

Directors' Liability, Indemnification and Insurance Coverage

By André Laurin

Summary

- Directors' risks can be reduced and their worries alleviated through:
 - ✓ fulfilment of their duties of loyalty and diligence
 - ✓ taking certain specific precautions
 - ✓ indemnification commitments and insurance coverage
- Statutes provide for indemnification powers and rights; however, such rights should be supplemented
- Obtain detailed contractual indemnification commitments
- Directors' and officers' liability insurance policies are not all the same and need to be reviewed individually

Caveat

Aside from the subject matter of this newsletter and the way in which it is treated, it is important to remember that a director's key mission is not to protect himself, but rather to act in the best interests of the corporation of which he is a director. The director must therefore devote his energy and skills to that end. That being said, taking certain precautions does not conflict with this primary mission.

Sources of Directors' Risks and Worries

Many directors worry about the risk of liability because of, among other factors:

- the bar being raised by securities regulators (regulations and guidelines);



- the heavy burden imposed by these regulators to ensure the quality of financial disclosures and the effectiveness of internal controls;
- new statutory requirements; and
- the increasing number of lawsuits, including class actions, the settlements in the Enron and WorldCom litigation in which personal contributions were required from directors out of their own assets, and various judgments of the courts which have attracted intense media coverage (especially in the United States).

These fears are not unjustified. However, they can be greatly alleviated, if not eliminated, through appropriate means. Directors should also consider the Canadian legal context, which is not known for being prone to excesses.

How to Alleviate These Fears and Protect Oneself

It is appropriate, at this point, to recall the basic duties of loyalty and diligence that come with the director's role. **A director who fulfils his duties will have a defence to present in virtually all cases.** It should also be remembered that the Supreme Court of Canada, in *Peoples Department Stores Inc. v. Wise* (2004 SCC 64), stated that **"the establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care."**

While fulfilling such basic duties, directors can take several precautions and, at the same time, leave the management free to do its work ("nose in, fingers out"). Among such precautions are the obtaining of commitments to indemnify directors and the purchase of directors' liability insurance coverage.

Commitment to Indemnify Directors

Both the *Canada Business Corporations Act* ("CBCA"), in Section 124, and the *Companies Act* (Quebec) ("CAQ"), in Sections 123.87, 123.88 and 123.89, contain provisions on directors' indemnification. These provisions establish the parameters and conditions for indemnification but they are somewhat ambiguous.

CBCA

The CBCA grants a corporation certain powers to indemnify its directors and provides them with certain rights to indemnity from the corporation.



Under the CBCA, a corporation:

- may indemnify a director (as well as an officer or former director or officer) or another individual who acted or acts at the corporation's request as a director or officer, or an individual acting in a similar capacity, of another entity:
 - √ against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding,
 - √ in which the individual is involved because of that association with the corporation or other entity;
- may advance moneys for these costs, charges and expenses, subject to repayment if the limitations or conditions of the law do not allow for indemnification in light of the outcome of the proceedings or investigations; and
- may indemnify a director against all costs, charges and expenses incurred by him because of his connection to an action by or against the corporation for which he acts or acted as a director, and may advance moneys to such individual for such purpose, subject to the approval of the court;

the whole, provided that the director, first, acted "honestly and in good faith with a view to the best interests of the corporation" for which he acted as a director and, second, "in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty", had "reasonable grounds for believing that the individual's [i.e. his] conduct was lawful" (the "conditions").

In parallel, the CBCA also states that these same directors have the right to an indemnity in the above-described cases if they were not judged to have committed any fault or to have omitted to do anything that they ought to have done and if the above-mentioned conditions are fulfilled.

The wording of Section 124 of the CBCA raises several questions. For instance,

- is there an obligation to indemnify in cases where neither the corporation nor the director are not yet the subject of an action or proceeding, but an action or proceeding is threatened?
- are fines imposed on a director included in the expression "costs, charges and expenses" paid to settle an action or satisfy a judgment?

- what happens in the case of criminal, administrative, investigative or other proceedings directed against the corporation?

It should be noted that directors who authorize the payment of an indemnity contrary to Section 124 of the CBCA are required to restore to the corporation any moneys so paid and not recovered by the corporation. Therefore, any contractual indemnity commitment or indemnity by-law or resolution which elaborates on the wording in the CBCA must not go beyond the indemnification powers granted under the CBCA.

CAQ

The Quebec statute uses more imperative wording. The CAQ provides that the company:

- shall assume the defence of a director of the company prosecuted by a third party for an act done in the exercise of his duties (unless the director has committed a grievous offence or a personal offence separable from the exercise of his duties);
- shall assume the expenses of a director if, having sued him for an act done in the exercise of his duties, it loses its case and if the court so decides; and
- shall assume the same obligations in respect of a director of another entity of which it is a shareholder, who acted as such at the company's request.

However, under the CAQ, in a penal or criminal proceeding, the company shall assume the payment of the expenses of a director only if he had reasonable grounds to believe that his conduct was in conformity with the law, or if the director has been freed or acquitted.

Since a director is a mandatary of the company, in accordance with the CAQ (sections 123.83 CAQ and article 321 C.C.Q.), the provisions of the *Civil Code of Québec* applicable to mandataries apply to a director to the extent that there is no contradiction with the provisions of the CAQ. Article 2150 of the *Civil Code of Québec* can therefore be used to supplement the company's indemnity obligations.

"Art. 2150. Where required, the mandator advances to the mandatary the necessary sums for the performance of the mandate. He reimburses the mandatary for any reasonable expenses he has incurred and pays him the remuneration to which he is entitled."

Just as under the CBCA, the wording of the CAQ leaves several questions without clear answers, even though this wording is rather broad.

OTHER INCORPORATING STATUTES

In the case of a company, corporation or other organization incorporated under a statute other than the CBCA or the CAQ, reference must be made to the incorporating statute and any other relevant statutes to state precisely the scope and nature of the protection which is or can be afforded a director. Certain statutes (for example, those governing Hydro-Québec and the Caisse de dépôt et placement) grant a certain immunity to directors against legal proceedings taken by third persons. Furthermore, public officials named by the government of Quebec to sit on the boards of directors of state owned companies benefit from certain protections afforded by the government. Each case must be reviewed to determine what protection already exists and what, if anything, needs to be done.

TAXATION

In some cases, the indemnity paid to a director has been considered by the courts to constitute taxable income in his hands. The indemnity should not appear as part of the director's compensation but rather as an expense associated with the carrying out of his duties. Direct payment of such expense by the company, rather than reimbursing the director, may also help avoid taxation of the director. Therefore, the way in which the indemnity commitment is worded is important for tax purposes, irrespective of what statute governs indemnification.

GENERAL BY-LAWS, RESOLUTIONS AND CONTRACTUAL COMMITMENTS

In the United States, the provisions concerning the indemnification of directors are often found in the articles of incorporation. In Canada, we often find directors' indemnity provisions in a corporation's general by-laws or in a resolution adopted by its board.

Indemnity provisions should always be adopted, either as part of the general by-laws or in a resolution of the board. Note that if such provisions are contained in the general by-laws, any amendment will need to be ratified by the shareholders or members, as the case may be, at their next meeting, unless power to act in relation thereto has been clearly delegated to the board in the general by-laws. Furthermore, a director would do well to obtain a **direct contractual commitment from the corporation** of which he is a director, in addition to the statutory protection and the protection afforded by the general by-laws or a board resolution.

Finally, a director should also obtain an indemnification commitment from a corporation that has requested that he sit on the board of a subsidiary or on the board of a corporation of which it is a creditor or in which it holds a minority interest.

In addition, to the extent that third persons not subject to the above-mentioned statutory limitations can provide contractual indemnification commitments to a director, he should seize the opportunity. In such cases, indemnification commitments can be broader, without necessarily approving behaviour which would constitute bad faith or gross misconduct.

The wording of the by-laws or the resolution, as well as that of the commitment itself, should cover the gaps and ambiguities left by the incorporating statute. However, there should not be any inconsistencies or contradictions between the wording of such documents, on the one hand, and the statutory provisions, on the other hand.

Insurance Coverage

It is common practice to purchase and maintain liability insurance for directors and officers. Clearly, any director who does not enjoy full indemnity from an entity which will not automatically always be solvent should require that adequate insurance coverage be maintained for his potential liability in his capacity as a director. Such coverage does not replace the indemnification commitment, but rather complements it.

Many corporations and directors do not place enough importance on the particulars of the insurance policies available in the market. All policies and all provisions they contain are not alike. It would be very

ill-advised not to review these policies and not to take precautions, both before agreeing to become a director, as well as periodically, once the policy has been issued.

The main advantage for a director in obtaining such insurance coverage is to protect himself against the possibility that the corporation could eventually experience financial difficulties and therefore be unable to fulfil the terms and conditions of its commitment to indemnify the director.

A Recapitulation of a Few Basic Rules

In Quebec, contracts of insurance are subject to the provisions of the *Civil Code of Québec* (articles 2389 to 2628).

Article 2503 C.C.Q. sets forth the principal obligation of the liability insurer.

“Art. 2503. The insurer is bound to take up the interest of any person entitled to the benefit of the insurance and assume his defense in any action brought against him.

Costs and expenses resulting from actions against the insured, including those of the defence, and interest on the proceeds of the insurance are borne by the insurer over and above the proceeds of the insurance.”

The provision in the second paragraph of Article 2503 C.C.Q. whereby the insurer bears defence costs and interest, over and above the proceeds of the insurance, is not found in most other North American jurisdictions. Some policies do not contain any coverage for defence costs. Thus, contracts of insurance governed by Quebec law provide the insured with an automatic additional protection for defence costs, notwithstanding any contractual wording to the contrary.

If the contract of insurance is not entered into in Quebec or is not otherwise subject to Quebec laws, this additional protection afforded to a director under Quebec law will not apply whether the lawsuit against the director is brought in Quebec or elsewhere, and it should therefore be expressly provided for in such a contract.

This additional protection is important, since the defence costs can, by themselves, exceed the proceeds of the insurance and leave the insured without protection for the amount of any judgement which could be rendered against him.

Under Quebec law, it is the policy itself which must specify:

- “the relation between persons and property and between persons and acts which entails liability;
- together with the amounts;
- exclusions from coverage;
- the compulsory or optional nature of the insurance; and
- the direct and indirect beneficiaries of it” (article 2499).

In other words, it is the policy that describes the risks covered and the coverage application conditions. The *Civil Code of Québec* further provides that:

“Art. 2470. The insured shall notify the insurer of any loss which may give rise to an indemnity, as soon as he becomes aware of it. Any interested person may give such notice...”

“Art. 2472. Any deceitful representation entails the loss of the right of the person making it to any indemnity in respect of the risk to which the representation relates...”

“Art. 2477. The insurer may cancel the contract on prior notice which shall be sent to every insured named in the policy. The cancellation takes place fifteen days after notice is received by the insured at his last known address...”

It should be noted that a person contracting for insurance has an initial obligation under Article 2408 C.C.Q. to disclose to the insurer “all the facts known to him which are likely to materially influence an insurer...” and a continuing obligation throughout the contract under Article 2466 C.C.Q. to “promptly notify the insurer of any change that increases the risks stipulated in the policy”.

In Quebec, any clause in a contract of insurance, which would have the effect of limiting the obligations prescribed by the *Civil Code of Québec*, is void (Article 2414).

A director will not be covered by an insurance policy if the damage was caused intentionally (not fortuitously) or if there has been fraud on the part of the director. The *Civil Code of Québec* and insurance policies governed by Quebec law authorize the insurer not to cover such an occurrence.

It must be emphasized that if the corporation purchases insurance coverage and pays the premiums, it will likely be unable to offer more, under the insurance coverage, than what its incorporating statute permits as an indemnity (see previous comments).

Taxation

Some people claim that the portion of the premium relating to insurance coverage which exceeds the corporation's obligation to indemnify under the CBCA or the CAQ constitutes taxable income in the hands of a director.

Here are some examples of the questions to be raised concerning insurance coverage

- Which law (e.g. Quebec, Ontario, etc.) governs the policy?
- What types of lawsuits are covered?
- Is it an "indemnity" type insurance or a "defence" type insurance?
- Is the directors' and officers' insurance coverage separate from the other insurance maintained by the corporation, does it have its own conditions, and is it provided to the director on a personal and individual basis?
 - √ Does the corporation's initial disclosure to the insurer bind the director?
 - √ Is there a monetary limit per loss or claim or is there a global limit?
 - √ Can a deceitful representation by the corporation invalidate a director's coverage?
- Does the corporation have the power to bind the insured director vis-à-vis the insurer?
- Does the insured director have the right or the opportunity (prior notice) to pay the premiums in lieu of the corporation, should the corporation fail to do so?
- Prior to replacing an existing insurance policy or upon the expiry of such a policy, can it be ascertained that another insurer will underwrite the risk?

- Is it a "claims made" type of policy and if so, will the coverage be in force for a sufficient period of time?
- If the allegations in a claim by a third party are such as to put the insurer's coverage obligation in doubt, is the insurer still obligated to assume the defence on the basis that the defence costs will be repaid by the insured if it turns out there is no coverage?
- What are the exclusions (for example: a lawsuit brought by the corporation or by a major shareholder)?
- Does the insured director have the right to retain his own legal counsel and experts?

Several other questions can arise and need to be asked. It is therefore essential for the director to carefully consider such questions. It is a very good idea to consult a specialized insurance broker and a lawyer familiar with the relevant questions.

Conclusion

Indemnification commitments and insurance coverage represent fundamental protections for the cautious director.

As we have seen, insurance coverage in favour of a director who already benefits from an extended indemnification commitment serves mainly to protect him in the event the corporation should experience financial difficulties. However, it is precisely when a corporation is experiencing financial difficulties that the insurer is likely to want to withdraw and terminate the policy or not renew it. The director should therefore ensure that the insurance coverage will indeed play its role and be in place to protect him in such an eventuality.

As far as the indemnification commitment is concerned, it is likely to be of little value if the director himself must pay for his legal counsel and experts, owing to the fact that the corporation is invoking some failure on his part to fulfil his obligations or because the situation faced by the director is not clearly

covered by the indemnification commitment. **The obligation of the corporation to advance the funds is therefore one of the commitments which the director should seek as a priority.** It is also important that the indemnification commitment cover aspects that the insurer can not or does not want to underwrite. These two methods compliment each other.

In this situation, just as in analyzing any particular issue, the questions to be answered are : What is the end result sought and what are the means to achieve it? **The protections offered by a corporation should be subjected to a much more rigorous analysis than that generally carried out by the majority of corporations and directors.**

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You may contact any of the following members of the Corporate Governance, Securities Law and Directors' and Officers' Insurance and Liability Law groups with regard to this bulletin.

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