it wished, [the corporation] cannot point to its own drafting failures as a defence to [its director's] advancement claim."²¹³ This rationale has been heavily criticized by American scholars, particularly with regard to direct actions, as it incorrectly assumes that corporations will be motivated to exclude direct suits from indemnification coverage.²¹⁴

Under Delaware law, corporations are obliged to pay defence costs to faithless directors in any and all circumstances – throughout trial and appeal – even in cases where the corporation's claims for breach of fiduciary duty are well-founded, and no matter what the director's conduct. This situation has been described as "maddening"²¹⁵ to the courts and corporations who have concluded that former directors have committed wrongdoing that has injured the corporation and there is strong evidence that the director will be disentitled to indemnification at the end of the proceeding. Most troublesome, even if the corporation ultimately prevails, there is often no realistic chance that the director will have the assets to repay the amounts advanced to fund their defence.²¹⁶

²⁰⁶ *Citadel Holding Corp. v. Roven*, 603 A. 2d 818 at p. 822 (Del. 1992) ["*Citadel*"].

²⁰⁷ Radin, S. A. "Sinners Who Find Religion": Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing", 25 Rev. Litig. 251 (2006) at pp. 269-270. See, for example, *Citadel, Id.* (claim by a corporation that corporate officers engaged in unlawful trading of stock); *Greco v. Columbia/HCA Healthcare Corp.*, No. Civ. A. 16801, 1999 WL 1261446 (Del. Ch. 1999); *Dunlap v. Sunbeam Corp.*, No. Civ. A. 1261339 (Del. Ch. 1999) (claims against two former corporate officers who had been terminated by the corporation in connection with restatements of financial statements); *Gentile, supra* note 204 (claims brought by the corporation against a former officer and director who had been terminated by the corporation and removed by the board for breach of contract, breach of fiduciary duty and tortious interference with contract); *Radiancy, Inc. v. Azar*, No. Civ. A. 1547-N, 2006 WL 224059 (Del. Ch. 2003) (claims by the corporation alleging three former directors breached their fiduciary duties to the corporation, committed fraud and wasted corporate assets); *Person v. Exide Corp.*, 157 F. Supp. 2d 429 (E.D. Pa. 2001) (claims brought by the corporation against corporate officers who had been terminated and whose conduct had become the subject of several lawsuits and criminal prosecutions for fraud).

²⁰⁸ *Delphi Easter Partners L.P. v. Spectacular Partners, Inc.*, No. Civ. A. 12409, 1993 WL 328079 at p. 8 (Del. Ch. 1993).

²⁰⁹ *Truck Components, Inc. v. Beatrice Cos.*, 143 F.3d 1057, 1061 (7th Cir. 1998).

²¹⁰ *Morgan, supra* note 198.

²¹¹ *Reddy, supra*, note 205 at p. 3.

²¹² *Id.* at p. 3.

²¹³ *Id.* at p. 4.

²¹⁴ As noted by Mazur, *supra* note 38 at p. 240: "Even if advised that their bylaws can effectively prevent them from bringing a direct suit against a director who loots the corporation, many corporations will forgo the opportunity for a direct suit".

²¹⁵ *Reddy, supra* note 205 at p. 5, quoted in *Morgan, supra* note 201 at p. 2.

²¹⁶ Radin, *supra* note 207 at p. 278.

Delaware's summary approach to the issue of advancement portrays the 'other side of the scale' in finding a proper balance for the scope of indemnification rights. Delaware's indemnification provisions strongly favor the rights of directors over and above those of shareholders. This approach completely disregards the fact that in direct actions, unlike in derivative and third party actions, the corporation will have evidence of bad faith against its director which has given it sufficient cause to instigate its action directly. The corporation is not faced with a situation where it has little knowledge of the allegations against its director and is unable to make an assessment of a director's conduct. A policy goal underlying the CBCA's indemnity provisions is that, where a director has breached his duty to the corporation, he should satisfy the resulting legal expenses incurred in connection with proceedings from his or her personal assets, since "[a]ny other rule could encourage socially undesirable conduct."²¹⁷ To permit corporations to advance expenses in direct actions effectively undermines this goal; once expenses are made to the faithless director, the money is gone and cannot be recovered. Corporations should be permitted to indemnify their directors who are proven meritorious in direct actions, but the rationale for advancement in such cases cannot be upheld.

5. CONCLUDING REMARKS

Payment of expense advances in direct suits violates public policy and should not be permitted by the courts. The corporation and its director are adversaries, unlike in a derivative action where the interests of the corporation and its director are aligned. That the corporation should be forced to fund the legal expenses of its opponent, the accused director, is fundamentally prejudicial to the corporation and its shareholders. The corporation is not faced with a situation where it has little knowledge of the allegations of its directors and so is unable to make an assessment of a director's conduct. If advancement is permitted in these direct actions, directors will be encouraged to litigate almost endlessly, thereby inflicting delay and expense on the corporation in order to defeat an otherwise meritorious claim. Corporations may ultimately be discouraged from initiating recovery actions against their unfaithful directors since a corporation will simply throw good money after bad; it is one thing to require repayment of monies advanced for legal expenses in the event that the corporation's case is made out, while it is another matter entirely to recover it.

Canadian law, as embodied in the CBCA and OBCA, does not contemplate the advancement of legal expenses to directors in direct actions by the corporation, as distinct from derivative or third party actions. The foregoing review of the legislative history of indemnification provisions has demonstrated that requiring a corporation to advance money to fund the legal costs of an accused director in *direct* actions has never been part of Canadian law. It is only latterly that it has become accepted in U.S. law. The state of affairs that has developed in U.S. states such as Delaware, as outlined in the previous section, is not such that Canadian jurisdictions should be under any encouragement to follow suit.

In response to this contention it is undoubted that the question will be posed, "but what if the director cannot afford to fund his defence?" Whilst this question may give pause, it should be no more than a momentary one. The corporation *itself*, not derivatively through the actions of

²¹⁷ CBCA Discussion Paper, *supra* note 14 at p. 26, para. 91.

adisgruntled shareholder, or by some third party, but directly, has taken action against one of its directors. Serving a claim and enclosing a cheque for a defence is something that the legislature has never intended. Likewise, allowing an accused director to take control of an action, as in *Amirault*, by suing for his advance is simply perverse. Canadian courts, if they are tempted down the easy path of lumping direct actions with derivative and third party actions when it comes to applications to advance defence costs, should bear these matters in mind.