

# Legal Protection for Directors and Officers

By Richard J. Berrow

Directors owe a duty of care to the company they represent, that is, to not be negligent in managing the company's affairs; as well as a duty of loyalty to act in the best interests of the company, that is to avoid conflict(s) of interest. Breaching these duties can result in lawsuits against the director(s) by shareholders, shareholder groups, lenders, competitors, even the company itself. Takeover situations, oppression proceedings, pension plans management, and securities class actions - to name just a few - all expose the director(s) to unplanned litigious situations.

Most companies provide legal protection for their directors and officers through the exercise of corporate indemnification powers, and Directors' & Officers' (D&O) insurance. Increasingly, directors and officers expect their corporations to provide relevant protection in their respective role. Directors should have an indemnity contract in place with the company, even if the company places D&O insurance since the indemnity might cover claims that the insurance does not. If the insurer refuses to pay, then the director has recourse to the indemnity.

Conversely, D&O insurance can respond where a corporate indemnity does not, and when the company has become

insolvent. The insurance also benefits the company itself by paying the company's indemnity obligations to the director so as to preserve corporate funds for other uses. D&O insurance policies are not limited by an honesty and good faith requirement. But they invariably have a serious misconduct exclusion, and other limitations. While basic D&O insurance does not cover the company for its own wrongdoing, "entity coverage" for the company itself is available, for some types of claims that are apt to be made against both it and its directors (e.g. securities class actions).

Here are some key points for directors and their accounting advisors to consider. Most apply to corporate officers as well.

## Ideal Corporate Indemnity

A corporate indemnity should take the form of a contract, so that the director can enforce it against the company. The company will also have a by-law governing indemnification, but the by-law is not a contract. Superior indemnity protection requires the company to:

- indemnify the director against all claims, unless a court has made a clear finding that the director did not meet the good faith conduct threshold. This removes the company's discretion to deny indemnity for other reasons;

- advance defence costs, unless and until there has been a finding or admission that the director did not meet the good faith conduct threshold;
- make advances without requiring security for repayment, or interest in the event that the director must repay (after a finding of bad faith);
- permit the director to select and instruct his own defence counsel, independently of company or for other directors, unless there is no risk of conflicting interests;
- provide the director with adequate D&O insurance while serving and for a stated period afterwards;
- fund coverage counsel for the director to deal with claims against the company under the indemnity, or against the D&O insurer; and
- arbitrate coverage issues, for speed and privacy (except for matters that the statute requires a judge to approve, such as the advancement of defence costs in a shareholder derivative action).

These are only a few examples of the possible enhancements. Some companies also set up trust funds to meet their indemnity obligations, which can assist in the event of insolvency, but this is more common in the US than Canada.

## Legal Protection [cont'd]

### Ideal Directors' & Officers' Policy

There is no standard D&O policy. Relatively little case law about the meaning of policy terms exists. Therefore, those placing coverage should consult insurance professionals and/or legal counsel with expertise in D&O coverage.

When assessing a D&O policy, consider the following:

- Does the policy pay defence costs even for claims that, if proven, will result in an uncovered obligation, such as a fine or penalty, or a judgment for fraud?
- What is the scope of the exclusion for major misconduct? Wording nuances are particularly important here, such as the differences among "fraud", "deliberate fraud", and "wilful violation of law".
- Does the misconduct exclusion apply only after a judicial finding, or can the insurer withhold defence funding beforehand?
- Is the exclusion for misconduct clearly severable, so that coverage is only removed for the actual wrongdoer, and not for others who may have negligently acquiesced?
- The policy will also contain an exclusion for claims alleging that a director received an illicit benefit. It too should be clearly severable among insureds.
- What is the scope of the exclusion for claims by one insured against another, and claims by or in right of the company itself, such as shareholder derivative actions? Better policies contain several exceptions to these exclusions.

- Does the policy cover the wage and tax claims arising on insolvency?
- Will the insurer control the defence, or can the director appoint and instruct his own defence counsel?
- Many policies impose a deductible, to be paid by the company where it has the ability to indemnify the director. Is the director at risk of having to pay the deductible if the company refuses to do so?
- Does the policy abate the insurer's ability at common law to rescind coverage for all insureds, if anyone has made a material misrepresentation (even an innocent one) in the application for the policy? Better policies are non-rescindable, or at least limit rescission to those who knew of the error.
- Does the policy have liberal reporting provisions, so that claims or potential claims arising late in the policy period can be reported during a window of opportunity afterwards?
- Does the policy contain "entity coverage" for the company itself, or would the directors rather not share the coverage with the company?
- How does the policy describe the insurer's obligation to fund the defence where there is a mixed of covered and non-covered claims?
- Does the policy contain a priority of payments clause, so that the proceeds go first to claims for which the company cannot indemnify?

When a claim arises, the company and the director defendant should expect a prompt and expert response from the D&O insurer. The insurer's representative will likely be an in-house lawyer who works exclusively in this area and possibly external coverage counsel as well. Often the insurer proposes a claims handling agreement at an early stage, dealing with what percentage of the defence costs the insurer will pay, the appointment of defence counsel, and other important matters. Often the insurer will also reserve its right to deny coverage, and make its own investigation of coverage, including the accuracy of the application for the policy. For the policyholder, managing the relationship with the insurer is just as important as defending against the underlying claim. Unless there is no doubt about the availability of coverage, policyholders should regard the insurer as an adverse party, and seek independent legal advice about their rights and obligations under the policy.



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