



## **Directors and Officers Liability in Canada: A Review of Exposures and Coverages Available under D&O Policies**

*by*

**Steven Donley  
and Nigel Kent  
at Clark Wilson LLP**

800-885 West Georgia Street  
Vancouver, BC V6C 3H1  
Canada

Tel. 604.687.5700  
Fax 604.687.6314

## TABLE OF CONTENTS

1.	INTRODUCTION .....	1
2.	SOURCES OF D & O LIABILITY.....	1
	<i>Company Law Suits</i> .....	2
	<i>Direct Shareholder Suits</i> .....	4
	<i>Securities Litigation</i> .....	6
	<i>Regulatory Enforcement Action</i> .....	8
	<i>Other Statutory Liability</i> .....	9
3.	INDEMNITY .....	10
4.	D&O LIABILITY INSURANCE .....	11
5.	COVERAGE UNDER A D&O POLICY .....	13
	<i>Side A Insuring Clause</i> .....	13
	<i>Side B Insuring Clause</i> .....	14
	<i>Side C Insuring Clause</i> .....	14
	<i>Losses, Claims and Wrongful Acts</i> .....	15
6.	COVERAGE EXCLUSIONS .....	17
7.	DEFENDING CLAIMS UNDER A D&O POLICY.....	18
	<i>Duty to Defend</i> .....	18
	<i>Allocation</i> .....	20
	<i>Cancellation or Rescission of the Policy</i> .....	21
8.	RECENT D&O INSURANCE ISSUES.....	24
	<i>Dilution of Claims</i> .....	24
	<i>Coverage of Defence Costs in Criminal Proceedings</i> .....	25
	<i>Corporation Insolvency</i> .....	30
	<i>Is Entity Coverage for Securities Claims Necessary?</i> .....	31
9.	CONCLUSION .....	33

# **Directors and Officers Liability: A Review of Exposures and Coverages Available under D&O Policies**

*Steven Donley / Nigel P. Kent  
June 2008*

## **1. INTRODUCTION**

Historically, the main responsibility of directors and officers of Canadian companies was to act in the best interests of their company. Accordingly, their main duty was to maximize corporate profits, and the ability to attract personal liability was, to a large extent, minimal.

Following a recent string of somewhat spectacular corporate scandals and failures in the USA and Canada, there has been a proliferation of debate and law reform designed to widen the scope of director's duties. Since the reforms, directors owe expanded duties to shareholders, employees, creditors and other stakeholders. There has also been an increasing trend towards holding directors personally responsible for acts of the corporation, in an attempt to force directors to take increased responsibility for oversight of the company's operations.

This paper examines some of the most common sources of liability for Canadian directors and officers and the relative risk presented. Next, the paper addresses the various types of D&O liability insurance available to directors and officers to minimize their personal liability. Finally, the paper reviews current legal issues in D&O liability insurance.

## **2. SOURCES OF D & O LIABILITY**

The powers and responsibilities of directors and officers are principally regulated through provincial and federal corporations law. Each province and the federal government have enacted their own corporate statutes, with a high degree of uniformity amongst them. To simplify, this paper will focus on the federal legislation – the *Canada Business Corporations Act*<sup>1</sup> (the “CBCA”)<sup>2</sup>.

Directors of Canadian corporations are elected by the shareholders to manage, or supervise the management of, the business and affairs of a corporation<sup>3</sup>. The powers vested in the directors are

---

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

<sup>2</sup> It should be noted that almost 50 percent of the largest 500 non-financial corporations in Canada are incorporated under the CBCA. However, there is a heavy preference for incorporation under provincial law, with only 12 percent of total Canadian companies incorporated under the CBCA. *Source: W. D. Gray (2003), Corporations as Winners Under CBCA Reform*, 39 Can Bus. L.J. 4 at pages 4, 22 and 34. It is the high degree of similarity between provincial and federal legislation that makes the CBCA useful for the purposes of analysis. For a discussion of key differences in corporations law in each jurisdiction, see *W. D. Gray (2003) supra* at pages 22 to 35.

<sup>3</sup> CBCA, s. 102.

subject to specific rights reserved to the shareholders, duties owed to the corporation (and entities that deal with it), liabilities, and penalties<sup>4</sup>.

Directors may designate the offices of the corporation, appoint officers, specify their duties and delegate to them powers to manage the business and affairs of the corporation<sup>5</sup>.

Contemporary directors and officers are expected to make decisions concerning a variety of business risks. Those decisions must be made in light of the considerable trust placed in the directors by the company shareholders and stakeholders. Further, since the high profile US Enron and WorldCom lawsuits, there has been a trend towards the view that the growth and success of all corporations ultimately requires a balance to be struck between regulation of corporate decision making (to ensure the stability and integrity in capital markets) and allowing corporations the flexibility to respond to competitive and dynamic markets<sup>6</sup>.

Presently, there are four main categories of litigation with the potential to result in director and officer liability:

- company lawsuits;
- direct shareholder suits;
- securities suits; and
- regulatory enforcement action.

The liability risk to directors varies within each category depending on whether the company is public or private, and whether the directors are “inside directors” (i.e. also officers) or “outside directors” (directors sitting on more than one board, who are independent and typically rely on information supplied by inside directors).

The remainder of this section will provide a brief outline of the current sources and nature of liability risks in each category. Further, the level of risk to directors and officers will be evaluated.

### Company Law Suits

Directors and officers are placed under a statutory obligation to discharge their duties honestly and in good faith with a view to the corporation’s best interests<sup>7</sup>. This fiduciary duty is a general

---

<sup>4</sup> See: B. Reiter (2006) *Directors’ Duties in Canada*, CCH Canadian Limited, Toronto, ON, p 18-153; W.M.H. Grover (2003) *Canada Corporation Manual*, Thomson Caswell, Toronto, ON, p 7-29.

<sup>5</sup> *BCA*, s. 121

<sup>6</sup> For comment on the challenges faced by Canadian securities regulators and market participants in responding to the 2002 US Sarbanes-Oxley legislation see: C.C. Nicholls (2003), *Policy Comment - The Canadian Response to Sarbanes-Oxley – January 2003*, Capital Markets Institute, Rotman School of Management, University of Toronto.

<sup>7</sup> *BCA*, s. 122(1).

codification of the director's common law duty of loyalty and good faith towards the corporation<sup>8</sup>.

Directors and officers must also exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances<sup>9</sup>. Directors and officers will discharge this duty where they act prudently and on a reasonably informed basis<sup>10</sup>. Further, courts have imposed upon themselves a rule of deference to board decisions, known as the "business judgment rule"<sup>11</sup>. This rule states that provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination.

Further, directors (but not officers) are extended a statutory "due diligence" defence which permits the director to rely in good faith upon experts' reports and financial statements presented by other directors/officers<sup>12</sup>.

The above duties are owed primarily to the corporation<sup>13</sup>, but duties may also be owed to entities that deal with the corporation<sup>14</sup>. Courts have permitted parties other than the corporation to bring a wide range of common law actions against directors and officers in their personal capacity, including claims of misrepresentation<sup>15</sup>, inducing breach of fiduciary duty<sup>16</sup>, negligence<sup>17</sup>, nuisance<sup>18</sup>, conspiracy<sup>19</sup>, and patent infringement<sup>20</sup>.

As might be expected, companies (acting through their directors) have historically shown a reluctance to bring proceedings against directors for breach of the above duties. Accordingly, legislation has been enacted allowing shareholders to bring derivative actions (a claim on behalf of the company because the directors and management have failed to exercise their authority for the benefit of the company and its shareholders)<sup>21</sup>. Among other things, the *CBCA* requires the complainant<sup>22</sup> to act in good faith and the suit to be in the best interests of the corporation<sup>23</sup>. The courts will give a liberal interpretation of the *CBCA* provisions in favor of the complainant,

---

<sup>8</sup> W.M.H. Grover (2003) supra, p 7-49.

<sup>9</sup> *CBCA*, s. 122(1).

<sup>10</sup> *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461

<sup>11</sup> *Ibid*

<sup>12</sup> W.M.H. Grover (2003) supra at p 7-76.8; *CBCA*, s. 123.

<sup>13</sup> *Peoples Department Stores Inc. (Trustee of) v. Wise*, supra

<sup>14</sup> B. Reiter (2006) supra, p18-153.

<sup>15</sup> For example see *NBD Bank, Canada v Dofasco Inc.* (1999), 46 O.R. (3d) 514 (C.A.) where the directors made misrepresentations about the financial condition of the corporation in a borrowing context.

<sup>16</sup> See *ADGA Systems International Ltd. v. Valcom Ltd.* (1999) 43 O.R. (3d) 101 (C.A.).

<sup>17</sup> *Lewis v. Boutilier* (1919), 52 D.L.R. 383 (S.C.C.)

<sup>18</sup> *Sullivan v. Desrosiers* (1986), 40 C.C.L.T. 66 (N.B. C.A.)

<sup>19</sup> *Meditrust Healthcare Inc. v. Shoppers Drug Mart* (1999), 124 O.A.C. 137 (C.A.)

<sup>20</sup> *Mentmore Manufacturing Co. v. National Merchandising Manufacturing Co.* (1978), 89 D.L.R. (3d) 195 (Fed. C.A.).

<sup>21</sup> *CBCA*, ss. 239 and 240.

<sup>22</sup> *CBCA* s. 238 allows registered holders; beneficial owners; former registered holders or beneficial owners; current and former directors; or any other proper person to make application.

<sup>23</sup> *CBCA*, s. 239(2).

p. 4

however they will require a reasonable basis for the complaint and a legitimate or arguable action before allowing a derivative action to proceed<sup>24</sup>.

As a derivative suit in this context is effectively a suit by the company against the director or officer, any judgment will be against the director personally. The *CBCA* does not specify any remedy for a breach of the duties in section 122. Accordingly, at common law:

- Acting in bad faith or dishonestly attracts liability as an intentional tort.
- Failure to act in the best interests of the corporation may give rise to liability for breach of the fiduciary duty of loyalty.
- Failure to exercise due care may give rise to liability in negligence.

Derivative actions are uncommon in Canada, and only a handful of cases have been brought involving directors where the core allegation was a failure to meet the duty of care<sup>25</sup>. Even in the USA, where the legal environment is uniquely hospitable to litigation against directors<sup>26</sup>, derivative suits constitute only a minority of claims the claims filed against directors for breach of fiduciary duty<sup>27</sup>. Accordingly, a recent survey of directors of TSX-listed companies revealed that Canadian directors perceived company suits to be the least important source of potential claims<sup>28</sup>.

### Direct Shareholder Suits

Shareholders can seek direct relief on the grounds of unfair prejudice by invoking the broad “oppression remedies” contained in the various corporations statutes. Under the *CBCA* a complainant<sup>29</sup> may apply for a remedy when faced with corporate conduct that is oppressive, unfairly prejudicial, or unfairly disregards the interests of the complainant<sup>30</sup>.

---

<sup>24</sup> *Richardson Greenshields of Canada Ltd. v. Kalmacoff* [1995] O.J. No. 941 at paragraph 22. An appeal to the S.C.C. (citation [1995] S.C.C.A. No. 260) was dismissed without reasons on September 28, 1995 (S.C.C. Bulletin, 1995, p. 1395.)

<sup>25</sup> *B.R. Cheffins and B.S. Black* (May 2006), *Outside Director Liability Across Countries*, 84 Tex. L. Rev. 1385, at page 1443.

<sup>26</sup> *Ibid*, at pages 1392-1393.

<sup>27</sup> *J.C. Coffee Jr.* (Nov. 2006), *Litigation Reform Since the PSLRA*, *supra* at pages 1153-4. Further, only 14 percent of all corporate fiduciary duty claims filed in Delaware Chancery in 1999-2000 were derivative suits – *Source: R.B. Thompson & R.S. Thomas* (2004) *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand. L. Rev. 133 at page 137.

<sup>28</sup> *C. Egri, I. Gordon and D. Shapiro* (June 2006). *Director and Officer Liability Insurance: Analysis of Survey Results*, CIBC Centre for Corporate Governance and Risk Management, Segal Graduate School of Business, Simon Fraser University.

<sup>29</sup> Again, broadly defined. See note 22.

<sup>30</sup> *CBCA*, s. 241.

Oppressive, unfairly prejudicial and unfair disregard will be found to exist where:

- dominant power is enforced against the will of weaker corporate stakeholders by some breach of legal or equitable rights<sup>31</sup>;
- A corporate stakeholder's equitable rights are breached<sup>32</sup>;
- Mismanagement or unjustified discrimination are present<sup>33</sup>;
- the disregard for the claimant's rights is unjust, unethical or contrary to convention<sup>34</sup>.

As in actions for breach of fiduciary duty, the court's show considerable deference to corporate decision making and apply the "business judgment" rule when evaluating conduct in an oppression remedy context<sup>35</sup>.

The court may order a wide variety of remedies where an oppression claim is made out, including the power to order a party to compensate an aggrieved person, order any person to pay money, or make any interim or final order it thinks fit<sup>36</sup>.

There have been substantially more oppression suits filed in recent times than derivative ones. However, oppression suits remain a relatively low source of director liability. Where oppression is made out, courts are most likely to grant a buy-out of the applicant's shares by the company, or injunctive relief, instead of damages<sup>37</sup>. Further, there do not appear to be any reported cases where this remedy has been granted against a director<sup>38</sup>.

That being said, there is a class of oppression remedy suit that presents some difficulty in a D&O liability insurance context – those arising from "compulsory acquisition". Under Canadian law, a company that acquires 90 percent of the shares in a target company is entitled to purchase the remaining ten percent of the target company shares by compulsion<sup>39</sup>. The "oppression remedy" provisions permit the minority shareholders in the target company to complain of oppressive and unfairly prejudicial conduct on the part of the directors of the takeover company. The provisions also permit the minority shareholders to be compensated for the value of their shares without regard to the depreciation in value caused either by the takeover itself, or improper conduct of

---

<sup>31</sup> D.H. Peterson (1989, updated in 2007), *Shareholder Remedies in Canada*, Lexis Nexis, Markham, ON, page 18.25.

<sup>32</sup> *Ibid*, page 18.26

<sup>33</sup> *Ibid*

<sup>34</sup> *Ibid*, page 18.31.3

<sup>35</sup> *Ford Motor Co. of Canada v. Ontario Municipal Employees Retirement Board* [2006] O.J. No. 27 at paragraph 95.

<sup>36</sup> *BCA*, s. 241(3).

<sup>37</sup> B.R. Cheffins and B.S. Black (May 2006) *supra* at pages 1444-5.

<sup>38</sup> D.H. Peterson (1989, updated in 2007), Appendix A.

<sup>39</sup> *BCA*, s. 206

the directors or officers<sup>40</sup>. It is not yet settled in Canada whether such a claim is categorized as a direct shareholder suit or a securities claim.

### Securities Litigation

Directors have the power to issue shares of the corporation at such times, to such persons, and for such a consideration as the directors determine<sup>41</sup>. A company's articles may permit a corporation to have multiple classes of shares<sup>42</sup>. Securities regulation in Canada is a provincial matter, with Ontario playing the lead role as it has the largest and most active capital markets<sup>43</sup>. Accordingly, Ontario's legislation will be used for the remainder of this section.

The Ontario *Securities Act*<sup>44</sup> (the "OSA"), regulates prospectuses for public offerings<sup>45</sup>, imposes periodic disclosure obligations on publicly traded companies<sup>46</sup>, and mandates that a target company in a takeover issue a circular to the shareholders<sup>47</sup>. Investors have a statutory right to sue for misrepresentations or misleading disclosure<sup>48</sup>. In most provinces, the statutory right is currently available only to investors who purchased their shares directly from the public issuer. Ontario legislation has extended liability so that purchasers in the secondary market (such as the stock exchange) can also recover losses resulting from inaccurate disclosure. Other provinces appear set to follow Ontario's lead<sup>49</sup>.

Every new issuance of securities by a corporation must be made under a prospectus that has been filed with the securities commission in the relevant jurisdiction (subject to exemption in limited situations)<sup>50</sup>. A prospectus must provide full, true and plain disclosure of all material facts<sup>51</sup>. Where a prospectus contains a misrepresentation the purchaser may sue the issuer for damages<sup>52</sup>.

The "business judgment" rule does not apply to the duty of disclosure<sup>53</sup>. However, issuers (directors, officers and the company) may rely upon the "safe harbor" defence, which removes liability where there was a reasonable basis for making a forecast or drawing a conclusion<sup>54</sup>. The

---

<sup>40</sup> *CBCA*, s. 241. See also: E.A. Dolden (Jan 2008) *Entity Coverage for Securities Claims Under a D&O Policy: Have We Come Full Circle? – Part II*, 26 Can. J. Ins. L. at page 2.

<sup>41</sup> *CBCA*, s. 25.

<sup>42</sup> *CBCA*, s. 24.

<sup>43</sup> B.R. Cheffins and B.S. Black (May 2006), *supra* at page 1444.

<sup>44</sup> R.S.O. 1990, Ch. S.5. (hereinafter referred to as "OSA")

<sup>45</sup> *OSA*, s. 56.

<sup>46</sup> *OSA*, ss. 75, 77 and 78.

<sup>47</sup> *OSA*, s. 99.

<sup>48</sup> *OSA*, ss. 130 (prospectus), 131 (takeover circulars).

<sup>49</sup> For example see British Columbia's *Security Act 2004*, Bill 38 – 2004 (received third reading on 11 May 2004, not yet in force). For key differences between Ontario and proposed BC acts, see: BC Ministry of Attorney General consultation papers, *Civil Liability Regime for Secondary Market Disclosure*, available online at: <<http://www.ag.gov.bc.ca/legislation/pdf/SecuritiesConsultation.pdf>>

<sup>50</sup> B. Reiter (2006) *supra*, p. 197.

<sup>51</sup> *OSA*, s. 56.

<sup>52</sup> *OSA*, s. 130.

<sup>53</sup> *Kerr v Danier Leather Inc.* [2007] S.C.J. No 44. at paragraphs 52 to 58.

<sup>54</sup> *OSA*, s. 132.1.

p. 7

defence is only available where the prospectus contains reasonable cautionary language and a statement of the underlying assumptions underpinning the forecasts/conclusions<sup>55</sup>.

Where misrepresentation in a prospectus or circular is made out, the liable parties will be held jointly and severally liable<sup>56</sup>.

A secondary-market purchaser may bring a statutory cause of action against an issuer (including directors, officers and “influential persons”<sup>57</sup>) for:

- misrepresentations in specified documents and public oral statements released by or on behalf of the issuer; and
- failure to disclose material changes in a timely manner<sup>58</sup>.

The plaintiff must obtain leave to proceed (requires good faith and reasonable possibility of success)<sup>59</sup>. Directors and the company will not be liable if a reasonable investigation was conducted and there were no reasonable grounds to believe that the misrepresentation or failure to make timely disclosure would occur<sup>60</sup>. The “safe harbor” defence is also applicable to forward-looking information in a secondary-market suit<sup>61</sup>.

A successful plaintiff in a secondary-market suit will obtain an award of damages. Liability is apportioned among defendants according to their responsibility<sup>62</sup>. Further, so long as there was no knowing involvement, a director’s liability is capped at the greater of \$25,000 or half the director’s annual salary.

For publicly listed companies in the United States, the dominant source of director and officer liability, both in terms of claims brought and liability exposure, is shareholder litigation<sup>63</sup>. On 2005 figures, US public companies have a two percent chance of being sued in a shareholder class action in any given year, with large companies at increased risk over small ones<sup>64</sup>. Average settlement values were \$24 million, and median settlement amount of \$7 million<sup>65</sup>. Hence, shareholder suits are characterized by a handful of very large settlements, with the typical case settling for much less. Almost all US shareholder litigation is settled<sup>66</sup>.

---

<sup>55</sup> *Ibid.*

<sup>56</sup> *OSA* ss. 130(2) and 131(2).

<sup>57</sup> *OSA* s. 138.1

<sup>58</sup> *OSA* s. 138.3(1)-(4)

<sup>59</sup> *OSA* s. 138.8

<sup>60</sup> *OSA* s. 138.4(6)-(7)

<sup>61</sup> *OSA* s. 138.4(9)-(11)

<sup>62</sup> *OSA* s. 138.6

<sup>63</sup> T. Baker and S.J. Griffith (2007) *supra* at page 494.

<sup>64</sup> *Ibid* at pages 494-5.

<sup>65</sup> *Ibid*

<sup>66</sup> T. Baker and S.J. Griffiths (August 2007) *supra* at page 1805.

While class-action securities suits are common in the USA, very few have been brought in Canada. The recent case of *Kerr v. Danier Leather Inc.*<sup>67</sup> is reported to be the first class-action securities lawsuit in Canada, with the shareholders' appeal to the S.C.C. dismissed.

The low incidence of class-action securities suits is attributed to the structure of the Canadian capital markets, which are characterized by:

- A small number of large, inter-listed companies;
- A large number of small public companies; and
- A high proportion of public companies with significant or controlling shareholders<sup>68</sup>.

The low incidence of Canadian class-action suits has also been attributed to the Canadian "loser pays" litigation costs rule, and historical difficulties in bringing plaintiffs into the same class<sup>69</sup>.

The above notwithstanding, directors of TSX-listed companies perceive shareholder suits, particularly those brought by large shareholders and institutional investors, as being the greatest potential sources of claims<sup>70</sup>.

### Regulatory Enforcement Action

Enforcement activity is predominantly undertaken through the *Canadian Securities Administrators* (the CSA), a collaboration between securities regulators from each of the Canadian provinces and territories. The scheme allows CSA enforcement personnel to bring matters before the local securities commission in the appropriate jurisdiction. The commissions can impose sanctions, bans on individuals acting as directors, mandatory disclosure, administrative penalties, disgorgement, and payment of costs. The enforcement personnel often negotiate settlement agreements under which those alleged to have contravened securities law submit to agreed sanctions. CSA investigations frequently give rise to criminal proceedings and penalties also<sup>71</sup>.

CSA figures indicate that in the six months from 1 April to 30 September 2007, the CSA instituted 56 new enforcement matters before a member commission, resulting in 14 court convictions, and restitutions and fines totaling approximately \$1.6 million<sup>72</sup>. Further, Exchange and Regulators fines totaling around \$7 million were imposed, and approximately \$2.6 million in illegal profits were disgorged.

---

<sup>67</sup> [2007] S.C.J. No. 44

<sup>68</sup> *C.C. Nicholls* (2003) *supra* at pages 9-10.

<sup>69</sup> *B.R. Cheffins and B.S. Black* (May 2006) *supra* at pages 1445-6

<sup>70</sup> *C. Egri, I. Gordon and D. Shapiro* (June 2006) *supra* at page 4.

<sup>71</sup> *Canadian Securities Administrators Report on Enforcement Activities From April 1, 2007 to September 30, 2007* page 4.

<sup>72</sup> *Ibid* pages 1, 5 and 6.

The majority of enforcement activity was undertaken by the CSA in relation to the following conduct:

- Illegal distribution of securities;
- Insider trading;
- Market manipulation and fraud;
- Disclosure violations;
- Misconduct by registrants<sup>73</sup>.

Additionally, some organizations (for example the Mutual Fund Dealers Association of Canada) are self-regulating and have the power to impose sanctions and administrative penalties on their members.

Provincial securities laws, regulations and rules provide numerous sources of potential liability for directors and officers. Even in cases where the investigations do not result in director liability, the directors' legal costs associated with the investigation can be very substantial.

### Other Statutory Liability

Directors and officers of Canadian companies are subject to the provisions of some 50 federal and over 50 provincial statutes, many of which impose personal liability on directors and officers<sup>74</sup>. An exhaustive list of the common federal provisions is attached to this paper as "Appendix A"<sup>75</sup>. Some relevant sources of personal liability include:

#### *Taxes*

Under section 227.1 of the *Income Tax Act*<sup>76</sup>, a director can be held personally liable for a corporation's failure to deduct withholding taxes as required under the Act. However, the director will not be liable where the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances<sup>77</sup>.

Similarly, personal liability may attach for failure to deduct or remit premiums under the *Employment Insurance Act*<sup>78</sup>. Other Acts under which directors and officers may be held

---

<sup>73</sup> *Ibid.*

<sup>74</sup> W.M.H. Grover (2003) *supra* at page 7-50. This figure has been estimated as high as 200 federal and provincial statutes *Source: Marsh Canada Limited* (December 2006) *Directors and Officers Liability*, publication number B061112 (C061205TE): 2006/12/13.

<sup>75</sup> B. Reiter (2006) *supra* at pages 311-324.

<sup>76</sup> R.S.C. 1985, c. 1 (5th Supp.)

<sup>77</sup> *Income Tax Act* s. 227.1(3).

<sup>78</sup> *Employment Insurance Act* S.C. 1996, c. 23, ss. 82 and 83(1).

liable for the corporation's failure to deduct, withhold or remit taxes include the *Excise Tax Act*<sup>79</sup> and the *Canada Pension Plan*<sup>80</sup>.

### *Wages and Salaries*

Section 119 of the *CBCA* provides that directors of federally incorporated companies are jointly and severally liable to the employees for outstanding wages (capped at six months) earned during the directorship. For the director to be liable the employees must have attempted recovery against the corporation, but been unsuccessful because the corporation has been dissolved, or is in liquidation or bankruptcy.

Further, directors of a corporation can be held liable for unpaid wages following an investigation by the Federal Minister of Labour under the *Canada Labour Code*<sup>81</sup>.

Many Canadian directors are concerned about the statutory liability for unpaid wages, and there has been lobbying for increased protection<sup>82</sup>.

### *Environmental Liability*

Under the *Canadian Environmental Protection Act*<sup>83</sup> a director or officer of a federally incorporated company can be held personally liable for any offence committed by the corporation where the director or officer directed, authorized, assented to, acquiesced in or participated in the commission of the offence<sup>84</sup>. The director can be liable to punishment whether or not the corporation has been prosecuted.

With such wide ranging sources of potential statutory liability, accepting a directorship can be a risky undertaking. The rest of this paper will deal with the types of insurance arrangements available to minimize the risks to an acceptable level.

## **3. INDEMNITY**

In order for corporations to attract qualified directors and officers in the face of wide-ranging sources of personal liability, it is often necessary to protect them from personal liability<sup>85</sup>. Protection from liability is also necessary to foster responsible entrepreneurialism<sup>86</sup>.

A corporation is permitted (at its option) to indemnify directors and officers against all costs reasonably incurred in respect of any civil, criminal, administrative or investigative or other

---

<sup>79</sup> R.S.C. 1985, c. E-15, s. 323.

<sup>80</sup> R.S.C. 1985, c. C-8, s. 21.1

<sup>81</sup> R.S.C. 1985, c. L-2, ss. 251.1 and 251.18.

<sup>82</sup> B.R. Cheffins and B.S. Black (May 2006) *supra* at page 1450.

<sup>83</sup> S.C. 1999, c. 33, s. ??

<sup>84</sup> *Canadian Environmental Protection Act*, s. 280.

<sup>85</sup> B. Reiter (2006) *supra*, p18-154.

<sup>86</sup> For policy reasons underlying indemnification of directors and officers see: *Blair v. Consolidated Enfield Corp.* [1995], 4 S.C.R. 5

proceeding arising out of the individual's association with the company<sup>87</sup>. The following prerequisites must be satisfied:

- the director/officer must have 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 action or proceeding that is enforced by a monetary penalty, the individual had reasonable grounds for believing that the individual's conduct was lawful<sup>88</sup>.

Where the costs relate to the defence of an above action, the company is required to indemnify the director or officer (current and former)<sup>89</sup>. The same prerequisites must be satisfied for the mandatory indemnity to apply. As the entitlement to indemnity is dependent on the finding of the court or tribunal, the mandatory indemnity cannot be extended until after resolution of the action against the director or officer<sup>90</sup>.

In the case of a derivative action, indemnity requires court approval<sup>91</sup>. Indemnity is generally approved if the suit is unsuccessful.

A corporation is not permitted to indemnify a director or officer where the pre-requisites are not made out.

A corporation may purchase and maintain insurance for the benefit of its directors and officers against any liability incurred by the individual in their capacity as a director or officer of the corporation<sup>92</sup>. While the statutory language is permissive, corporate bylaws of larger companies typically impose a mandatory duty to purchase and maintain insurance for the directors and officers.

#### **4. D&O LIABILITY INSURANCE**

There is no standard D&O policy wording. Each insurer has its own policy forms, which have typically been altered over the years to narrow and expand coverage as required by market conditions. Insurers typically have different forms for differing types of companies (for example public, private or non-profit organizations).

That said, "D&O Liability Insurance" is the general label applied to three distinct insurance arrangements. First, there is coverage to protect individual managers from the risk of liability incurred in execution of office (Side A). Side A coverage typically covers amounts the directors and officers are legally obligated to pay resulting from claims made for a wrongful act, if the directors and officers have not been indemnified by the corporation. Side A coverage is generally

---

<sup>87</sup> *BCA*, s. 124(5).

<sup>88</sup> *BCA*, s. 124

<sup>89</sup> *BCA*, s. 124(5).

<sup>90</sup> B. Reiter (2006) *supra*, at page 18-156

<sup>91</sup> *BCA*, s. 124(4)

<sup>92</sup> *BCA*, s. 124(6)

triggered where the corporation is not permitted to indemnify (see Side B coverage below) or the company is unable to do so, for example when the corporation is insolvent.

Secondly, there is coverage to reimburse the corporation for its indemnification obligations (Side B). Side B insurance covers the corporation where it has indemnified the directors and officers for a covered loss. In most cases, Side B coverage is triggered only when the corporation is legally permitted to indemnify. As stated above, the corporation is not permitted to indemnify where the director has acted in contravention of the statutory indemnity prerequisites, or where the directors are sued by the company in a derivative suit. Consequently, policy exclusions notwithstanding, Side A coverage (instead of Side B) would be triggered for director liability arising from a non-indemnifiable wrongful act or derivative suit.

Finally, there is coverage to protect the corporation from securities litigation to which the corporate entity itself is a party (Side C). Side C coverage evolved as a solution to disputes between insurance companies and corporate defendants over what portion of a securities settlement ought to be allocated to the managers (and therefore reimbursed by the insurer under the corporation's Side B coverage) and what portion allocated to the corporation (and therefore uncovered and paid directly by the corporation)<sup>93</sup>. Side C coverage moots the allocation issue.

D&O insurance is typically written for a one-year period. It responds to all claims that are made during the currency of the policy. Accordingly, if some corporate act occurs in year one but is not discovered and no claim made until year two, the D&O insurer on risk in year two will respond to any loss<sup>94</sup>.

The policy will contain a provision setting out the maximum amount for which the insurer is liable to pay for claims made during the policy period. The maximum amount will be set out on a per loss aggregate. Unlike most other insurance policies, the D&O policies are "self-consuming", meaning the policy limits include all legal expenses incurred defending a claim<sup>95</sup>.

Not surprisingly, with the increasing incidence and quantum of claims against directors, D&O liability insurance is now an integral part of corporate governance. A 2006 survey indicated 93 percent of TSX listed companies hold D&O liability insurance<sup>96</sup>. This is on par with the USA, where well over 90 percent of public companies also buy D&O insurance<sup>97</sup>.

The Canadian survey indicates that most companies pay premiums of under \$150,000 per year and have deductibles under \$250,000. Coverage limits vary widely, with about half of the companies holding coverage under \$20 million. However, one third of companies held coverage over \$50 million. The majority of D&O coverage is underwritten by four major providers<sup>98</sup>.

---

<sup>93</sup> S.J. Griffith (May 2006) *Uncovering a GateKeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. Pa. L. Rev. 1147 at pages 1166-68.

<sup>94</sup> B. Reiter (2006), *supra*, at page 548.

<sup>95</sup> A. Baker (July 2007) *Directors' and Officers' Liability Insurance: An Overview – Part I*, 25 Can. J. Ins. L. at page 63.

<sup>96</sup> C. Egri, I. Gordon and D. Shapiro (June 2006). *supra* at page 5.

<sup>97</sup> S.J. Griffith (May 2006) *supra* at page 1168

<sup>98</sup> C. Egri, I. Gordon and D. Shapiro (June 2006) *supra* at pages 5-6.

In the USA, a 2004 study indicated coverage limits ranged from \$4.7 million (for corporations with a market capitalization of up to \$100 million) to \$122.9 million (for corporations with a market capitalization of over \$5 billion)<sup>99</sup>.

In general, no one insurer is willing to underwrite the entire limit purchased by any one corporation. As at late 2005, most north American policies had limits of \$10 million or less, with few insurers offering a policy larger than \$25 million<sup>100</sup>. Corporations therefore purchase several D&O policies to reach the aggregate amount of desired insurance. D&O insurance packages are thus said to come in “towers”, separate layers of insurance policies stacked to reach the total desired coverage.

The insurer providing the “primary policy” (at the bottom layer of the tower) is the first to respond to a covered loss and most likely to incur a payment obligation. Accordingly, the primary insurer charges a higher premium. The north American market for primary insurance is dominated by a small number of companies<sup>101</sup>.

The excess insurers (higher up in the tower) become responsible for losses as the limits of each underlying policy are expended by loss payments. Excess policies are typically sold on the same contractual terms as the primary policy (except price and limit). Excess policies are less likely to respond to a covered loss the higher they sit in the tower, and premiums lower accordingly<sup>102</sup>.

## 5. COVERAGE UNDER A D&O POLICY

### Side A Insuring Clause

A typical Side A insuring clause provides:

The Company will pay on behalf of any Insured Person Loss resulting from Claims first made during the Policy Period for Wrongful Acts by an Insured Person in his or her capacity as such, except to the extent that such Loss is paid by any other insurance or as indemnification from any source<sup>103</sup>.

A commonly used alternate wording provides:

The Company shall pay, on behalf of each of the Insured Persons, Loss for which the Insured Person is not indemnified by the Organization and which the Insured Person becomes legally obligated to pay on account of any Claim first made against the Insured Person, individually or otherwise, during the Policy Period or, if exercised, during the Extended Reporting Period, for a Wrongful Act committed, attempted, or allegedly committed or attempted by such Insured Person before or during the Policy Period, but

---

<sup>99</sup> J.C. Coffee Jr. (Nov. 2006) *supra* at pages 1577-1579.

<sup>100</sup> T. Baker and S.J. Griffith (2007) *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. Chi. L. Rev. 487 at pages 504-6

<sup>101</sup> *Ibid* at pages 504-5.

<sup>102</sup> *Ibid*.

<sup>103</sup> The Travelers Companies, Inc. - *Broad Form PLUS+sm Directors and Officers Liability Insurance Policy* - Form DOB-1001 PR (08-02).

only if such Claim is reported to the Company in writing in the manner and within the time provided in [the policy]<sup>104</sup>.

### Side B Insuring Clause

The Side B insuring agreements that generally accompany those referred to above are as follows:

The Insurer shall pay on behalf of the Company all Loss which the Insured Persons shall be legally obligated to pay as a result of a Claim (including an Employment Practices Claim or a Securities Claim) first made against the Insured Persons during the Policy Period or the Discovery Period for a Wrongful Act, but only to the extent the Company is required or permitted by law to indemnify the Insured Persons<sup>105</sup>.

And:

The Company shall pay, on behalf of the Organization, Loss for which the Organization grants indemnification to an Insured Person, as permitted or required by law, and which the Insured Person becomes legally obligated to pay on account of any Claim first made against the Insured Person, individually or otherwise, during the Policy Period or, if exercised, during the Extended Reporting Period, for a Wrongful Act committed, attempted, or allegedly committed or attempted by such Insured Person before or during the Policy Period, but only if such Claim is reported to the Company in writing in the manner and within the time provided in [the policy]<sup>106</sup>.

### Side C Insuring Clause

The companion insuring agreements to those discussed above provide:

The Insurer shall pay on behalf of the Insured Entity all Loss which the Insured Entity shall be legally obligated to pay as a result of a Securities Claim first made against the Insured Entity during the Policy Period or the Discovery Period for a Wrongful Act<sup>107</sup>.

And:

The Company shall pay, on behalf of the Organization, Loss which the Organization becomes legally obligated to pay on account of any Securities Claim first made against the Organization during the Policy Period or, if exercised, during the Extended Reporting Period, for a Wrongful Act committed, attempted, or allegedly committed or attempted by the Organization or the Insured Persons before or during the Policy Period, but only if such Securities Claim is reported to the Company in writing in the manner and within the time provided in [the policy]<sup>108</sup>.

---

<sup>104</sup> The Chubb Corporation – *Executive Protection Portfolio Directors & Officers Liability Policy - Retail* – Form 14-02-7303.

<sup>105</sup> Great American Insurance Group – *Exec Pro Directors', Officers', Insured Entity and Employment Practices Liability Insurance Policy* – Form D2100C.

<sup>106</sup> Chubb Form 14-02-7303 supra, note 81.

<sup>107</sup> Great American Form D2100C supra, note 82.

<sup>108</sup> Chubb Form 14-02-7303 supra, note 81

## Losses, Claims and Wrongful Acts

### Losses

As can be seen from the above clauses, the insurer will pay “Loss” on account of “Claims” (or in the case of Side C insurance “Securities Claims”) made during the policy period for a “Wrongful Act”, subject to further policy conditions and exclusions.

While the policy definition of “Loss” will vary, it generally includes three elements: damages, settlements and defence costs<sup>109</sup>. It is well settled that “loss” is broad enough to include the relief sought in the types of proceedings that a corporation is permitted to indemnify directors and officers for under the *CBCA* (see indemnity section above). However, insurers are beginning to assert that certain types of relief are not a covered form of loss.

Presently, there are two main areas of uncertainty with regard to covered losses. Firstly, it is currently uncertain whether punitive damages are an insurable loss. Although some policies expressly include coverage for punitive damages, it has not been finally determined whether punitive damages are insurable<sup>110</sup>.

Secondly, in the case of *Level 3 Communications, Inc. v. Federal Insurance Company*<sup>111</sup>, the United States Court of Appeals for the Seventh Circuit ruled that payments made by a company to settle securities fraud claims against the directors were not covered under the company’s D&O policy. In *Level 3*, the settled claim was brought by former shareholders of a company that had been purchased by Level 3, alleging the value of Level 3’s stock (used to purchase the plaintiff-shareholders’ company) was inflated due to misrepresentations by Level 3’s directors. The plaintiff’s suit sought to rescind the transaction and recover the monetary value of the shares. Accordingly, the settlement payment to shareholders was the difference between the value of the stock at the time of trial and the price the defendants had received for the stock from Level 3.

Level 3 contended that it was entitled to coverage as a “settlement” was a loss covered under the policy. The insurance company contended that Level 3’s settlement was characterized as a disgorgement of ill-gotten profits which *Level 3* was never entitled to receive, and not a loss to the insured. The Appeal Court accepted the insurance company’s argument and held the loss was not covered.

There has been no subsequent consideration of the *Level 3* decision in the USA or Canada. However, in *Alstrin v. St. Paul Mercury Insurance Co*<sup>112</sup>, the court took a more pro-insured stance when called upon to interpret the meaning of “illegal profit or advantage” contained in an exclusion clause. In *Alstrin*, the court concluded that the exclusion applied only where the gain itself was illegal, not merely the conduct that yielded the gain.

---

<sup>109</sup> B. Reiter (2006) supra, at page 18-163

<sup>110</sup> *Victoria General Hospital v. General Accident Assurance Co. of Canada* (1995), 32 C.C.L.I (2d) 243 (Man. Q.B.)

<sup>111</sup> 272 F.3d 908 (7th Cir. 2001).

<sup>112</sup> 179 F. Supp. 2d 376 (D. Del. 2002).

The Quebec Superior Court applied a similar doctrine in a fiduciary liability context in the decision of *Concordia v. Compagnie D'Assurance London Guarantee*<sup>113</sup>. The University had made unilateral changes to its employee pension plan which reduced benefits and created a \$71 million surplus that the University appropriated. The employees sued to recover the pension surplus, and the University sought coverage for the claim. The court concluded there had been no loss for insurance purposes, and that to allow coverage would enrich the University by allowing it to finance its pension plan by means of its insurer.

In light of the above decisions, it is anticipated there will be an increasing incidence of litigation to determine the scope for insurers to exclude coverage for judgments and settlements that do not constitute a loss to the insureds (for example penalties and return of illegal profits)<sup>114</sup>.

### Claims

As outlined in the above insuring clauses, the policy typically covers claims first made during the policy period and reported in accordance with the policy. Hence claims arising from acts which occurred prior to policy commencement are generally covered. However, claims reported prior to policy commencement are usually subject to exclusion.

A “claim” is usually defined in the policy as an overt communication stating an intention by the third party to hold the insured entity liable for some wrongful act. A lawsuit is not necessary<sup>115</sup>. A mere threat to seek legal counsel for anticipated losses has been held insufficient to constitute a “claim” within the meaning of a D&O liability insurance policy<sup>116</sup>.

### Wrongful Act

A “wrongful act” is typically defined as:

any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted by an Insured Person in his or her Insured Capacity, or for purposes of coverage under [the Side C insuring clause], by the organization; or any other matter claimed against an Insured Person solely by reason of his or her serving in an Insured Capacity<sup>117</sup>.

The above clause is intended to provide a broad scope of coverage while precluding coverage for suits that are wholly unrelated to performance of the duties of office. The broad nature of the definition suggests that all wrongful acts are covered unless excluded elsewhere in the policy. The difficulty arises when determining whether deliberate or intentional wrongful acts are covered.

---

<sup>113</sup> [2002] J.Q. no 5011 (QL). Case analyzed in *E.A. Dolden* (Jan 2008) *supra* at pages 11-2.

<sup>114</sup> For a detailed analysis of the *Level 3* and subsequent decisions, see *E.W. Collins* (2004) *Level 3 v. Federal Insurance: Do You Know What is in Your Directors and Officers Liability Insurance Policy*, 73 UMKC L. Rev. 199.

<sup>115</sup> *A. Baker* (July 2007) *Directors' and Officers' Liability Insurance: An Overview – Part I*, *supra* at page 64.

<sup>116</sup> *Winkler v. National Union Fire Insurance*, 1991 U.S. App. LEXIS 4079, 930 F.2d 1364 (9th Cir.)

<sup>117</sup> *Chubb* Form 14-02-7303 *supra*

It is well settled in Canada that as a matter of public policy an insured cannot take advantage of their own wrongdoing nor insure against the consequences of it<sup>118</sup>. However, the position is not so clear-cut in the D&O insurance context as securities fraud often requires a deliberate or intentional act. Some USA courts have therefore been persuaded that securities fraud coverage purportedly offered by a D&O policy would be eviscerated if it applied only to claims based on reckless or negligent behavior<sup>119</sup>. However, due to the use of exclusion clauses (discussed below) it has not been necessary for the judiciary to draw a clear line between covered wrongful acts and excluded ones based only on the definition of “wrongful act”.

Finally, it is important to note that the definition of a “wrongful act” usually includes acts that are “committed, attempted, or allegedly committed or attempted”. The reference to “alleged” acts has been held to extend coverage for settlements even where there is no finding of liability against the director or officer<sup>120</sup>.

## 6. COVERAGE EXCLUSIONS

D&O policies have three principal exclusions<sup>121</sup>:

- the “fraud” exclusion for claims involving deliberately fraudulent acts or unjust personal enrichment.
- the “prior claims” exclusion for claims either noticed or pending prior to the commencement of the policy.
- the “Insured v. Insured” exclusion for litigation between insured persons. Coverage is excluded for litigation between the corporation and the directors and officers<sup>122</sup>.

The “fraud” exclusion is usually incorporated into the policy so the directors or officers cannot benefit from their own wrong-doing. The operation of the fraud exclusion has not been heavily litigated in Canada, and the majority of Canadian commentary is based on decisions from the USA.

The first limb of the “fraud” exclusion generally excludes any claim brought about or contributed to by the Insured Person gaining any profit, advantage, or remuneration to which the Insured Person was not legally entitled<sup>123</sup>. The Colorado District Court described the policy reasons underlying the exclusion thus:

The Personal Profit exclusion in the D & O Liability policy is drafted in clear and specific language. The reasons for such an exclusion are equally clear--to prevent the looting of corporate assets by directors and officers and then, after being forced to remit

---

<sup>118</sup> *Co-operative Fire & Casualty v. Saindon* [1976] 1 S.C.R. 735.

<sup>119</sup> See *Alstrin v. St. Paul Mercury Insurance Co.*, supra at paragraphs 397-98

<sup>120</sup> *Wayne County Neighbourhood Legal Services v. National Union Fire Insurance Co.*, 971 F.2d 1 (6th Cir. 1992).

<sup>121</sup> T. Baker and S.J. Griffith (2007) supra at pages 499-501.

<sup>122</sup> See: *Kohanski v. St. Paul Guarantee Insurance Co.* (2006) 78 O.R. (3d) 684

<sup>123</sup> *B. Reiter* (2006) supra, at page 18-164.16

p. 18

the funds, turning to an insurer seeking indemnification for their wrongful acts under a directors and officers policy<sup>124</sup>.

The second limb generally excludes deliberately fraudulent acts. An example of one such exclusion provides:

The Insurer shall not pay any Loss in connection with any Claim brought about or contributed to any dishonest or fraudulent act or omission, any criminal act or omission or any willful violation of any statute, rule or law by an Insured Person<sup>125</sup>

There is very little Canadian law on this limb of the exclusion. Canadian commentators have suggested decisions dealing with similar provisions in E&O policies can provide guidance in a D&O context<sup>126</sup>.

The scope of the fraud exclusion (both limbs) is generally limited to apply only if it is “finally adjudicated” that the excluded conduct occurred. Alternatively, the exclusion may only apply if the conduct “in fact” occurred. This prevents coverage from being refused until the matter has been judicially determined. However, US research shows shareholder litigation is almost always settled. Consequently, final adjudication rarely takes place and the fraud exclusion is not as commonly invoked as one might expect<sup>127</sup>.

In addition to the three main exclusions listed above, D&O policies generally exclude claims that are traditionally covered under other types of insurance. D&O policies typically exclude claims that would be covered under a CGL policy – for example bodily injury, property damage, various intentional torts such as invasion of privacy, wrongful entry, eviction, malicious prosecution, libel or slander<sup>128</sup>. D&O policies usually exclude environmental and pollution risks also<sup>129</sup>.

## 7. DEFENDING CLAIMS UNDER A D&O POLICY

### Duty to Defend

In other areas of liability insurance, insurers usually provide and control the defence of claims made against the insured. D&O policies, however, are written on an indemnification basis<sup>130</sup>, meaning the policyholder has the right to choose defence counsel and manage their own defence

---

<sup>124</sup> *Jon S. Nicholls v. Zurich American Insurance Group* (2003) 244 F. Supp. 2d 1144; 2003 U.S. Dist. LEXIS 2058 at pages 40-41

<sup>125</sup> *The Travelers Companies, Inc. - Broad Form PLUS+sm Directors and Officers Liability Insurance Policy - Form DOB-1001 PR (08-02)*

<sup>126</sup> See *Nichols v American Home Assurance Co.* (1990), 68 D.L.R. (4th) 321 (S.C.C.).

<sup>127</sup> *T. Baker & S.J. Griffith* (2007) *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 Geo. L.J. 1795 at pages 1804-5.

<sup>128</sup> *B. Reiter* (2006) *supra*, at page 18-164.14

<sup>129</sup> See *Boliden Limited v. Liberty Mutual Insurance Company* (2008), ONCA 288 (CanLII).

<sup>130</sup> A 2007 survey of the USA market found all available D&O policies were written on an indemnification basis.

See *R.S. Betterley* (Oct 2007) *The Betterley Report – D&O Liability Insurance Market Survey 2007*, Betterley Risk Consultants, Sterling, MA.

at the insurer's expense, subject only to the dollar limits of the policy and the requirement that defence costs be reasonable. However, the policy will typically grant the insurer the right to be consulted about, and associated with, the defence.

The D&O policy will usually provide that authority to settle within the policy limit rests with the insurer. However, the authority must be exercised without the benefit of the close relationship with defence counsel that comes from controlling the defence. The defence arrangement substantially constrains the insurer's ability to minimize defence costs and settlement payments.

Despite the adverse effects of the arrangement on the insurer, policies continue to be written on an indemnity basis to meet the needs of the insured directors and officers. Allegations of oversight failure, mismanagement, misrepresentation have a significant impact on an insured's professional reputation, causing many insureds to prefer using trusted counsel. Further, insureds tend to be mistrustful of insurers as it is now common business practice to litigate coverage issues. Understandably, many insureds would prefer not to invest time and personal resources on indemnity disputes.

As stated above, the costs of the litigation are usually included in the policy limits. USA studies indicate almost all shareholder litigation settles within the limits of available D&O insurance<sup>131</sup>, suggesting coverage is not generally exhausted by defence costs. However having one pool to draw settlement and defence costs may lead to allocation problems, which are discussed below.

### Settlement of the Claim

It is trite law that once an insured makes a valid claim, the D&O insurer must deal fairly and in good faith with the insured. This requires the insurer to make an objective analysis of the claim and to pay the claim promptly and in full when the criteria for payment have been met<sup>132</sup>.

However, the position is more complicated where an insurer is under an obligation to indemnify the insured for a settlement brokered by the insured. Further, where the policy coverage fund is insufficient to cover all potentially liable insured parties (e.g. inside directors, outside directors and the company), the insurer must discharge its duty of good faith to all insured parties.

The Ontario Superior Court of Justice considered the principles applicable to the indemnification of a securities claim settlement brokered by the insured in *Hollinger International Inc. v. American Home Assurance Co.*<sup>133</sup>. In *Hollinger* the primary insurer asked the court to determine whether it should fund a company-brokered settlement of a USA action. The inside directors objected to the settlement on the basis it would exhaust the primary policy limits and leave insufficient funds to cover the inside director's defence costs.

The court stated it was bound by precedent to approve settlement where there is a reasonable basis for the settlement, taking into account the competing interests of all the constituents. The court listed a range of factors to consider, such as absence of collusion, likelihood of success,

---

<sup>131</sup> T. Baker & S.J. Griffith (2007) *supra* at page 1806.

<sup>132</sup> *Cox v. Blanksdale* [1955] 2 Lloyd's Rep. 437 (G.B. Div. Comm. List.) at page 442.

<sup>133</sup> [2006] O.J. No. 140

future costs, recommendations made by counsel and the number and nature of objections. The court concluded that having regard to those factors, the settlement must fall within a reasonable zone or range<sup>134</sup>. The *Hollinger* settlement was found to fall within such a zone and approved by the court.

With regard to the insurer's balancing of the competing interests of the insureds, the court found the policy contemplated that finally determined claims would be paid as presented on a first come, first served basis. The court found that to require the insurer to defer payment until the finalization of potential claims against the inside directors would constitute an unwarranted re-writing of the policy. The fact that payment of the settlement sum would extinguish the proceeds available to other insureds does not detract from that principle<sup>135</sup>.

Although the outcome of *Hollinger* may appear somewhat unfair to the inside directors, a review of current literature suggests that it is the insureds that benefit from the insurer's relatively low control over the settlement process. Research indicates insureds pressure insurers to settle claims sooner and at greater expense than an insurer in full control of the defence and settlement would allow<sup>136</sup>.

### Defence Costs

Recent USA research suggests the defence arrangements under a D&O policy result in a substantial increase in defence costs<sup>137</sup>. On 1991 figures, defence costs in Canadian D&O claims averaged approximately \$250,000, whereas the average claim settled for \$300,000<sup>138</sup>.

D&O policies typically provide the insurer with the option to advance defence monies to the insured prior to the final adjudication of the claim. The advancement is normally conditional upon the insured's agreement to repay the funds in the event the insurer is found to have no liability.

### Allocation

Pleadings in claims against directors and officers usually involve a wide range of allegations, some of which are likely to be excluded from coverage under the D&O policy. The pleadings may also name parties that are not insured under the policy, for example the company itself<sup>139</sup> and agents of the company. Consequently, it is often necessary to "allocate" a share of judgments, settlement sums and legal costs to various types of claims and parties.

For example, Canadian securities legislation permits directors, officers, "influential persons" and/or the company to be found liable for many breaches. Absent any D&O insurance, liable defendants would presumably contribute to a settlement figure based upon their share of

---

<sup>134</sup> at paragraphs 61-2.

<sup>135</sup> at paragraphs 110-119.

<sup>136</sup> T. Baker & S.J. Griffith (2007) supra at pages 1813-17

<sup>137</sup> *Ibid.*

<sup>138</sup> A. Baker (Sep 2007) supra at page 77.

<sup>139</sup> Where no Side C insurance is held, or the claim against the company is not a "Securities Claim".

responsibility. Such an apportionment is typically not undertaken where D&O insurance is held by the directors only. Such practices have led D&O insurers to challenge their obligation to settle the entire claim where a share of liability is arguably attributable to an uninsured party.

Allocation of settlement sums is determined by the insurance contract. Absent any contractual allocation provisions, the Canadian courts have adopted the “larger settlement rule”<sup>140</sup>. This rule provides that an uninsured company is entitled to reimbursement of all settlement amounts if the corporation’s liability is purely “derivative” of the liability of the insured directors or officers. “Derivative” in this context means any direct or vicarious liability of the company. The D&O insurer is obliged to pay the entire settlement provided the monetary exposure of the directors and officers is equal to that of the company. The D&O insurer is only entitled to an allocation to the uninsured party if the insurer can demonstrate that the settlement sum was “made larger” by reason of the company’s role as a potentially liable party.

D&O insurers responded to the “larger settlement rule” in two ways. Firstly, some insurers introduced allocation clauses into their policies, requiring the insured and insurer to agree on a “fair and proper allocation” of damages. Secondly, many insurers now offer Side C coverage, which removes the need for apportionment between directors/officers and the corporation.

As far as defence costs are concerned, the general rule is that the insurer is not obliged to pay the full defence costs where the pleadings include covered and non-covered claims<sup>141</sup>. As stated above, D&O policies generally contain clauses entitling the insurer to associate itself with the defence. Insurers may rely upon such a clause to scrutinize the insured’s legal accounts. Defence costs are then assessed retrospectively to determine the components attributable to uncovered claims<sup>142</sup>. The obligation is on the insurer to prove what portion of the defence costs are attributable to uncovered claims<sup>143</sup>. Where it is not possible to separate covered from uncovered claims, it is appropriate for a court to order the insurer to assume all defence costs until it is possible to identify a principled basis for apportionment<sup>144</sup>.

To avoid assessments of costs and related litigation, D&O insurers often include a fixed allocation of defence costs in the policy (for example 80 percent of the total legal costs).

### *Cancellation or Rescission of the Policy*

As part of the D&O insurance application process, the insurer will require the prospective insured to provide basic information about the company in a written application form. The application form will generally request current and historical financial information, details of the experience of the directors and officers, the claims history of the corporation, plans for acquisitions or securities issuances, and any prior knowledge of acts or omissions likely to give rise to a claim. Where large corporations are concerned, it is also customary for insurers to meet

---

<sup>140</sup> *Coronation Insurance Co. v. Clearly Canadian Beverage Corp* [1999] B.C.J. No. 43 (B.C. C.A.)

<sup>141</sup> *Continental Insurance Co. v. Dia Met Minerals Ltd.* [1996] B.C.J. No. 1293 (B.C. C.A.).

<sup>142</sup> *Ibid* at paragraph 18.

<sup>143</sup> *Continental Insurance Co. v. Dia Met Minerals Ltd* [1995] B.C.J. No. 650 (B.C.S.C). The appeal case, reported at [1996] B.C.J. No. 1293, did not disturb this finding.

<sup>144</sup> *Alofs v. Temple Insurance Co.* [2005] O.J. No. 4372 at paragraph 10.

with the insured's senior managers and gather information about the insured's business model, strategies and risks<sup>145</sup>.

The application form will require the prospective insured to commit to the veracity of all written statements and documents furnished with the application. Further, the policy will also contain a "cognizance representation" clause which requires confirmation by the applicants that they are unaware of facts or circumstances which may give rise to a claim under the terms of the policy<sup>146</sup>. Provision of untrue information during the application process will usually allow the insurer to rescind the contract.

However, applications are usually completed by one or two people on behalf of all the individual applicants and the company. This may cause "innocent co-insureds", who were not involved in the application process, to lose their coverage. While a loss of coverage may be harsh to the innocent insureds, the courts have recognized that the insureds are in a better position than the insurer to investigate the facts that are material to the application<sup>147</sup>.

To address this issue, D&O policies typically contain "severability" for directors and officers. "Severability" operates at two levels to allow the policy to be rescinded only against those directors or officers involved in the breach of the insurance policy.

Firstly, severability is applied at the coverage level. The policy will usually provide that an applicant's knowledge of matters relating to the application is not imputed to other applicants. Further, it is common for a policy to state that it is to be treated as a separate policy with respect to each officer or director. However, there are many variations of the above clause, and it is important for insureds to understand when severability will apply.

For example, in *Cutter & Buck Inc. v. Genesis Insurance Company*<sup>148</sup> a US court found a misrepresentation by the CFO on the application form entitled the D&O insurer to rescind the policy against all directors, including those with no knowledge of the misrepresentation. The court's decision was affirmed on appeal<sup>149</sup>.

In *Cutter & Buck* the former CFO, without the knowledge of other directors, had engaged in a series of transactions with distributors to inflate the company's sales. The inflated results were reported in the audited financial statements. The financial statements were in turn submitted to the D&O insurer along with an application form, signed by the CFO, warranting the information supplied was correct. Insurance was provided and a claim arising from the distributor transactions was notified during the policy period. The D&O insurer voided the policy for misrepresentation of a material fact with intent to deceive.

---

<sup>145</sup> T. Baker and S.J. Griffith (2007) supra at page 508-512

<sup>146</sup> A. Baker (Sep. 2007) supra at page 85.

<sup>147</sup> *Ibid.*

<sup>148</sup> 306 F. Supp. 2d 988 (W.D. Wash. 2004)

<sup>149</sup> 144 Fed. Appx. 600 (U.S. C.A 9th Cir. 2005)

The relevant policy provision stated:

In the event that the Application, including materials submitted therewith, contains misrepresentations made with the actual intent to deceive, or contains misrepresentations which materially affect either the acceptance of the risk or the hazard assumed by the INSURER under this Policy, this Policy in its entirety shall be void and of no effect whatsoever; and provided, however, that no knowledge possessed by any DIRECTOR or OFFICER shall be imputed to any other DIRECTOR or OFFICER except for material information known to the person or persons who signed the Application. In the event that any of the particulars or statements in the Application is untrue, this Policy will be voided with respect to any DIRECTOR or OFFICER who knew of such untruth.

The court interpreted the clause to mean a director's or officer's knowledge of a misrepresentation made with an intent to deceive is not imputed to other directors or officers unless the application's signor knew of the misrepresentation.

The CFO had pleaded guilty to fraud, and the court therefore found the CFO had made the misrepresentation with the intent to deceive. Consequently, the court held the insurer was entitled to rescind the contract against all directors.

Many recent policies do not impute any knowledge of misrepresentation during the application process to innocent directors. For example, in the case of *In Re Healthsouth Corporation Insurance Litigation*<sup>150</sup> a group of directors admitted participating in a scheme to alter financial reports and overstate earnings. As in *Cutter & Buck*, the financial statements contained material facts represented to the insurer during the application process as being correct. When the fraud was discovered and a claim made, the D&O insurers attempted to rescind the policy against all directors. The innocent directors successfully argued the severability provisions entitled them to coverage.

In *Healthsouth*, the severability clause provided:

[The] written application(s) for coverage shall be construed as a separate application for coverage by each of the Insured Persons. With respect to the declarations and statements contained in such written application(s) for coverage, no statement in the application or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available.

The court held that the innocent directors were covered, but allowed the insurers to rescind the policy against the directors involved in the fraud.

Secondly, severability is applied at the liability level. The policy will generally provide that knowledge of the wrongful act giving rise to liability will not be imputed to all insureds. Thus, when a claim is made, the insurer is required to determine the state of mind of each insured before determining those that are subject to a conduct exclusion (for example the "fraud" exclusion) and therefore not covered under the policy.

---

<sup>150</sup> 308 F.Supp. 2d 1253 (N.D. Ala. March 16, 2004).

## 8. RECENT D&O INSURANCE ISSUES

### Dilution of Claims

The increasing popularity of entity coverage, together with the increasing frequency, complexity and severity of securities litigation, may result in the accelerated dilution of policy limits. The concern amongst directors and officers is that the policy limit will be exhausted by retiring the company's liability, leaving the directors exposed. Typically, "inside management" favor entity coverage since their conduct and that of their non-insured senior management group is retired by entity coverage. However, "outside directors" traditionally do not favor entity coverage, taking the view that the D&O policy should be solely for the benefit of the directors (with corporate exposure paid from corporate assets)<sup>151</sup>. As stated above, the "first come, first served" principle applies (absent a priority of payments clause). Accordingly, there is some merit in the outside directors' concerns<sup>152</sup>.

D&O insurers have addressed the dilution problem in a range of ways. Firstly, some insurers now include a "priority of payments" clause. Many policies provide that loss will first be paid on account of the directors (Side A), then on account of Side B reimbursement, and finally on behalf of the entity (Side C). Although priority of payments clauses have not yet been heavily litigated, the preliminary indication is that such clauses can be effective<sup>153</sup>.

Directors and officers may also purchase their own Side A policy separately from the company's D&O policy. Such a policy will ensure there is a separate, dedicated pool of insurance available for the directors. The dedicated policy may be stand-alone, or stacked on top of existing coverage (and triggered if the joint director/company policy is expended leaving the directors with liability). The "stacked" form of the policy is known as a "Side A Excess" policy.

Finally, insurers have recently offered a Side A "difference in conditions" policy ("Side A DIC"). The DIC policy "drops down" to serve as the primary policy when that policy does not cover the directors' or officers' loss. DIC insurance may therefore provide protection for directors where none existed, or the primary policy was rescinded or subject to exclusion.

For example, a primary D&O policy may contain an exclusion for a failure to purchase adequate insurance. If the company suffered a material loss from a fire at a plant that wasn't adequately insured, the board could be sued for making a poor decision to underinsure. The exclusion could give the insurer a basis for excluding the claim. However, the loss would be most likely covered under the DIC policy.

The *Cutter & Buck* case is a further example of a loss that could have been protected by a DIC policy. In that case, the primary D&O policy contained a narrow severability clause that did not protect innocent directors from application fraud on the part of the officer signing the application. Upon rescission of the primary policy, a Side A DIC policy that was either (a) non-

---

<sup>151</sup> E.A. Dolden (Jan 2008) *supra* at page 15.

<sup>152</sup> For example see: *Laidlaw Inc. (Re)* [2003] O.J. No. 1135

<sup>153</sup> E.A. Dolden (Jan 2008) *supra* at page 10.

rescindable or (b) contained a broad application severability clause, could be used to protect the directors.

As Side A Excess and DIC policies provide broader protection than the basic Side A policy, they carry a significantly higher price tag. Directors and officers must therefore evaluate whether the increased cost is justified.

### Coverage of Defence Costs in Criminal Proceedings

A director or officer is entitled to be indemnified by the corporation for the costs of defending a criminal proceeding provided that the director or officer:

1. 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;
2. acted honestly and in good faith with a view to the best interests of the corporation; and
3. had reasonable grounds for believing that their conduct was lawful<sup>154</sup>.

Where conditions 2 and 3 are not fulfilled the corporation is not permitted to indemnify<sup>155</sup>. Where conditions 2 and 3 are satisfied but not condition 1 (i.e. the director or officer is found guilty, but acted in the corporation's best interests on reasonable grounds the conduct was lawful) the corporation may (at its option) indemnify the director or officer<sup>156</sup>.

The corporation's ability to purchase insurance for the benefit of the directors and officers is not restricted by the *BCA*<sup>157</sup>. Hence the corporation may purchase insurance that will cover directors and officers for criminal defence costs and penalties even when they act improperly or are convicted. The losses associated with criminal proceedings are therefore, in theory, insurable under Side A Coverage (for non-indemnifiable losses) and Side B Coverage (for indemnifiable losses).

Coverage under D&O insurance policies in respect of criminal proceedings varies. It should be recalled policies typically state the insurer will pay "Loss" on account of "Claims" (or in the case of Side C insurance "Securities Claims") made during the policy period for a "Wrongful Act", subject to further policy conditions and exclusions. Coverage in respect of criminal matters is restricted or extended through the exclusion clauses and by modification of the terms "claim", "loss" and "wrongful act".

Leaving exclusions to one side, a common policy wording that does not expressly provide criminal cover states<sup>158</sup>:

---

<sup>154</sup> *BCA* s. 124(3) and (5).

<sup>155</sup> *BCA* s. 124(3).

<sup>156</sup> *BCA* s. 124(1), (3) and (5).

<sup>157</sup> *BCA* s. 124(6).

<sup>158</sup> Chubb policy 14-0207303 (ed. 11/2002)

**Claim** means:

(1) when used in reference to the coverage provided by Insuring Clause 1 or 2:

- (a) a written demand for monetary damages or non-monetary relief;
- (b) a civil proceeding commenced by the service of a complaint or similar pleading; or
- (c) a formal civil administrative or civil regulatory proceeding commenced by the filing of a notice of charges or similar document or by the entry of a formal order of investigation or similar document,

against an Insured Person for a Wrongful Act, including any appeal therefrom;

(2) when used in reference to the coverage provided by Insuring Clause 3:

- (a) a written demand for monetary damages or non-monetary relief;
- (b) a civil proceeding commenced by the service of a complaint or similar pleading; or
- (c) a formal civil administrative or civil regulatory proceeding commenced by the filing of a notice of charges or similar document or by the entry of a formal order of investigation or similar document, but only while such proceeding is also pending against an Insured Person,

against an Organization for a Wrongful Act, including any appeal therefrom; or

(3) when used in reference to the coverage provided by Insuring Clause 4, a Securityholder Derivative Demand.

Except as may otherwise be provided in Subsection 12, Subsection 13(g), or Subsection 15(b) of this coverage section, a Claim will be deemed to have first been made when such Claim is commenced as set forth in this definition (or, in the case of a written demand, including but not limited to any Securityholder Derivative Demand, when such demand is first received by an Insured).

**Loss** means:

- (a) the amount that any Insured Person (for purposes of Insuring Clauses 1 and 2) or the Organization (for purposes of Insuring Clause 3) becomes legally obligated to pay on account of any covered Claim, including but not limited to damages (including punitive or exemplary damages, if and to the extent that such punitive or exemplary damages are insurable under the law of the jurisdiction most favorable to the insurability of such damages provided such jurisdiction has a substantial relationship to the relevant Insureds, to the Company, or to the Claim giving rise to the damages), judgments, settlements, pre-judgment and post-judgment interest and Defense Costs; or
- (b) for purposes of Insuring Clause 4, covered Investigative Costs.

**Loss** does not include:

- (a) any amount not indemnified by the Organization for which an Insured Person is absolved from payment by reason of any covenant, agreement or court order;
- (b) any costs incurred by the Organization to comply with any order for injunctive or other non-monetary relief, or to comply with an agreement to provide such relief;
- (c) any amount incurred by an Insured in the defense or investigation of any action, proceeding or demand that is not then a Claim even if (i) such amount also benefits the defense of a covered Claim, or (ii) such action, proceeding or demand subsequently gives rise to a Claim;
- (d) taxes, fines or penalties, or the multiple portion of any multiplied damage award, except as provided above with respect to punitive or exemplary damages;
- (e) any amount not insurable under the law pursuant to which this coverage section is construed, except as provided above with respect to punitive or exemplary damages;
- (f) any amount allocated to non-covered loss pursuant to [the allocation provisions]; or (g) any amount that represents or is substantially equivalent to an increase in the consideration paid (or proposed to be paid) by an Organization in connection with its purchase of any securities or assets.

**Defense Costs** means that part of Loss consisting of reasonable costs, charges, fees (including but not limited to attorneys' fees and experts' fees) and expenses (other than regular or overtime wages, salaries, fees or benefits of the directors, officers or employees of the Organization) incurred in defending any Claim and the premium for appeal, attachment or similar bonds.

**Wrongful Act** means:

- (a) any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted by an Insured Person in his or her Insured Capacity, or for purposes of coverage under Insuring Clause 3, by the Organization, or
- (b) any other matter claimed against an Insured Person solely by reason of his or her serving in an Insured Capacity.

It would appear the above policy does not provide coverage in respect of criminal proceedings. Although "formal civil administrative or civil regulatory" actions are included in the definition of "claim", criminal proceedings are not. Excluded from the definition of "loss" are "fines", "penalties" and amounts incurred in respect of "the defense or investigation of any action, proceeding or demand that is not then a 'claim'". However, it is arguable that sufficient ambiguity exists to interpret the clause against the insurer and find criminal proceedings are covered.

A common policy wording that covers criminal defence costs, but not any penalty imposed in a criminal matter, states<sup>159</sup>:

“**Claim**” shall mean:

- (1) a written demand for monetary or non-monetary relief made against any Insured and reported to the Insurer pursuant to [the policy]; or
- (2) a civil, criminal, administrative or arbitration proceeding made against any Insured seeking monetary or non-monetary relief and commenced by the service of a complaint or similar pleading, the return of an indictment, or the receipt or filing of notice of charges or similar document, including any proceeding initiated against any Insured before the Equal Employment Opportunity Commission or any similar governmental body.

“**Loss**” shall mean compensatory damages, punitive or exemplary damages, the multiple portion of any multiplied damage award, settlements and Costs of Defense, provided, however, Loss shall not include criminal or civil fines or penalties imposed by law, taxes, or any matter which may be deemed uninsurable under the law pursuant to which this Policy shall be construed...Loss shall also not include any portion of damages, judgments or settlements arising out of any Claim alleging that the Company paid an inadequate price or consideration for the purchase of the Company’s securities.

“**Costs of Defense**” shall mean reasonable and necessary legal fees, costs and expenses incurred in the investigation, defense or appeal of any Claim including the costs of an appeal bond, attachment bond or similar bond (but without obligation on the part of the Insurer to apply for or furnish such bonds); provided, however, Costs of Defense shall not include salaries, wages, overhead or benefit expenses associated with any Insured Persons.

“**Wrongful Act**” shall mean:

- (1) any actual or alleged act, omission, error, misstatement, misleading statement, neglect or breach of duty, or Employment Practices Wrongful Act, by any Insured Persons in their capacity with the Company;
- (2) any actual or alleged act, omission, error, misstatement, misleading statement, neglect or breach of duty by the Insured Entity, but only with respect to [Insuring Clause C];
- (3) any matter claimed against any Insured Person solely by reason of their status with the Company; or
- (4) any matter claimed against any Insured Persons arising out of their service as a director, officer, trustee, or governor of an Outside Entity, but only if such service is at the request of the Company.

---

<sup>159</sup> Great American Insurance Co., policy D2100 (1/99)

As can be seen from the above, coverage in respect of criminal proceedings varies widely with the terms of the policy. However, it should be noted that the “fraud” exclusion will continue to operate in many criminal contexts to exclude:

- deliberately fraudulent acts; and
- claims brought about or contributed to by the insured person gaining profit, advantage, or remuneration to which the insured person was not legally entitled.

As a guilty mind and deliberate act are the cornerstones of criminal liability, the fraud exclusion would be expected to play a large role in coverage in a criminal context. It should also be recalled the fraud exclusion is typically subject to a “final adjudication” clause. Accordingly, where criminal defense costs are ostensibly covered but potentially subject to exclusion, the insurer may be obliged to advance defense costs until final adjudication.

There is little case law on this issue in Canada, however it has been considered by US courts. In the case of *In Re Enron Corporation – Securities, Derivative & “ERISA” Litigation*<sup>160</sup> the corporation was placed into bankruptcy after it was revealed that management had engaged in a series of transactions designed to hide the corporation’s debt and overstate profits. At the time of the subject decision, the directors were facing parallel civil, criminal and administrative proceedings. Several insured officers had pleaded guilty to criminal charges involving fraud and dishonesty.

The defendants made a claim under the D&O policy seeking payment, on a current account basis, of the legal costs which would be incurred defending the criminal charges through the sentencing process. The insurer’s position was that the defence costs were not covered or were excluded. Further, as the exclusion clause contained a “final adjudication” clause, the insurer argued a guilty plea constituted a final adjudication of fraud and estopped the defendants from asserting otherwise in civil proceedings. The insured’s motion for summary judgment in a proceeding seeking indemnity for legal costs was granted, however an estoppel was found to apply.

The policy was phrased in similar terms to the first policy example in this section. A “claim” included “any demand, suit or proceeding...which seeks actual or monetary damages or other relief”. “Loss” was defined to include defence costs arising from a wrongful act. “Wrongful act” did not draw a distinction between criminal and civil acts, nor did it refer to the insured’s state of mind, and was therefore capable of including both criminal and civil acts.

Under the exclusion clause, claims “for any fines or penalties imposed in a criminal suit, action or proceeding” were excluded. The “fraud” exclusion applied where it had been finally adjudicated that “acts of deliberate dishonesty were committed or attempted with actual dishonest purpose and intent and were material to the cause of action”.

The Court found the policy was ambiguous as to whether criminal defence costs were covered. When interpreting the policy, the Court concluded there were two conflicting lines of case law.

---

<sup>160</sup> 391 F. Supp. 2d 541; 2005 U.S. Dist. LEXIS 31077 (S.D. Tex. Aug. 1, 2005)

One branch stated D&O policies do not cover costs for criminal actions, including legal costs, because criminal punishments do not seek damages that “compensate” a party for injuries suffered. A second branch drew a distinction between fines/penalties (not covered) and legal costs incurred in defence (covered). The court concluded there was sufficient ambiguity to construe the policy against the insurer and find the criminal defence costs were covered.

Secondly, the court found the favored legal position was that a D&O insurer faced with a claim covered until “final adjudication” must pay defence costs as incurred. The court adopted the following statement of public policy from *Little v MGIC Oudem. Corp*<sup>161</sup>:

If the D&O policy allowed absolute discretion to the insurer to withhold payment whenever charges of intentional dishonesty are leveled against directors and officers, . . . then insurers would be able to withhold payment in virtually every case. That would be a most unsatisfactory result. It would leave directors and officers in an extremely vulnerable position. Any allegations of intentional dishonesty, no matter how groundless, could bring financial ruin upon a director or officer. . . . Directors and officers would be forced to advance their defense expenditures, which are likely to be staggering. Meanwhile the insurer defers all payment until the final disposition of suit, which may take years. This situation is unreasonably favorable to the insurers who may blithely disclaim responsibility for the insured's enormous financial burdens while the insured must fight on<sup>162</sup>.

Finally, the court held that a guilty plea does not constitute final adjudication until sentence is imposed by the court. However, the court did find the defendants who pled guilty were estopped from arguing that their guilt did not trigger the fraud exclusion clause. The court held estoppel under Texas law was an equitable doctrine invoked at the court's discretion to protect the integrity of the judicial process by prohibiting litigants from arguing inconsistent positions during litigation. The civil court concluded the criminal court's adoption of the guilty plea gave rise to an estoppel.

Our experience suggests that the majority of D&O policies in the market today cover criminal proceedings, with almost all of those requiring repayment of advanced defence costs upon conviction of fraud or dishonesty. Directors and officers wishing to protect their interests should ensure criminal coverage is included in the policy.

### Corporation Insolvency

Under the federal *Bankruptcy and Insolvency Act*<sup>163</sup> (the “BIA”), when a company is placed in bankruptcy all the bankrupt's “property” comes under the administration of the bankruptcy trustee<sup>164</sup>. Although the point has not been decided in Canada<sup>165</sup>, there is a viable argument that the proceeds of a D&O policy, including the advancement of defence costs during bankruptcy, constitute part of the bankrupt estate.

---

<sup>161</sup> 836 F.2d 789, 793 (3d Cir. 1987)

<sup>162</sup> *In Re Enron Corporation Securities, Derivative & “ERISA” Litigation* supra at page 83.

<sup>163</sup> R.S.C. 1985, c. B-3

<sup>164</sup> BIA, Part IV.

<sup>165</sup> E.A. Dolden (Jan 2008) supra at page 7.

For example, in the famous *In re Enron Corp.*<sup>166</sup> case, the D&O policy contained a “priority of payments” clause requiring Side A claims to be paid ahead of Side B and Side C ones. The insurer proposed to advance defence costs to the directors. Enron’s creditors objected, wishing to see the insurance proceeds applied on the company’s behalf to creditors. Ultimately, the court gave effect to the “priority of payments” clause and advanced defence costs to directors.

It is likely that in Canada the proceeds of a Side A D&O policy would be regarded as trust property. Under section 67 of the *BIA*, the bankruptcy trustee is entitled administer trust property, however the trustee is not permitted to divide trust property among creditors<sup>167</sup>.

A useful starting position would be that Side C coverage is a corporate asset, and Side A coverage not a corporate asset. However, if a D&O policy and its proceeds form part of the bankrupt estate, disbursement will be at the trustee’s discretion. The directors would then be placed in a problematic circumstance where their defence costs cannot be borne by the insolvent company, and the proceeds of the policy are expended in favor of the creditors.

The dominant view in the USA is that Side A policies are the property of the directors and officers<sup>168</sup>. When determining whether Side B and C policies are property of the company, the courts look at who purchased (and therefore owns) the policy over who benefits from the proceeds. Where the policy proceeds are applied to the company for losses associated with the indemnification of the directors or officers on account of the latter’s liability, the courts favour the view that the policy is the property of the corporation<sup>169</sup>.

It remains to be seen whether Canada will follow the US approach.

The insurance market has responded to the above jurisprudence in a number of ways. Firstly, directors and officers may now purchase dedicated policies (as discussed above) which are likely to be beyond the reach of creditors. However, dedicated policies paid for by the company are at an increased risk of being labeled bankrupt property.

Secondly, as alluded to above, many policies include a “priority of payments” clause which state policy proceeds are to be paid out on account of director liability before that of the company. Such clauses have been upheld against creditors in USA bankruptcy courts<sup>170</sup>.

### *Is Entity Coverage for Securities Claims Necessary?*

The current uncertainty surrounding rescission, allocation, dilution and insolvency, has lead several industry groups and commentators to question whether entity coverage is useful and cost effective.

---

<sup>166</sup> *In re Enron Corp.*, 2002 Extra LEXIS 411 (Bankr. S.D.N.Y.)

<sup>167</sup> *Royal Bank of Canada v. North American Life Assurance Co.*, [1996] 1 S.C.R. 325.

<sup>168</sup> For a recent example, see: *In re Laminate Kingdom LLC*, No. 07-10279, 2008 BL 59691 (Bankr. S.D. Fla. Mar. 13, 2008)

<sup>169</sup> E.A. Dolden (Jan 2008) supra at page 8.

<sup>170</sup> *In re Enron Corp.* supra; and *In re Laminate Kingdom LLC* supra.

In essence, entity protection spreads the risk of shareholder litigation from the corporation to a third party insurer. Naturally, the insurer charges the corporation a premium which reflects the actuarially determined probability of loss plus a loading fee to cover the insurers overhead and profits. The loading fee means it always costs more to buy insurance for a risk than to bear it oneself.

It has been suggested that corporations are able to absorb the risk of shareholder litigation, thus rendering entity coverage unnecessary. Firstly, it is argued that the corporation controls the governance process that creates the litigation risk. Corporations can therefore mitigate this risk by improving their governance practices<sup>171</sup>.

Secondly, corporations are sophisticated risk shifting mechanisms, ultimately allocating the risk of business failure to shareholders whose losses, thanks to limited liability, cannot exceed the extent of their investment<sup>172</sup>.

Finally, the shareholders can cheaply eliminate risk by holding a diversified portfolio of equity securities. Because the risk of shareholder litigation attaches to the specific company, and not the market generally, the risk can be effectively managed through diversification<sup>173</sup>.

It has also been suggested from a public policy perspective D&O insurance insulates directors from losses caused by mismanagement and therefore reduces the deterrent effect of shareholder litigation.

Despite extensive debate of the above issues, the majority of large companies still hold Side A, B and C insurance<sup>174</sup>. It is thought that entity coverage continues to be popular as it does offer benefits to both managers and the corporation itself.

Managers, unlike diversified shareholders, have a significant personal stake in the corporations that they manage. Further, management compensation packages are generally tied to accounting measures of performance. Shareholder litigation is likely to have a large and adverse impact on performance measures. Entity coverage allows managers to trade large but infrequent losses for smaller annual insurance costs. Managers may therefore buy entity coverage to protect their compensation even though it may not be a good investment for the company<sup>175</sup>.

As far as the corporation is concerned, shareholder litigation requires a large outlay of company capital. Traditional methods of raising capital – issuing shares or borrowing from creditors – are unlikely to be available in the midst of a large shareholder claim. Accordingly, where there is no D&O insurance, one option would be for the company to maintain reserves that could fund shareholder litigation. However, reserving ties up funds that could be used more efficiently elsewhere within the company. If reserves were not maintained, the corporation would be forced

---

<sup>171</sup> S.J. Griffith (May 2006) supra at page 1171

<sup>172</sup> Ibid at pages 1168-9

<sup>173</sup> T. Baker and S.J. Griffith (August 2007) supra at pages 1821-3.

<sup>174</sup> Ibid (August 2007) supra at page 1830 found between 70 and 80 percent of large USA companies hold Side A, B and C insurance.

<sup>175</sup> S.J. Griffith (May 2006) supra at pages 1172-3.

p. 33

to borrow on unfavorable terms once the litigation arose, assuming borrowers were prepared to lend<sup>176</sup>.

Accordingly, entity coverage may be viewed as a commitment from a creditor to make capital available at a time when traditional means of raising capital are unavailable. Thus, the corporation is protected from borrowing on disadvantageous terms once a claim has arisen.

Ultimately, the availability of diverse and often negotiable D&O policies should ensure that corporations, and their directors and officers, are able to insure on the terms and price appropriate to environment in which the corporation operates.

## 9. CONCLUSION

Following a string of spectacular corporate scandals and failures in North America, there has been a proliferation of debate and litigation respecting the duties and liabilities of corporate directors and officers. For publicly listed companies, particularly in the United States, the dominant source of director and officer liability, both in terms of claims brought and liability exposure, is shareholder litigation. In Canada exposure to secondary market liability is still somewhat circumscribed and class action securities law suits remain infrequent. Nonetheless, directors and officers of Canadian companies have become increasingly concerned at the prospect of personal liability and, not surprisingly, D&O liability insurance has become an integral part of corporate governance.

In the past couple decades coverage under D&O liability policies has changed quite dramatically. Traditional exclusions have been modified and market response to judicial rulings has seen coverage expanded to include such things as non-rescindable policies and coverage for the cost of defending regulatory or criminal proceedings. Underwriters are increasingly prepared to negotiate terms and more so than ever do directors and officers require sophisticated and experienced broker and risk management services.

**Steven Donley**

Tel. 604.891.7716

sxd@cwilson.com

**Nigel P. Kent**

Tel. 604.643.3135

npk@cwilson.com

---

<sup>176</sup> T. Baker and S.J. Griffith (August 2007) *supra* at page 1827-9

## APPENDIX A

Extracted from Barry Reiter, *Directors' Duties in Canada*,  
 3rd Edition (CCH Canadian Limited, 2006)

# A P P E N D I X I

### Common Sources of Directors' Liability Under Federal Statutes (Last Updated June 2006)

THIS IS NOT A COMPREHENSIVE LIST. THE PASSAGES SET OUT BELOW ARE SUMMARIES ONLY, AND THE READER MUST REFER TO THE SPECIFIC STATUTE FOR A COMPLETE STATEMENT OF THE DIRECTOR'S LEGAL RESPONSIBILITIES AND THE STATUTORY CONTEXT IN WHICH THOSE LEGAL RESPONSIBILITIES ARISE.

S11

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Bankruptcy and Insolvency Act</i> , R.S.C. 1985, c. B-3			No person may commence an action or proceeding against directors that arose before the commencement of bankruptcy proceedings and proceedings related to obligations of the corporation for which directors are liable: <sup>1</sup> [ss. 69.31(1) and (2)]
<i>Bankruptcy and Insolvency Act</i>	Any person privy to non-arm's-length transactions with bankrupt, without adequate consideration, occurring within the 1-year period preceding initial bankruptcy event and bankruptcy, is subject to judgment in favour of trustee: [s. 100]	Liable for difference between the actual consideration given or received and the fair market value: [s. 100]	None <sup>2</sup>

<sup>1</sup> To encourage directors of an insolvent corporation to remain in office during a reorganization, a stay is created in respect of claims against directors. The stay does not apply to actions against a director on a guarantee or actions seeking injunctive relief against a director: [s. 69.31(2)]. See ss. 50(13)–50(15).

<sup>2</sup> "None" means that no defence is built into the statute. A defence may be available at common law.

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Bankruptcy and Insolvency Act</i>	Director is liable for paying a dividend (other than a stock dividend) or for redeeming or purchasing corporate shares for cancellation, if it occurred within 12 months preceding the bankruptcy and if it is done at a time when the corporation is insolvent: [s. 101(2)]	Liable, jointly and severally, or solidarily, for the amount of the dividend, redemption or purchase price, plus interest: [s. 101(2)]	Director is not liable if he proves the corporation was not insolvent by the transaction or the director had reasonable grounds to believe the corporation was not insolvent at the time of, or rendered insolvent by, the transaction: [ss. 101(2) & 101(5)]. In assessing whether the director had reasonable grounds for belief under s. 101(2)(b), the court must consider the statutory "due diligence defence": [s. 101(2.1)] <sup>3</sup>  Director is not liable if he or she protested against payment: [s. 101(3)]
<i>Bankruptcy and Insolvency Act</i>	Officer or person in direct/indirect control of corporation is liable if he or she failed to perform all of the duties imposed on a bankrupt by s. 158 (see s. 158 for duties): [s. 159]	Punishable as though bankrupt: [s. 159]	None
<i>Bankruptcy and Insolvency Act</i>	Director, officer, agent, mandatory, or a person in direct/indirect control is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of the offence under the Act: [s. 204]	Liable to punishment provided for in the offence, whether or not the corporation was prosecuted or convicted; liable to pay for the loss caused to the third party: [ss. 204 and 204.3]	None

<sup>3</sup> Due diligence in s. 101(2.1) states that a director is not liable if the director exercised the care, diligence, and skill that a reasonably prudent person would have exercised in comparable circumstances, including reliance in good faith on (a) the financial statements of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation to fairly reflect the financial condition of the corporation; or (b) a report of a person whose profession lends credibility to a statement made by the professional person.

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Canada Business Corporations Act</i> , R.S.C. 1985, c. C-44 ("CBCA")	Director is liable if he or she authorized the issuance of shares under s. 25 for a consideration other than money if the amount received is less than the fair equivalent of money: [ss. 25(3) and 118(1)]	Liable, jointly and severally or solidarily for the difference between the fair equivalent of money and the amount received: [s. 118(1)]	Director is not liable if the director proves that he or she did not reasonably know, and could not reasonably have known, that the share was issued for a lesser consideration: [s. 118(6)]. Action must be commenced within 2 years from the date of the resolution authorizing the action complained of: [s. 118(7)]  Director is not liable if the director proves care, diligence, and skill under due defence, set out <i>supra</i> note 4: [s. 123(4)] <sup>4</sup> or if the director proves that he or she dissented: [s. 123(1)]
<i>Canada Business Corporations Act</i>	Director is liable if he or she authorized (a) purchase, redemption, or other acquisition of shares, contrary to s. 34, 35, or 36; (b) payment of unreasonable commission regarding corporation's shares, contrary to s. 41; (c) payment of dividend, contrary to s. 42; (d) financial assistance, contrary to s. 44; (e) payment of indemnity, contrary to s. 124; or (f) payment to shareholder, contrary to ss. 190 or 241: [s. 118(2)]	Liable, jointly and severally, or solidarily, to restore to the corporation any amounts distributed and not otherwise recovered by the corporation: [s. 118(2)]	Action must be commenced within 2 years from the date of resolution authorizing the action complained of: [s. 118(7)].  Director is not liable if the director proves that he or she exercised care, diligence, and skill under the due diligence defence, set out <i>supra</i> note 4: [s. 123(4)]  Director is not liable if the director proves that he or she dissented: [s. 123(1)]

<sup>4</sup> Due diligence defence under s. 123(4) states that a director is not liable if the director exercised the care, diligence, and skill that a reasonably prudent person would have exercised in comparable circumstances, including reliance in good faith on (a) financial statements of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation to fairly reflect the financial condition of the corporation; or (b) a report of a person whose profession lends credibility to a statement made by the professional person.

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Canada Business Corporations Act</i>	Director is liable to employees of the corporation for wages (if incurred while the director was in office): [s. 119(1)]	Liable, jointly and severally, or solidarily for all debts not exceeding 6 months' wages that are payable to each employee for services performed for the corporation: [s. 119(1)]	Director is not liable unless the corporation (1) died or was dissolved or liquidated within 6 months after becoming due and execution was returned unsatisfied; (2) commenced liquidation and dissolution proceedings or has been dissolved and the claim was proved within 6 months thereof; or (3) made an assignment or was the subject of a receiving order under the <i>Bankruptcy and Insolvency Act</i> and the debt was proved within 6 months: [s. 119(2)] Action must be commenced while the director was in office or within 2 years after the director ceases to be a director: [s. 119(3)] Director is not liable if the director proves that he or she exercised care, diligence, and skill under the due diligence defence set out <i>supra</i> in note 4: [s. 123(4)]
<i>Canada Business Corporations Act</i>	Directors or officers are liable if in exercising their powers and discharging their duties they failed to (a) act honestly and in good faith with a view to the best interests of the corporation; or (b) exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances, and, subject to s. 146(5) (USA), cannot contract out of these duties by provisions in contract, articles, by-laws, or a resolution: [ss. 122(1) and (3)]	Liable for civil liability, which varies depending upon the breach	Director is not liable if he or she establishes good faith reliance on officer or auditor financials or on professional reports: [s. 123(5)] <sup>5</sup>

<sup>5</sup> Subsection 123(5) states that a director has complied with his or her duties under s. 122(1) if the director relied in good faith on (a) financial statements of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation to fairly reflect the financial condition of the corporation; or (b) a report of a person whose profession lends credibility to a statement made by the professional person.

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Canada Business Corporations Act</i>	Director or officer is liable if he or she failed to comply with Act, regulations, articles, by-laws, and unanimous shareholder agreements (USA), and subject to s. 146(5) (USA), cannot contract out of this duty by provisions in contract, articles, by-laws, or resolution: [ss. 122(2) and (3)]	Liable in accordance with the provision with which they failed to comply	Director is not liable if the director proves that he or she exercised care, diligence, and skill under the due diligence defence, <i>supra</i> note 4: [s. 123(4)]
<i>Canada Business Corporations Act</i>	Insider (including a director or an officer) is liable for tipping if he or she discloses to another person (tippee) confidential information regarding the corporation that has not been generally disclosed and that, if generally known, might reasonably be expected to materially affect the value of the corporation's securities: [s. 131(6)]	Liable, jointly and severally, or solidarily (1) to compensate a person with whom the tippee subsequently trades for damages suffered, and (2) to account to corporation for any benefit/advantage received by an insider: [ss. 131(6), (7), (8), and (9)]	Insider is not liable to compensate a person with whom the tippee traded if he or she proves (a) that the insider reasonably believed that information had been generally disclosed; (b) that information was known, or ought reasonably to have been known, by the person with whom the tippee traded; (c) that disclosure of information was necessary in the course of the business of the insider, except if the insider is the offeror in a take-over bid for, or a business combination with, the corporation; or (d) where the insider is an offeror in a take-over bid for or a business combination with the corporation, the disclosure of information was necessary to effect the take-over bid or business combination: [s. 131(6)]  Insider is not liable to compensate the corporation if the insider establishes the circumstances described in ss. 131(6)(a), (c), or (d) above: [s. 131(7)]

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
Canada Business Corporations Act	Insider (including a director or officer) is liable if he or she trades while making use of confidential information that, if generally known, might reasonably be expected to materially affect the value of the security for the insider's own benefit/advantage in a sale or purchase from the shareholder of the corporation or any affiliates: [s. 131(4)]	Liable, jointly and severally, or solidarily (1) to compensate a person with whom the insider traded for damages suffered and, (2) to account to the corporation for any benefit/advantage received by the insider	Insider is not liable to compensate the person with whom the insider traded if he or she proves that (a) the insider reasonably believed that information had been generally disclosed; (b) information was known, or ought reasonably to have been known, by the person with whom the insider traded; or (c) the purchase or sale of the security took place in prescribed circumstances: [s. 131(4)] Insider is not liable to account to the corporation if he or she proves the circumstances described in s. 131(4)(a) above: [s. 131(5)]
Canada Business Corporations Act	Director or officer is liable if he or she knowingly failed to notify the audit committee and the auditor of an error/misstatement in the financial statements reported on by the auditor or former auditor: [s. 171(6)]	Liable to a fine not exceeding \$5,000 and/or imprisonment not exceeding 6 months: [s. 171(9)]	None
Canada Business Corporations Act	Director or officer is liable if he or she knowingly failed to prepare/issue revised financial statements and inform shareholders/director: [s. 171(8)]	Liable to a fine not exceeding \$5,000 and/or imprisonment not exceeding 6 months: [s. 171(9)]	None

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
Canada Business Corporations Act	Director is guilty of offence if he or she knowingly authorized, permitted, or acquiesced in the corporate transfer of constrained shares where it was not satisfied, on reasonable grounds, that it would assist the corporation or affiliates in receiving licences or permits or maintaining a specific level of Canadian ownership: [s. 32(4)]	Liable to a fine not exceeding \$5,000 and/or imprisonment not exceeding 6 months, whether or not the corporation is prosecuted or convicted: [s. 32(4)]	Director is not liable if there was a reasonable cause for transfer: [s. 32(3)]
Canada Business Corporations Act	Director or officer is guilty of an offence if he or she knowingly authorized, permitted, or acquiesced in the corporation failing, without reasonable cause, to issue a proxy while concurrently giving notice of a meeting of shareholders: [ss. 149(1)-(4)]	Liable to a fine not exceeding \$5,000 and/or imprisonment not exceeding 6 months, whether or not the corporation is prosecuted or convicted: [s. 149(4)]	None
Canada Business Corporations Act	Director or officer is guilty of an offence if he or she knowingly authorized, permitted, or acquiesced in the failure to send a proxy prior to any solicitation of proxies: [ss. 150(1)-(4)]	Liable to a fine not exceeding \$5,000 and/or imprisonment not exceeding 6 months, whether or not the corporation is prosecuted or convicted: [s. 150(4)]	None
Canada Business Corporations Act	Director or officer is guilty of an offence if he or she knowingly authorized, permitted, or acquiesced in the failure of the corporation to comply with the duties of a registrant where the corporation is the registered owner but not the beneficial owner of shares: [ss. 153(1)-(9)]	Liable to a fine not exceeding \$5,000 and/or to imprisonment not exceeding 6 months, whether or not the corporation is prosecuted or convicted: [s. 153(9)]	None

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Canada Business Corporations Act</i>	Director or officer is guilty of an offence if he or she knowingly authorized, permitted, or acquiesced in making a report, return, notice, or other document required under the Act/regulations to be sent to the Director or to another person that (a) contained an untrue statement of material fact, or (b) omitted a material fact: [ss. 250(1) and (2)]	Liable to a fine not exceeding \$5,000 and/or imprisonment not exceeding 6 months: [s. 250(2)]	Director or officer is not guilty of offence if he or she did not know, in exercise of reasonable diligence could not have known, of an untrue statement or omission: [s. 250(3)]
<i>Canada Cooperative Act</i> , R.S. 1998, c. C-1	Directors and officers are liable for the failure to perform various duties or for offences, similar to those identified under the CBCA, including, but not limited to, those in s. 101(1) (issuance of shares for less than money value); s. 101(3) (redemption of shares contrary to Act, commission contrary to Act, payment of dividend contrary to Act); s. 102(1) (unpaid employee wages for a maximum of 6 months)	Liability varies, according to the circumstances of the case or the penalty imposed by the Act; see the Act for exact provisions.	Director or officer is not liable if various statutory defences or limitation periods apply; see the Act for exact provisions
<i>Canada Corporations Act</i> , R.S.C. 1970, c. C-32	Directors and officers are liable for the failure to perform various duties, or for offences, similar to those identified under the CBCA, including, but not limited to, those in s. 40(2) (transfer of shares to a person without the sufficient means to pay for them); s. 99(1) (unpaid employee wages to a maximum of 6 months); s. 101(2) (issuance of shares for less than money value); s. 204(1) (unpaid wages for clerks, labourers, and apprentices)	Liability varies, according to the circumstances of the case or to the penalty imposed by the Act; see the Act for exact provisions.	Director or officer is not liable if various statutory defences or limitation periods apply; see the Act for exact provisions

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Canada Labour Code</i> , R.S.C. 1985, c. L-2.	Persons (including directors and officers) are guilty of an offence if they knowingly authorized, permitted, or acquiesced in contravening a direction by a safety officer or if they failed to make accessible to employees the employer's policy concerning safety and health: [s. 148]	Liable to a fine not exceeding \$1,000,000 and/or imprisonment not exceeding 2 years: [s. 148]	Director or officer is not liable if the director proves that he or she exercised due care and diligence to avoid a contravention: [s. 148(4)]
<i>Canada Labour Code</i>	Director is liable on the inspector finding that the employer failed to pay wages and other amounts to employees: [ss. 251.1 and 251.18]	Liable, jointly and severally, for wages and other amounts to which the employee is entitled to at the maximum equivalent of 6 months' wages: [s. 251.18]	Director is not liable unless (a) the entitlement arose during the particular director's incumbency; and (b) the recovery of the amount from the corporation is impossible or unlikely: [s. 251.18]
<i>Canada Pension Plan Act</i> , R.S.C. 1985, c. C-8	Director or officer is liable, together with the corporation if the corporation failed to deduct or remit to the Receiver General the amount owing under the Act: [s. 21.1(1)]	Liable, jointly and severally, or solidarily, together with the corporation, to pay the amount and interest or penalties: [s. 21.1(1)] <sup>6</sup>	
<i>Canada Pension Plan Act</i>	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced, or participated in the commission of an offence contrary to the Act: [s. 103(2)]	Liable to punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 103(2)]	None

<sup>6</sup> Subsections 227.1(2) to (7) of the *Income Tax Act* apply in respect of this breach.

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Canadian Environmental Protection Act, 1999, S.C. 1999, c. C-33.</i>	Director, officer, or agent is guilty of an offence if he or she directed, authorized, assented to, acquiesced, or participated in the commission of the offence by the corporation, or if he or she intentionally or recklessly caused disaster or showed wanton or reckless disregard for lives and safety that could result in prosecution under ss. 203 and 204 of the <i>Criminal Code</i> : [s. 274-280.1] Director or officer is liable if he or she failed to take reasonable care to ensure corporate compliance with the Act: [s. 280(1)]	Liable to fines or imprisonment which vary, depending upon the offence; punishment can be as high as fine of \$1,000,000 and/or 3 years imprisonment: [s. 272(2)]	Persons are not guilty, other than those charged under s. 273 (providing false or misleading information if committed knowingly), or under s. 228 (providing false information or obstructing enforcement officer or analyst) or s. 274 (intentionally or recklessly causing disaster or wanton or reckless disregard), where the person exercised due diligence to prevent the commission of the offence: [s. 283] Action must be commenced within 2 years: [ss. 272-280.1]
<i>Competition Act, R.S.C. 1985, c. C-34</i> <sup>7</sup>	Director or officer is liable for the corporation's offence if he or she is in a position to direct or influence the policies of the corporation, such as corporate engagement in deceptive telemarketing practices: [s. 52.1(8)]	Liable for the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 52.1(8)]	Officer or director is not liable if it is established that he or she exercised due diligence to prevent the commission of the offence: [s. 52.1(8)]
<i>Competition Act</i>	Director or officer is guilty of an offence where he or she directs or influences policies of the corporation in violation of s. 53 (deceptive notice of winning a prize): [s. 53(5)]	Liable for the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 53(5)]	Officer or director is not liable if it is established that he or she exercised due diligence to prevent the commission of the offence: [s. 53(5)]
<i>Competition Act</i>	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in or participated in the corporation's destruction or alteration of a record or another thing required under the Act or for which a warrant has been issued: [s. 65(4)]	Liable for the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 65(4)]	None

<sup>7</sup> The *Competition Act* includes other offences that do not expressly mention directors and officers' liability, but a breach of such an offence could attract liability if a director or an officer is a controlling mind of the corporation.

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Consumer Packaging and Labelling Act, R.S.C. 1985, c. C-38</i>	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence under the Act: [s. 20(3)]	Liable to punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 20(3)]	None
<i>Criminal Code, R.S.C. 1985, c. C-46.</i>	Director or officer is guilty of an offence if he or she made, circulated, or published a prospectus, statement, or account that he or she knew was false with the intent to deceive and defraud: [s. 400(1)]	Liable to imprisonment for up to 10 years: [s. 400(1)]	None
<i>Customs Act, R.S.C. 1985, c. C-1 (2nd Supp.).</i>	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence under the Act: [s. 158]	Liable to the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 158]	None
<i>Employment Insurance Act, S.C. 1996, c. 23</i>	Director or officer is liable if the corporation failed to deduct and remit to the Receiver General the prescribed amount from the employee's remuneration: [s. 83(1)]	Liable, jointly and severally, or solidarily to pay the amount and related interest and penalties: [s. 83(1)]	None
<i>Excise Tax Act, R.S.C. 1985, c. E-15. (Part IX — Goods and Services)</i>	Director is liable if he or she is a director at the time the penalty is imposed for the act or omission under ss. 38 or 39 (false representation, false benefit claims, fraud or deceit): [s. 46(1)]	Liable, jointly and severally, or solidarily for the penalty imposed: [s. 46.1(1)]	Director is not liable unless certain conditions met under s. 46.1(2) or if director establishes due diligence defence under s. 46.1(3)
<i>Excise Tax Act</i>	Director, officer, or agent is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of the offence under the Act: [s. 96(3)]	Liable for the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 96(3)]	None

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation
<i>Excise Tax Act</i>	Directors are jointly and severally, or solidarily liable if the corporation fails to remit an amount of net tax as required under the Act: [s. 323(1)]	Liable to pay the amount and any interest on or penalties related to the amount: [s. 323(1)]	Director is not liable unless certain conditions are met under s. 323(2) or if the director establishes a due diligence defence under s. 323(3)
<i>Excise Tax Act</i>	Director, officer, or agent is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence under Part IX: [s. 330]	Liable for the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 330]	None
<i>Export and Import Permits Act</i> , R.S.C. 1985, c. E-19.	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence under the Act, for example, the export of goods included in the Export Control List: [s. 20]	Liable for the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 20]	None
<i>Fisheries Act</i> , R.S.C. 1985, c. F-14.	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence by the corporation, for example, carrying on without authorization, any work or undertaking that results in the harmful alteration or destruction of habitat frequented by fish: [s. 78.2]	Liable to the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 78.2]	Director or officer is not liable if he or she exercised due diligence or proves that he or she reasonably and honestly believed in the existence of a fact that, if true, would render a person's conduct innocent: [s. 78.6]
<i>Hazardous Products Act</i> , R.S.C. 1985, c. H-3.	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence, for example, advertising, selling, or importing a prohibited product: [s. 28(2)]	Liable to the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 28(2)]	Action must be commenced within 12 months after subject-matter arose: [s. 28(3)]

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Income Tax Act</i> , R.S.C. 1985, c. 1-1 (5th Supp.)	Director or officer is liable if he or she failed to deduct or withhold amount as required, including unpaid source withholdings of employee payroll deductions (s. 153); 25 percent withholding tax, respecting payments or credits such as dividends, interest, royalties (s. 215): [s. 227.1(1)]	Liable to pay amount required to be deducted or withheld and any interest or penalties relating thereto: [s. 227.1(1)]	Director is not liable unless certain conditions are met: [s. 227.1(2)] or if he or she exercised care, diligence, and skill to prevent failure that a reasonably prudent person would have exercised: [s. 227.1(3)] <sup>8</sup>
<i>Income Tax Act</i>	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of a corporate offence in failing to file any return, deduct or remit withholdings from employees, and maintain adequate books to allow for inspection: [ss. 238, 239 and 242]	Liable to criminal prosecution under either the <i>Criminal Code</i> or s. 242 of the <i>Income Tax Act</i>	None
<i>Pension Benefit Standards Act</i> , R.S.C. 1985, c. P-32 (2nd Supp.)	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in failing to remit all amounts owing: [s. 38(5)]	Liable to the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 38(5)]	Action must be commenced within 2 years after subject-matter arose: [s. 38(4)]
<i>Proceeds of Crime (Money Laundering) and Terrorist Financing Act</i> , S.C. 2000, c. P-17	Director, officer, agent, or entity is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence under the Act: [s. 78].	Liable to the punishment provided for the offence, whether or not the corporation is prosecuted or convicted: [s. 78]	None

<sup>8</sup> IC-89-2, "Director's liability Section 227.1 of the *Income Tax Act*", outlines Revenue Canada's position concerning the application of the due diligence defence. Revenue Canada states that a director may take positive action toward establishing this defence by (a) establishing controls to account for withholdings from employees and remittances; (b) calling upon financial officers of the corporation to report regularly on the continued implementation of these controls; and (c) obtaining regular confirmation that withholdings and remittances have in fact been made during all relevant periods.

Federal Statute	Statutory Breach	Liability for Offence	Statutory Defence and Limitation Period
<i>Transportation of Dangerous Goods Act</i> , 1992, S.C. 1992, c. T-34.	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in the commission of an offence under the Act, for example, the failure to handle dangerous goods while abiding by prescribed safety requirements: [s. 39]	Liable to the punishment provided for the offence in the Act, whether or not the corporation is prosecuted or convicted: [s. 39]	Director is not liable if it is established that all reasonable measures to comply with the Act were taken: [s. 40]
<i>Winding-up and Restructuring Act</i> , R.S.C. 1985, c. W-11.	Director or officer is liable if the company, within 12 months preceding the commencement of winding-up, paid a dividend in respect of shares of the company (other than a stock dividend) or purchased for cancellation any capital stock of the company, thereby rendering the company insolvent: [s. 102.1]	Liable, jointly and severally, in the amount of the dividend or purchase price that has not been paid to the company: [s. 102.1(2)]	Director is not liable if the director proves that he or she had reasonable grounds to believe that the transaction was occurring at a time when the company was solvent or would not render the company insolvent (the burden of proof is on a director or an officer): [s. 102.1(7)]
<i>Winding-up and Restructuring Act</i>	Director or officer is guilty of an offence if he or she directed, authorized, assented to, acquiesced in, or participated in an attempt to deceive or defraud any person, or to destroy, mutilate, alter, or falsify books, records, or securities of the company being wound up: [s. 141]	Liable to imprisonment not exceeding 2 years: [s. 141]	None