CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

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

SECOND EDITION

Richard A. Shaw, Q.C., ICD.D

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Table of Contents

Preface vii

Introduction 1

Fiduciary Duty and Duty of Care 1

Other Statutory Liabilities 3

A Word of Caution 3

Questions Directors Should Ask about Indemnification and Insurance 5

1. How often should the corporation's indemnification program and D&O insurance program be examined in detail and what outside advisors should be engaged to assist in the review? 5
2. What are the elements of an indemnification and D&O insurance program? 6
3. What should be provided in the corporation's by-laws pertaining to indemnification of directors and officers? 8
4. What is the purpose of an indemnification agreement between the corporation and each of its directors and officers? What standard terms and conditions does the indemnification agreement contain? 8
5. What are the limitations of indemnification under the by-laws and indemnification agreement and why does D&O insurance provide the most reliable protection to directors and officers? 10

6. What does a D&O insurance program look like and what insurance coverages are provided by a D&O insurance policy? **11**

7. How much D&O liability coverage (limit of liability) should be obtained? Which insurers should be chosen to underwrite the coverage? **13**

8. What are appropriate deductibles under a D&O policy? **14**

9. At what point should coverage under a D&O policy commence? Or, when should a claim be covered by the D&O policy? **14**

10. How is "loss" defined, and what kind of loss is, and is not, normally covered under a D&O policy? **15**

11. How long is the term of a D&O policy? What is the meaning of a "claims made" policy? **16**

12. What are the customary coverage exclusions in a D&O policy? **17**

13. What is the purpose of severability clauses in a D&O policy? **18**

14. What insurance coverages, in addition to the protection for claims against directors and officers, might be included in a D&O policy? Is there a risk to directors and officers in adding these additional coverages? **18**

15. What is the purpose of an allocation clause in a D&O policy? May the allocation be pre-determined? **20**

16. What is the purpose of Side A "difference in conditions" coverage (commonly called "DIC coverage")? **21**

17. What is meant by a "follow form" policy? **22**

18. What coverage will the D&O policy provide to directors and officers of newly acquired subsidiaries or to directors and officers of a subsidiary that is sold by the parent organization? **22**

19. What is "directors' and officers' run-off insurance," and under what circumstances should it be obtained? **23**

20. What coverage is available under a D&O policy for: a) claims under environmental legislation; and b) claims under Canada's Anti-Spam Legislation (CASL)? **24**

Conclusion 27

About the Author 29

Preface

Directors and officers have a responsibility to exercise due diligence while overseeing the activities of the corporations they serve. An individual serving as a director or an officer of a publicly listed corporation is exposed to a myriad of potential liabilities imposed by federal and provincial legislation and common law. It is irresponsible for an individual to consider serving as a director or an officer without inquiring about the protection a corporation has in place to shield directors and officers from personal liability for failure to satisfy the many duties and responsibilities imposed on them.

The Risk Oversight and Governance Board of the Chartered Professional Accountants of Canada (CPA Canada) developed *20 Questions Directors Should Ask about Directors' and Officers' Indemnification and Insurance* to help directors and officers assess the effectiveness of a corporation's indemnification as well as director and officer (D&O) insurance programs. For each question, there is a brief explanatory background and some recommended practices, which will aid readers to better understand topics such as the importance of having D&O insurance programs in place; when and how to seek advice from insurance and legal professionals; and what to include in a corporation's by-laws.

Introduction

Protecting a director or officer from the risk of personal liability is not merely a matter of having an effective indemnification and insurance program in place. Such protection begins with a corporation having the appropriate governance structure and processes that allow decisions to be made in a manner that reduces the risk of directors' being exposed to personal liability.

This publication will focus on the critical elements of a protection program for directors and officers. The provisions of the *Canada Business Corporations Act* (CBCA) will serve as the reference corporate statute for the enabling provisions pertaining to directors' and officers' indemnification and insurance. Similar, if not nearly identical, enabling provisions are found in provincial corporate statutes.

Fiduciary Duty and Duty of Care

The CBCA imposes two principal duties upon directors (as well as officers):

- to act honestly and in good faith, with a view to the best interests of the corporation (this is commonly known as the "fiduciary duty"), and
- to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (this is commonly known as the "duty of care.")

The relationship between the board of directors and a corporation is a fiduciary one. The board is a fiduciary in the sense that it has a scope of authority that enables it to act unilaterally in the beneficiary's interest.

The beneficiary, namely the corporation, is peculiarly vulnerable to, or at the mercy of, the fiduciary. It is important to note that in Canada, the corporation —not its shareholders—is the beneficiary.

As fiduciaries, directors must fulfil various duties and obligations:

- The directors' personal interests must be subordinated to those of the corporation.
- The directors must act in the interests of the corporation as a whole, rather than in the interests of any particular shareholder, group of shareholders or other stakeholders, such as creditors, employees, the community, the environment or the government. In making its decisions however, the board should give consideration to these interests to better inform its decision making.
- Nominee directors may not consider the interests of their nominating shareholder to the exclusion of other interests. They too, must act in the best interests of the corporation and not in the best interests of their nominating shareholder.
- Directors are not permitted to enter into engagements which have, or may have, a conflict between their personal interests and the interests of the corporation — unless they disclose their interests in the material contract or transaction involving the corporation and abstain from voting in respect of the matter (subject to limited exceptions).
- Directors must maintain the confidentiality of information which comes to them as a director of the corporation.

The duty of care requires that a director employ the skill and knowledge that they possess. Those who possess greater knowledge or skill therefore, may be subject to a higher standard of care than those possessing less. The director must be diligent in attending to the affairs of the corporation by reading relevant materials, attending board and committee meetings and briefings, and becoming knowledgeable about the corporation's business. Appropriate decision-making processes must be followed. Board decisions will be protected by the business judgment rule when the proper process and procedures have been followed.

Under the business judgment rule, there is a presumption of the soundness of the decisions made by the board and the courts generally will not review board decisions in hindsight. Factors that may establish that the duty of care has not been met include:

- the directors' failure to act prudently and in an informed manner in making their decision
- the directors making the decision were not independent and free of any conflict of interest
- the decision had no reasonable corporate purpose
- the decision was made in haste

Said one court: "The court looks to see that the directors made a reasonable decision, not a perfect decision. 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. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision."[1]

The decision-making process is the determining factor, rather than the decision itself. There needs to be recorded evidence of the information reviewed and of the process followed by the board in reaching its decision, to demonstrate that the directors have satisfied the fiduciary duty and the duty of care imposed by statute.

Other Statutory Liabilities

Apart from the general nature of the fiduciary duty and duty of care obligations imposed under corporate legislation, many other statutory liabilities are imposed on directors and officers under legislation that deals with income tax, pension, employment insurance, employment standards, environmental protection, health and safety, among others.

A current listing of major federal and provincial statutes that impose liability on directors exceeds 50 pages and references more than 40 statutes. This suggests the need for a proper indemnity and insurance program for those serving as directors.

A Word of Caution

Where the conduct of a board of directors is particularly wanting, directors may still be deemed personally liable and be required to pay personally, even where insurance is in place to cover the payments. This is one of the lessons of the collapse of Enron in 2001 and Worldcom in 2002. Directors from both companies had to pay damages from their own pockets, despite there being sufficient coverage under the directors' and officers' insurance maintained by the two corporations to pay the amounts. Enron directors paid US$13 million of a US$168 million settlement; WorldCom directors paid US$24.5 million of a US$60.5 million settlement. It was a condition of the settlements that the directors contribute from their personal resources rather than being absolved entirely from the insurance available to them.

1 *Maple Leaf Foods v. Schneider* (1998), 42 O.R. (3rd) 177 (Ontario Court of Appeal) at p. 192.

Questions Directors Should Ask about Indemnification and Insurance

Set forth below are 20 questions that directors may ask in order to assess the effectiveness of a corporation's indemnification and directors' and officers' insurance (D&O insurance) programs. The questions also serve as a checklist.

The questions are organized into several groups. Questions 1 and 2 outline the principal elements of indemnification and D&O insurance programs and address the engaging of appropriate insurance and legal advisors. Questions 3, 4 and 5 deal with the indemnification elements contained in a corporation's by-laws and indemnification agreements, the limitations of those elements in protecting directors and officers, and the reasons why D&O insurance provides the best protection. The remaining questions concern D&O insurance, and end with Question 20, which speaks to two significant sources of directors' and officers' liability: environmental legislation; and the recently proclaimed Canadian Anti-Spam Legislation.[2]

1. How often should the corporation's indemnification program and D&O insurance program be examined in detail and what outside advisors should be engaged to assist in the review?

A corporation should have an experienced D&O insurance broker engaged on an ongoing basis. The broker will be responsible for reviewing annually the corporation's D&O insurance coverage and policy wording, in recognition of the rapidly evolving insurance marketplace and expansions of coverage

2 The official title of the legislation is: An Act to promote the efficiency and adaptability of the Canada economy by regulating certain activities that discourage reliance on electronic means of carrying out commercial activities, and to amend the Canadian Radio-television and Telecommunications Commission Act, the Competition Act, the Personal Information Protection and Electronic Documents Act and the Telecommunications Act.

in recent years. Coverage should also be reviewed by the broker when there is a significant change in the corporate risk profile, such as in situations of rapid growth, engaging in merger and acquisition activity, moving from a private to a public company, listing on a U.S. stock exchange or deteriorating financial conditions.

Knowledgeable legal counsel should be engaged in connection with any material change in insurance coverage, or in statutory provisions governing indemnification and D&O insurance, but, in any event, at least once every five years. The very detailed wording of a D&O insurance policy needs to be reviewed carefully by an expert, and changes in wording must be negotiated with the insurers where required.

For a better understanding of the indemnity and insurance programs, it is helpful to have the insurance broker and legal counsel review them either with a board committee responsible for the management of risk, or with the board as a whole. Doing so will help give individual directors comfort that the proper programs are in place.

2. What are the elements of an indemnification and D&O insurance program?

There are four elements to a well-crafted directors' and officers' indemnification and insurance program:

- statutory enabling provisions (CBCA)
- by-laws of the corporation
- indemnification agreements
- D&O insurance

Section 124(1) of the CBCA provides that a corporation may indemnify a director or officer of the corporation, a former director or officer or another individual who acts or acted at the corporation's request as a director or officer, or an individual acting in a similar capacity of another entity, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgement, reasonably incurred by an individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation or other entity.

Section 124(3) of the CBCA imposes two conditions precedent (collectively the "conditions precedent") on the corporation's ability to indemnify:

- The individual must have satisfied their fiduciary duty.
- In a criminal or administrative action or proceeding that is enforced by a monetary penalty, the individual had reasonable grounds for believing that their conduct was lawful.

The corporation may advance defence costs to a director or officer, subject to the individual's repaying the amounts advanced if the individual fails to satisfy the conditions precedent.

Where the action against the directors or officers is brought by the corporation or on behalf of the corporation (such as a derivative lawsuit by shareholders of the corporation), the corporation must first obtain court approval to indemnify a director or officer or to advance defence costs, subject to the conditions precedent being met by the individual.

A director or officer has a right to indemnity from the corporation in respect of an action where the individual seeking indemnity fulfils the conditions precedent and is 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.

The CBCA permits a corporation to purchase insurance for the benefit of its directors and officers against any liability these individuals may incur while acting as a director or officer of the corporation, or while acting as a director, officer, or in a similar capacity, of another entity, if they act or acted in that capacity at the corporation's request.

The corporation or any entitled person or entity may apply to a court for an order approving an indemnity and the court may so order.

3. What should be provided in the corporation's by-laws pertaining to indemnification of directors and officers?

CBCA s.124(1) permits a corporation to indemnify its directors and officers, but this is not mandatory. The by-laws of the corporation must contain a section requiring the corporation to indemnify the directors and officers to the fullest extent permitted by the CBCA and the law. The right to indemnification under the by-laws is also subject to the conditions precedent being satisfied. If the conditions precedent are not met, any monies advanced for defence costs must be repaid.

4. What is the purpose of an indemnification agreement between the corporation and each of its directors and officers? What standard terms and conditions does the indemnification agreement contain?

In addition to the by-law provisions, an indemnification agreement should be entered into between the corporation and each of its directors and officers. The indemnification agreement creates an easier mechanism for enforcing the indemnification obligation in a court of law. It also addresses a number of other important obligations, including the corporation's maintenance of D&O insurance coverage. An indemnification agreement obligates the corporation to indemnify the director or officer to the fullest extent permitted by the CBCA and the law, and to advance defence costs when they are required. In accordance with the CBCA, the indemnity is subject to the conditions precedent being met, and defence costs must be repaid if the individual fails to satisfy the conditions precedent. Where the corporation does not honour its indemnification obligation, an individual may bring action in a court of law to enforce the indemnification agreement.

In most instances, it would be expected that a corporation would meet its indemnity obligation. A director or officer may be particularly at risk should a hostile board of directors be appointed following a contested take-over or merger. The new board may choose not to honour or to delay honouring the corporation's indemnity obligations under the by-laws and the indemnification agreement.

An indemnification agreement should include the following standard terms and conditions:

- The individual agrees to serve as a director or officer.
- The corporation's obligation to indemnify to the fullest extent permitted by the CBCA and the law, subject to the conditions precedent being met.
- The corporation undertakes to apply at its expense for any court approval required to effect any indemnification.
- The corporation will advance all costs that the director or officer incurs in investigating or defending any action or proceeding, subject to amounts being repaid if it is ultimately determined that the individual was not entitled to be indemnified for all or any portion of such amounts.
- The corporation undertakes to contest and defend any claim against the director or officer at the corporation's expense, subject to the corporation being reimbursed to the extent the director or officer was not entitled to have the corporation incur such expenses on their behalf.
- A provision grossing up the indemnified amount for any taxable benefit or other tax or levy incurred on the indemnified amount.
- The obligation of the corporation to purchase and maintain D&O insurance while the individual remains a director or officer and for a minimum of six years after leaving office, containing such customary terms and conditions and in such amounts as are available to the corporation on reasonable commercial terms having regard to the cost of the insurance and size of the business and operations of the corporation.

5. What are the limitations of indemnification under the by-laws and indemnification agreement and why does D&O insurance provide the most reliable protection to directors and officers?

The table below compares the availability of indemnification and D&O insurance in various critical circumstances.

Circumstance	Indemnification	D&O Insurance
Insolvency of corporation	Unavailable	Available while the term of the policy continues
Hostile takeover: failure or delay by new board in honouring indemnification or action by new board against former directors and officers	Directors at risk of paying legal costs in the first instance	Run-off D&O insurance provides protection (See Question 19)
Need for directors to repay defence costs	Repayment required if conditions precedent not met	Conditions precedent do not apply
Fines and penalties	May be reimbursed by corporation if director had reasonable grounds for believing the conduct was lawful	May be paid by insurance where permitted by law

In summary, D&O insurance provides the most reliable protection available to directors and officers. Subject to the exclusionary clauses in the D&O policy, the benefits of D&O insurance include:

- it is available when the corporation is insolvent
- the conditions precedent need not be satisfied
- payments are not dependent upon the actions of a hostile board.

Defence costs, settlements and judgements will be paid under the D&O insurance to the extent that the limits of liability are available to make such payments.

6. What does a D&O insurance program look like and what insurance coverages are provided by a D&O insurance policy?

A typical D&O insurance program is schematically represented below:

The three principal insurance coverages provided by a D&O insurance policy are:

a. Side A coverage: Payment on behalf of each of the insured persons of all loss for which they are not indemnified by the insured organization, and which the insured persons become legally obligated to pay as a result of any claim made against them during the policy period for a wrongful act committed, or attempted or allegedly committed, or attempted by such person before or during the policy period. The Side A coverage is normally expressed by the insurer as being non-rescindable. Despite being expressed as non-rescindable, the coverage is still subject to the various exclusionary clauses in the policy.

b. Side B coverage: Payment on behalf of the insured organization of all loss for which the insured organization grants indemnification to each insured person, as permitted or required by law, which the insured person has become legally obligated to pay as a result of

any claim first made against them, individually or otherwise, during the policy period for a wrongful act committed, attempted, or allegedly committed or attempted by such person before or during the policy period.

c. Side C coverage (or "entity coverage"): Coverage for loss incurred by an insured organization as a result of any securities claim first made against it during the policy period.

As illustrated above, the D&O insurance program will be structured with a base policy over which will be layered excess coverage policies and a top layer known as "difference in conditions" coverage (DIC coverage). The DIC coverage is available to directors and officers only (see Question 16).

"Insured organization" will be defined to include the parent organization and all subsidiaries. Where the business includes entities other than subsidiary corporations—such as partnerships, limited partnerships, limited liability companies or joint ventures—care must be taken to determine that the definition of "insured organization" extends to and includes all such entities. With joint ventures, coverage may be limited to the insured organization's personnel serving the joint venture.

"Insured persons" will include directors and officers of the insured organization. Again, where there are entities other than corporations within the insured organization, make certain that the definition extends to all persons exercising roles similar to that of director and officer of a corporation. It is also common, particularly with publicly listed corporations, for "insured persons" to include:

- an employee, where the employee is named as a co-defendant with a director or officer
- the most senior individual in investor relations who acts on behalf of the insured organization
- a spouse or common-law partner of an insured person, where the claim is made against them due to their status as spouse or common-law partner, or for their interest in property which is being sought for recovery of claims against an insured person
- any director or officer of an insured organization in respect of claims made against them while serving in an outside directorship of a not-for-profit outside entity at the request of the insured organization, or as part of the duties regularly assigned to the insured person by the insured organization
- an employee in respect of an employed lawyer's claim

- other individuals in a position of authority, such as de facto directors, advisory board members or executives in foreign jurisdictions, who may not be officers, but are seen to be in positions of authority

7. How much D&O liability coverage (limit of liability) should be obtained? Which insurers should be chosen to underwrite the coverage?

An experienced D&O insurance broker will work with an organization to determine the appropriate amount (i.e., the limit of liability) of D&O liability insurance to purchase. This will depend on the organization's size, its corporate governance framework, market capitalization and share-price volatility, the jurisdictions where it carries on business, and the practice in its, or similar, industries, as well as premium considerations. The broker will also provide advice on the creditworthiness of the insurers writing the coverage, their claims paying reputation, underwriting appetite and longevity.

It is also incumbent on the broker to obtain competitive premium quotes to assure that the corporation is not paying excessive amounts for its coverage. Any significant amount of D&O insurance consists of two components: a base policy; and one or more excess policies, which will be layered on top of the base policy. Typically, all of the policies will be issued by different insurers (although the same insurer sometimes shows up at more than one position in the layered stack of insurers). In large public corporations, it is not uncommon to see limits of liability of $100 million or more, particularly if the corporation is publicly traded in the United States, as this significantly increases directors' and officers' liability exposure.

When determining the appropriate limit of liability it is important to recognize that loss includes defence costs. Significant defence costs are common in actions against directors and officers.

8. What are appropriate deductibles under a D&O policy?

There should be no deductible amounts payable by directors or officers for Side A coverage. If the organization does not, or cannot, honour its indemnification obligation to its directors and officers, the D&O Policy should provide coverage without any deductible being paid by the directors or officers.

For Side B and Side C coverage, there will always be a deductible amount to be paid by the insured organization, the amount of which will depend on the organization's size as well as its and the insured persons' comfort levels with the amount of the deductible. For larger organizations, the deductible may reach millions of dollars. Larger deductibles will result in somewhat smaller premiums.

9. At what point should coverage under a D&O policy commence? Or, when should a claim be covered by the D&O policy?

When coverage under a D&O policy begins is dependent on the definition of "claim" in the policy. In the definition of "claim" in many policies, the D&O coverage begins only upon some formal action being initiated against the directors or officers, such as a:

- written demand for monetary damages
- civil proceeding commenced by the service of a complaint or similar pleading
- criminal proceeding commenced by the return of an indictment
- a formal administrative or regulatory proceeding commenced by the filing of notice of changes, formal investigative order or similar document.

These definitions of a claim would not provide coverage if, for example, an informal investigation or inquiry or extradition proceedings were to be initiated against an insured person. Such coverages are available sometimes for an additional premium.

10. How is "loss" defined, and what kind of loss is, and is not, normally covered under a D&O policy?

"Loss" is defined as the amount an insured becomes legally obligated to pay as a result of any claim made against the insured for wrongful acts and will contain a non-exclusive list of included claims and a list of excluded claims.

To be covered under a D&O policy, a claim must meet the definition of loss, and include allegations of "wrongful acts." (Note: The included list is a non-exclusive list and is expressed as "including but not limited to.")

- compensatory damages
- punitive, exemplary or multiplied damages, fines or penalties (including civil penalties under the *Corruption of Foreign Officials Act* of Canada and the *Foreign Corrupt Practices Act* of the U.S.), if and to the extent insurable under the law
- judgments, including pre-judgment and post-judgment interest
- settlements
- defence costs
- amounts payable for misrepresentations in prospectuses or offering memorandums

The following items will likely appear on a typical exclusionary list:

- costs to comply with an order for non-monetary or injunctive relief (but this coverage is available for an additional premium)
- amounts not insurable under the applicable law
- excess consideration paid by the insured organization to purchase assets or securities
- taxes (but this exclusion will not apply (i) to Side A coverage if the tax is imposed on the insured person in connection with an insolvency proceeding, to the extent the tax is insurable under the applicable law or (ii) to tax that is payable to Canada or a province where an insured person becomes personally liable to make such payment based solely on the insured organization's failure to pay the tax). This latter item protects directors from having to pay payroll, pension and employment withholdings where the corporation fails to remit them to the government.
- costs incurred in cleaning up, containing, treating, detoxifying, neutralizing, assessing the effects of, testing for, or monitoring pollutants. These events may be dealt with under a separate pollution policy.

"Wrongful acts" that will trigger the D&O coverage include any error, misstatement, misleading statement, act, omission, neglect or breach of duty committed, attempted or allegedly committed or attempted by any insured person in their insured capacity. Also included is any matter claimed against an insured person solely by reason of their serving in an insured capacity. This latter category also covers statutory liabilities for withholdings that are to be paid to the government.

11. How long is the term of a D&O policy? What is the meaning of a "claims made" policy?

D&O policies are issued for a term of one year and must be renewed at the end of each one-year term. The standard policy allows each party to terminate it before the term expires. Many policies provide that the insurer may terminate on 60 or 90 days' notice. With such a clause, a corporation's D&O policy may disappear at the behest of the insurer on very short notice. This clause should be amended to provide that the insurer may terminate early only for non-payment of premiums. The insured organization should have the ability to terminate early, or both parties may terminate on mutual agreement.

A claims-made policy only provides coverage for claims that are made or reported by an insured within the term of the policy. There will normally be an additional grace period of 30 to 60 days after the term ends within which a claim that arose during the one-year term must be reported. The grace period may vary, depending on whether or not the D&O policy has been renewed for a subsequent year. It is possible to obtain an extended reporting period of up to one year by paying an additional premium. The extended reporting period will allow coverage for claims arising prior to the policy's expiry date and reported during the extended reporting period. Concerns about the claims-made nature of the policy are normally alleviated by the insured organization's renewing the policy from year to year. Where the D&O policy is not renewed, it may be advisable to pay the premium for the extended reporting period or consider obtaining a run-off D&O policy (see Question 19).

12. What are the customary coverage exclusions in a D&O policy?

Customary coverage exclusions may be broadly grouped into three categories:

a. Items that are unindemnifiable and uninsurable at law.

Included in this category are directors' and officers' liability for insider trading, fraud and other crimes, and except where insurance is permitted by law, fines and penalties. The exclusion should only apply where a final, non-appealable adjudication has been made that insider trading, fraud or other crime has occurred. Corporate by-laws and indemnity agreements generally provide coverage for criminal or administrative actions or proceedings and fines and penalties, provided that the individual had reasonable grounds for believing their conduct was lawful.

b. Items that are indemnified by the company but generally excluded under a D&O policy, because they usually can be insured using a different type of policy, include:

   i. bodily injury, mental or emotional distress or property damage, which can be managed with general liability insurance

   ii. breach of fiduciary duty with respect to pensions or other employee benefit plans which can be managed with fiduciary liability insurance

   iii. pollution, which can be managed with separate pollution coverage, although the D&O policy will usually provide coverage for: (x) pollution claims brought by a shareholder of the insured organization without the assistance of any insured person in their own right or as a derivative claim on behalf of the insured organization and (y) defense costs for pollution claims, except where the claim is brought in the United States, where the insured organization is not permitted or required, or due to financial impairment fails or refuses, to indemnify the insured person

iv. Claims brought by an insured person against another insured organization or an insured person (the "insured vs. insured" exclusion). This exclusion is based upon the risk of collusion between the insured parties. Customary exceptions to the exclusion are: financial impairment of the insured organization (which includes the appointment of a receiver, liquidator, trustee or similar official), a derivative action by the insured organization against an insured person where such action is brought without the assistance of an insured person or where the insured person is no longer acting in an insured capacity (usually requiring that a period of time has elapsed since the person so acted).

13. What is the purpose of severability clauses in a D&O policy?

The D&O policy is intended to provide protection to directors and officers in their individual capacities as if a separate policy had been issued in favour of each individual. To assure that this is the case, the policy must contain severability clauses which provide that no fact pertaining to or knowledge possessed by an insured person shall be imputed to any other insured person in order to determine if coverage is available and that no declaration or statement in the written application for coverage or knowledge possessed by any insured person shall be imputed to any other insured person for the purpose of determining if coverage is available or an exclusion applies. Where the policy contains entity coverage, the knowledge of a small group of senior officers — generally the chief executive officer and chief financial officer — will be imputed to the corporation in determining if coverage is available to the corporation.

14. What insurance coverages, in addition to the protection for claims against directors and officers, might be included in a D&O policy? Is there a risk to directors and officers in adding these additional coverages?

A D&O policy is purchased to protect directors and officers where the corporation is unable to indemnify them and to protect the corporation's balance sheet when it is obligated to indemnify the directors and officers. That protection is capped at the limit of liability of the D&O policy. When other insurance coverages are added to the D&O policy, payment under those coverages may erode the limits of liability available to the directors and officers.

The most common additional insurance coverage included in a D&O policy for a publicly traded corporation is Side C coverage. This coverage protects the corporation against securities law claims made against the corporation. Given the nature of the coverage, a securities law claim could substantially erode the limits of liability available to the directors and officers. There are arguments for and against the inclusion of Side C coverage. In support of the coverage is that a securities law claim may severely impair the corporation financially and the coverage will help to protect the continued viability of the corporation. This would be particularly true in the case of companies with smaller market capitalizations. On the other hand, it may be argued that shareholders who sue the corporation for securities law violations should look to the corporation's assets for recovery, not a D&O policy.

Side C coverage may encourage securities lawsuits against the corporation and prolong the time needed to defend or settle a lawsuit. With no entity coverage in place, shareholders successfully suing the corporation, rather than benefitting from the windfall of Side C coverage, will experience the same diminution in value of their investment as other non-suing shareholders.

Another coverage often seen in D&O policies relates to employment claims, and deals with claims against the insured persons by a past, present or prospective employee relating to employment matters. This coverage might be better dealt with in a separate employment-practices policy. Furthermore, particularly in light of the introduction of secondary-market civil liability in securities legislation in Canada, the "insured persons" category has expanded to include additional individuals, such as employed lawyers providing professional services and the senior investor relations person.

Care must be taken to ensure that in adding the additional insurance coverages or expanding the categories of insured persons, there is not a risk of a material erosion of the limits of liability intended to protect directors and officers.

Where the D&O policy provides coverages in addition to protection against directors' and officers' liability, the policy must include a "priority of payments" clause. This clause gives priority to the payment of claims under the Side A coverage, where the amount of losses being claimed for under the various policy coverages exceeds the limits of liability or remaining limits of liability under the policy.

15. What is the purpose of an allocation clause in a D&O policy? May the allocation be pre-determined?

Where a claim includes a loss that is covered under the D&O policy and a loss that is not covered—due to either covered and uncovered persons, or covered and uncovered matters, being included in the claim—the allocation clause establishes how the insurer determines what portion of the loss will be covered under the policy. It is best to have the proportion of covered loss as high as possible which can be accomplished through the use of a predetermined allocation clause.

In the absence of a predetermined allocation clause, the insureds and the insurer will use their best efforts to agree upon an allocation between covered loss and uncovered loss and if no agreement is reached, the insurer will advance as incurred the portion of defence costs which the insurer decides is covered until otherwise negotiated, arbitrated or judicially decided.

To avoid an arbitrary determination by the insurer, insert a predetermined allocation clause into the policy. With publicly traded corporations, it is common in respect of the Side B coverage to have an 80 per cent allocation to covered loss for securities losses (including securities defence costs). For loss other than securities loss, there would be an 80 per cent allocation to cover loss for defence costs (except if the insured organization is bankrupt, in which case no defence costs will be allocated to the insured organization). For losses, other than defence costs, the parties are to use their best efforts to allocate such amount based upon the relative legal and financial exposures of the parties to such matters and in the case of the settlement of such a claim, based also on the relative benefits to the parties from such settlement.

The predetermined allocation will avoid arguments and delays when a claim is made.

16. What is the purpose of Side A "difference in conditions" coverage (commonly called "DIC coverage")?

As illustrated in Question 6, a D&O insurance program is normally structured in layers, with one insurer providing a base limit of liability coverage and other insurers providing excess limits of liability coverage. For instance, a program with a $100-million maximum limit of liability may have a base coverage of $25 million by one insurer, with additional insurers providing successive excess layers of coverage of, for example, $25 million, $20 million, $20 million and $10 million. The top layer (or sometimes more than one top layer) of coverage, $10 million, in this instance, will often be a DIC policy.

The DIC policy only provides protection to the directors and officers where there is no other protection available. It is designed to provide coverage to directors and officers where:

- the insured organization fails to or is unable to indemnify the directors or officers and the limits of liability of the underlying policies have been exhausted
- coverage under an underlying policy is not available according to the terms of that policy
- an underlying insurer wrongfully denies coverage or has gone bankrupt
- coverage under an underlying policy is rescinded
- there is a wrongful delay in the flow of either indemnity amounts or insurance proceeds

In each of these events, the DIC policy and its limits of liability will "drop down" to provide the coverage that is otherwise unavailable.

DIC policies feature fewer exclusions-from-coverage clauses than base or excess policies and are particularly valuable in ensuring that directors and officers will have the insurance they need — and that they will not have to dig into their own pockets to hire counsel to reach a negotiated settlement of the claim against them. In the above example, directors and officers would at least be assured that there will be $10 million available to them should all else fail. That would in many circumstances be sufficient funding for directors and officers to reach a negotiated settlement.

17. What is meant by a "follow form" policy?

A D&O program is made up of a base-coverage layer with various excess coverage layers above it provided by different insurers. The D&O policies of the excess insurers are known as "follow form" policies. These policies have, or should have, the same terms and conditions and contain the same exclusions as the base policy, with the exception that the coverage will begin only when one or more limits of liability under the policy or policies in the lower levels of the policy stack have been exhausted. As "follow form" is the goal, it is important that the excess policies be reviewed by legal counsel or others knowledgeable in D&O insurance coverage to assure that they meet the criteria, and if they do not, to understand the coverage gaps created by any differences. Many programs will use the same policy wording for each layer to ensure conformity of coverage.

Given its purpose, a DIC policy does not "follow form."

18. What coverage will the D&O policy provide to directors and officers of newly acquired subsidiaries or to directors and officers of a subsidiary that is sold by the parent organization?

Directors and officers of a newly acquired subsidiary of an insured organization will only have D&O coverage under the acquiring corporation's policy with respect to wrongful acts committed, attempted or allegedly committed or attempted after the subsidiary is acquired. Coverage may be extended to wrongful acts that occurred prior to the acquisition date upon the insured organization completing and filing an application for such coverage and likely paying an additional premium. When the amount paid to acquire the subsidiary exceeds a set percentage (at least 10 per cent, but often 25 per cent) of the total assets of the parent organization, the parent organization is required to file a written notice of the acquisition with the insurer and may have to pay any additional premium required by the insurer.

Similarly, where a subsidiary is disposed of by a parent organization, coverage continues for the directors and officers of that subsidiary, but only for claims for wrongful acts committed or attempted or allegedly committed or attempted prior to the date such organization ceased to be a subsidiary.

19. What is "directors' and officers' run-off insurance," and under what circumstances should it be obtained?

Directors' and officers' run-off insurance covers directors and officers of an insured organization that has been taken over by or merged into another entity, and continues for a defined period of time. It is most commonly found in situations involving takeovers or mergers of publicly traded corporations or entities.

Where a publicly listed corporation (the "target") is taken over by or merged with another corporation or entity, many if not all of the target's directors and officers will step down upon completion of the acquisition. Departing directors and officers will need protection for liabilities arising prior to their stepping down. This protection usually comes in two forms:

a. The acquiring corporation or entity provides a written indemnity to each departing director or officer for claims arising against them in their capacity as directors or officers prior to the date of acquisition. This indemnity may be unlimited in time or time-limited, and if the latter, the time limit will normally range from three to six years.

b. A run-off D&O insurance policy, the insurance premiums of which may be paid for by either the acquiring entity or the target. A run-off D&O insurance policy provides D&O insurance coverage for the departed directors and officers for wrongful acts committed or allegedly committed prior to the acquisition date. The policy will have a multi-year term (generally from three to six years), and the entire premium is paid up front. With such a policy, care must be taken with the wording of the insured vs. insured exclusion from coverage.

In a friendly takeover or merger, the acquisition agreement will protect target directors and officers from claims being made by the acquirer (other than for fraud or deliberate acts). But in a hostile takeover, that will likely not be the case; nor is there likely to be an indemnity from the acquiring entity. It is important, then, to limit the insured vs. insured exclusion as much as possible, or consider setting funds aside in some other manner for the benefit of directors and officers should the exposure continue.

In a friendly takeover, the acquirer will most likely act as the liaison with the insurer for the run-off insurance. In a hostile situation, this will need to be dealt with by one or more departing directors or officers of the Target.

A corporation might consider purchasing run-off D&O insurance if it decides not to renew its D&O coverage with a particular insurer. A new insurer may be reluctant to provide D&O coverage for claims arising prior to the commencement date of the new D&O policy, or there may be a significant additional premium cost. Run-off D&O insurance with the existing carrier may be less expensive and easier to obtain.

20. What coverage is available under a D&O policy for: a) claims under environmental legislation; and b) claims under Canada's Anti-Spam Legislation (CASL)?

Environmental Claims

The recent Northstar Aerospace Canada case in Ontario illustrates the severity of personal liability that may be visited upon directors and officers in an environmental claim. The firm's directors and officers personally paid $4.75 million (in addition to $800,000 already spent on remediation work) to settle clean-up orders issued against them by the Ontario Ministry of Environment following the bankruptcy of Northstar Aerospace Canada.[3]

As noted in Question 12, above, a D&O insurance policy limits coverage in respect of pollution or environmental matters. Generally the coverage is limited to defence costs for a shareholder action or, where the corporation is not permitted or required or, due to financial impairment, fails or refuses to indemnify the directors or officers. The policy typically contains: a bodily injury/property damage exclusion; a pollution exclusion; and a remediation-cost exclusion. Remediation costs for environmental claims are more appropriately covered under a stand-alone environmental policy. Paying the premium for the policy requires the corporation to be solvent. Such a policy is unlikely to cover non-indemnified losses incurred by directors and officers following a bankruptcy.

3 For more information, see Janet McFarland, "Former Northstar directors, officers reach deal with Ontario over cleanup; Former directors will personally provide $4.75-million toward remediation of polluted land at Cambridge, Ont., site", *The Globe and Mail* (28 October 2013) online: The Globe and Mail, **www.theglobeandmail.com/report-on-business**

We understand that, as of this writing, efforts are underway to work with insurance markets to create appropriate D&O wording to address environmental remediation liability, where the insured organization is unable to do so due to insolvency. There has been some success to date in obtaining such coverage in DIC policies.

Environmental legislation, although somewhat similar, will vary from jurisdiction to jurisdiction. The potential environmental liabilities that may be faced by directors and officers need to be understood in each jurisdiction where the corporation does business. For example, the *Quebec Environmental Quality Act* provides that, where a corporation or one of its agents, mandatories or employees commits an offence under that Act, directors and officers are presumed to have committed the offence unless it can be established that they exercised due diligence and took all necessary precautions to prevent the offence. The onus is on directors and officers to prove their innocence once the offence has occurred.

Where the corporation and its directors and officers are exposed to significant environmental liability, appropriate environmental policies and environmental management systems need to be in place in order to reduce the exposure and assist in establishing a due diligence defence for the corporation and its directors and officers. In addition, if appropriate or sufficient insurance is not available, other avenues—such as establishing a trust to which monies are contributed for the purpose of meeting ongoing environmental remediation requirements—may need to be explored. Any such trust will need to be protected from the claims of creditors should the corporation go bankrupt.

Care must be taken that the environmental policies and environmental management system, together with the D&O policy and other environmental insurance coverage, meets the issues arising in the particular jurisdictions in which the corporation does business.

Canada's Anti-Spam Legislation (CASL)

Canada's Anti-Spam Legislation (CASL) came into force July 1, 2014.[4] The law is directed at eliminating unsolicited electronic communications and is broadly applicable to any commercial communication received in Canada, irrespective of the communication's point of origin. Canadians and foreign companies doing business in Canada are required to obtain consent prior to sending electronic communication.

The legislation, which will be enforced by the Canadian Radio and Television Commission (CRTC), is accompanied by an administrative monetary penalty regime, with penalties of up to $1 million for individuals and $10 million for organizations. These penalties may be imposed on directors and officers, subject to a due diligence defence, if they directed, authorized, assented, acquiesced to, or participated in such violation. Directors and officers are liable for violations committed by a corporation's employees while acting in the scope of their employment.

CASL also creates a private right of action (beginning in 2017), subject to a three-year limitation period, for recipients of commercial communications to seek damages in the Federal Court of Canada.

In the absence of specific exclusions, D&O insurance will be available to deal with an investigation by the CRTC, or a private action for alleged non-compliance. These policies bar coverage for wilful violations of a statute or law where finally so adjudicated by a court of law. If directors or officers wilfully commit, or cause others to wilfully commit, violations of CASL, they will not be covered, and any amounts paid out for defence costs will have to be repaid.

Security holders of publicly traded corporations targeted by the CRTC may bring action against directors and officers if there has been a loss of shareholder value. D&O policies customarily will respond to such claims. Fines and penalties may or may not be covered under the D&O policies, depending on wording.

Corporations are advised to consult with their insurance brokers and legal counsel to determine the extent of the CASL coverage provided under their D&O policies.

4 Canada's Anti-Spam Law ("CASL"): It's the Law on July 1, 2014—Questions for Directors to Ask; **www.cpacanada.ca/CASL**

Conclusion

A properly tailored directors' and officers' indemnification and insurance program will provide the needed protection from the personal liabilities that may arise from serving in those roles. Ensuring that the right program is in place begins with having a knowledgeable insurance broker engaged and an active program to review and update the coverage as required to accommodate any legislative and other changes. This needs to be combined with periodic legal reviews of indemnification agreements and D&O policies to provide assurance that the program is effective in providing the needed protection. This document serves as a checklist for assessing your corporation's program to determine the effectiveness of its coverage.

About the Author

Richard A. Shaw, Q.C., ICD.D, was a senior partner in the Business Law Group of McCarthy Tétrault LLP in Calgary, Alberta until his retirement from the firm in December 2010. His legal practice broadly included corporate governance, corporate finance, mergers and acquisitions, securities law, director and officer liabilities, indemnification and insurance and acting as an advisor to boards of directors and board committees. Through his professional corporation, he continues to provide legal advisory services in these practice areas.

Richard has extensive experience with respect to corporate governance practices in Canada, having served as a director on the national board of the Institute of Corporate Directors and the chair of its Calgary Chapter. He is a lecturer in the Director Education and MBA Programs at the Haskayne School of Business at the University of Calgary and has served as Chair of the Board of Governors of Mount Royal University. He is the Chair of Inter Pipeline Ltd. and is a director of Enmax Corporation and serves as the lead independent member on the Alberta Securities Commission. In the past, he has served as a Governor and Acting Vice Chair of the Glenbow Museum and as a director of Theatre Calgary.

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