EMERGING TRENDS IN CANADIAN DIRECTORS AND OFFICERS LIABILITY

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EMERGING TRENDS IN CANADIAN DIRECTORS/OFFICER AND EMPLOYMENT PRACTICE LIABILITY - SUBSTANTIVE AND COVERAGE

In the past five years, Canadian law, as it affects directors and officers, has undergone dramatic change. Not only has the substantive law involving directors and officers undergone change, but as well, the Canadian courts have embarked upon an approach to coverage issues that differs markedly from the historical Canadian approach. The purpose of this paper is to highlight the significant changes and how they impact on a D & O insurer that is underwriting business in Canada.

A. HOW THE OTHER SEVEN PROVINCES, APART FROM QUEBEC, ONTARIO AND BRITISH COLUMBIA, "INHERITED" CLASS ACTION LITIGATION - *WESTERN CANADIAN SHOPPING CENTRES V. DUTTON*

The potential for "class actions" or "representative actions" has increased dramatically as a result of a recent judicial development. In Canada, the Provincial Governments of Quebec, Ontario and British Columbia ("BC") have all enacted legislation which allows litigation to proceed by way of class action if the following (5) basic conditions are satisfied:

(a) the claim must disclose a cause of action;
(b) there must be a class of two or more persons;
(c) the proposed representative plaintiff must be appropriate and have no conflicts with other class members;
(d) there must be issues of fact or law common to all class members; and
(e) the court must find that a class action would be the preferable procedure for resolving the issues.

In the recent decision of *Western Canadian Shopping Centres v. Dutton*[1], the Supreme Court of Canada judicially widened the availability of the class action option for litigants in the other seven provinces which lack similar legislation.

The case, heard on appeal from Alberta, involved a representative action by investors who became participants in the Federal Government's Business Immigration Program. The investors purchased debentures in WCSC, which was incorporated by Dutton, its sole shareholder, for the purpose of helping investor-class immigrants qualify as

[1] [2001] SCC 46

permanent residents in Canada. WCSC solicited funds through two offerings to invest in income-producing properties. When the developments never materialised, the investors launched a representative action suit pursuant to Rule 42 of the *Alberta Rules of Court* alleging WCSC breached fiduciary duties to the investors by mismanaging their funds.

Rule 42 of the *Alberta Rules of Court* states:

> *Where numerous persons have a common interest in the subject of an intended action, one or more of those persons may sue or be sued or may be authorized by the Court to defend on behalf of or for the benefit of all.*[2]

The Rule of Court upon which the Plaintiffs relied is significant in that a like or similar Rule exists in virtually every province in Canada, notwithstanding that those provinces do not presently have legislated schemes for class action legislation.

Of particular importance to D & O insurers was the Supreme Court of Canada's conclusion that, in the absence of comprehensive class action legislation, the courts must fill the void pursuant to their inherent power to settle the rules of practice and procedure as to disputes brought before them.

Thus, it was concluded that class actions should be allowed to proceed, even in the absence of comprehensive provincial legislation, if the following conditions are met:

a) the class is capable of clear definition;
b) there are issues of law or fact common to all class members;
c) success for one class member means success for all; and
d) the proposed representative adequately represents the interests of the class.

Even if these conditions are met, the court must also be satisfied, in the exercise of its discretion, that there are no countervailing considerations that outweigh the benefits of allowing the representative action to proceed. The court should take into account the benefits the class action offers in the circumstances of the case as well as any unfairness that class proceedings may cause. In the end, the court must strike a balance between efficiency and fairness.

In this case, Canada's highest court concluded that the basic conditions for a class action were met and efficiency and fairness favoured permitting it to proceed. While

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[2] Rule 42 of the *Alberta Rules of Court*

differences existed among some of the investors, the fact remained that all the investors raised essentially the same claims requiring resolution of the same facts. If material differences emerged during the proceedings, the court could deal with them at that time.

Further, a class action should not be foreclosed on the ground that there was uncertainty as to the resolution of issues common to all class members. If it was determined that the investors must show individual reliance to establish a breach of fiduciary duty, the court may then consider whether the class action should continue. The same applies to the contention that different defences will be raised with respect to different class members. Simply asserting this possibility does not negate a class action. If and when different defences are asserted, the court may solve the problem or withdraw leave to proceed as a class.

The practical result is that by means of the "vehicle" of representative proceedings pursuant to the provincial Rules of Court, Canada's highest court has *de facto* paved the way for "class actions" in all of the Canadian provinces, notwithstanding that the Provincial Legislatures have not created a statutory scheme. The significant difference, perhaps, is that under the Rules of Court of a particular Province, a Provincial superior court Judge cannot create a "national class" as is potentially available by means of a statutory scheme.

In practical terms, this ensures that the "going forward" exposure for Canadian D & O insurers will begin to "mirror" the U.S. experience, when one has regard to the portion of "claims" that are constituted as class actions. That fact alone has a significant impact in terms of the potential severity of Canadian D & O exposures which, historically, have traditionally been more modest than the comparable U.S. experience.

B. CURRENT LIMITS ON CERTIFYING A CLASS ACTION FOR MISREPRESENTATION/ SECURITIES FRAUD IN CANADA – HOW INSURERS CAN OPPOSE CERTIFICATION

This issue is of particular importance to D & O insurers, as cases alleging misrepresentation and fraud by shareholders are now emerging as one of the largest single source for D & O claims in Canada. Historically, securities fraud cases were not common in Canada since, until class action legislation was enacted in the mid-1990's in certain Provinces, a shareholder in Canada could only sue for his or her own loss. A shareholder could not sue on behalf of other shareholders. That meant, in practical terms, that the "cost/benefit" ratio in suing was not justified, particularly when you take into consideration the practical impact of the "loser pay" rule.

However, since 1997 there has been a significant increase in the frequency and severity of "security fraud" lawsuits in Canada. In using the term "security fraud" cases, we are encompassing claims by shareholders in which there is either a claim for rescission, negligence misrepresentation, or, fraudulent misrepresentation. That being so, it is useful to explore whether and to what extent Canadian Courts will in fact "certify" a securities fraud case as a class action. D & O claims personnel need to understand this issue, if for no other reason than to recognize that absent certification the lawsuit may not be economically viable to maintain, having regard to the cost in maintaining the lawsuit. That, in turn, has a significant impact for reserving purposes.

We will briefly review the state of Canadian law concerning certification, having regard generally to cases of misrepresentation, and more specifically, "security fraud" cases which are merely a species of the broader group of cases entailing misrepresentation.

1. EFFORTS TO CERTIFY A MISREPRESENTATION CASE AS A CLASS ACTION

There is little scope under the class proceedings legislation in Canada for actions based on negligent or fraudulent misrepresentation. A shareholder or creditor of a company seeking damages for misrepresentation must establish:

a) a special relationship between the parties giving rise to a duty of care;
b) the making of the representation in a negligent manner in breach of this duty; and
c) reasonable reliance by the plaintiff to his detriment.

In general, representations that have become the subject of proposed class proceedings have been made to different persons at differing times under varying circumstances. This mitigates against "commonality" as it concerns the existence of a duty of care, a breach of that duty, and most important, the requisite element of reliance and makes difficult the creation of a class action. That is the dominant rationale for denying certification.

Exceptional situations arise where the claim is based on a single representation to all class members, or, the representation can be framed, as it had been in the case of *Carom v. Bre-X Minerals Ltd.*[3] (the "*Bre-X*" case), into a claim for fraud based on the finding of a

[3] (1999) 44 O.R. (3d) 173

"*single lie from the beginning*". The *Bre-X* case involved proceedings by shareholders against the D & O's of this famous (and now infamous) Canadian mining and exploration company. The legal action included claims against various stock broker firms and stock analysts employed by those brokerage firms. The stock, which rose to fame, and brought fortune to many, as a result of its' rise from meagre $0.50 beginnings to prices of $228 per share, fell in value to zero following revelations that the gold samples had been "salted" by company employees in Southeast Asia.

But apart from allegations stemming from a single representation, shareholders will not likely succeed in certification of a class action. To allege a series of individual negligent acts or representations mitigates against a finding of a common issue.

A class of shareholders in British Columbia tried to overcome this obstacle in *Collette v. Great Pacific Management Co.*[4] (the *"Colette"* case), by founding the claim, not on individual representations, but on systemic negligence in that the defendants promoted and made an investment scheme that subsequently failed.

In his Reasons for Judgment, Justice Macaulay held:

> *Pleadings of systemic negligence are novel but not unheard of. There appears to be a trend towards pleading such claims so as to give rise to common issues suitable for certification in class actions. The Court of Appeal recently recognized that a claim of systemic negligence could be pleaded so that the proceedings were more amenable for certification as a class action: L.R. v. British Columbia (1999) 72 B.C.L.R. (3d)*

In the *L.R. v. British Columbia* case referred to in the *Collette* case, the British Columbia Court of Appeal accepted the claims, by victims of sexual abuse, entailing allegations of systemic negligence, insofar as the management of a residential school failed to create procedures to prevent abuse. However, the finding of systemic negligence in one area did not save those aspects of the plaintiff's claim based on misrepresentation and a failure to warn:

> *Issues of reliance and causation linking representations to the harm alleged will undoubtedly vary from claimant to claimant. Claims based on failure to warn face similar individualized questions of linking causation of the harm to the absence of a warning. In my view, these considerations support the conclusion that these claims lack sufficient commonality to be amenable to class proceedings.*

[4] [2001] B.C.J. No. 253

The Judge determined that the mixed result in the *L.R. v. British Columbia* case could not sustain a claim of systemic negligence in the context of misrepresentation, or at least not on the facts of the *Collette* case:

> *the plaintiff's pleadings truncate the relevant course of dealings between the defendant and the plaintiff at the point where the investment opportunity was made available to the plaintiff so as to avoid the need to consider the essential elements of reliance…. I conclude that reliance is an essential element of the plaintiff's claim in spite of the attempt to avoid making it so.*

Following the *Collette* and *L.R.* decisions, it is now uncertain in Canada whether class actions based on systemic negligence can meet the requirement of commonality of issues, except in cases having particularly strong merits. Though the claim succeeded, in part, in the *L.R. v. British Columbia* case, it likely will not give rise to a widespread increase in the number of misrepresentation cases that are certified for class proceedings.

2. EFFORTS TO CERTIFY A "SECURITIES FRAUD" CASE AS A CLASS ACTION

In Canada, much attention has been given to class actions in the securities fraud context, since excesses in class actions have frequently occurred in this sector in the U.S. Unfortunately for D & O underwriters, Canadian investors and their legal advisors have become increasingly animated by class action developments in the United States, particularly given that an increasing portion of Canadian public companies are registering on either the N.Y. Stock Exchange or on NASDAQ.

Recent financial troubles at the Canadian "high tech giant", Nortel, have spawned at least nine class action suits in the U.S., and two in Canada. The central allegations are misrepresentation and insider trading by the D & O's.

Not unlike claims of misrepresentation generally, securities fraud cases are unlikely to be certified unless they can demonstrate the existing of a "common lie" that all investors could rely upon. The existence of differing representations in differing factual contexts mitigates against certification as a class action. Unfortunately for D & O insurers, Plaintiffs' legal counsels are becoming increasingly inventive in pleading the existence of a "common lie" that overcomes the constraints on class certification.

In the *Bre-X* case, the Ontario Court distinguished between fraudulent and negligent misrepresentation. The Court pointed out that finding of fraud, not unlike the "parallel" jurisprudence in the United States, required:

a false representation of fact, made with a knowledge of its falsehood, or recklessly, without belief in its truth, with the intention that it should be acted upon by the complaining party, and actually inducing him to act upon it.

The Court also accepted that the claim for fraudulent misrepresentation was suitable for certification as a class proceeding in that:

the claim in fraudulent misrepresentation raises common issues. The plaintiffs' allegation is that the Bre-X operation was fraudulent. Therefore, it is contended, every representation, whenever made, is tainted by the fraud. The allegation that the fraud permeates every statement raises common issues regardless of whether individual issues may arise from the actual communications made to the class members.

The claim for negligent misrepresentation, in contrast, failed to raise common issues sufficient to permit for certification in that:

A reduction of the numerous representations to a common representation requires analysis and characterization of each individual representation, the plaintiffs perception of the representation and the circumstances in which it was made. This is, of necessity, an individual inquiry. Thus, the plaintiffs contention that a multitude of statements can be reduced to a single core representation is antithetical to the essence of a common issue in a class proceeding…. There is no prospect of a resolution in a trial on common issues which would advance this litigation in any manner as it relates to the claim in negligent misrepresentation.

In the recently commenced Nortel "security fraud" class actions, any claim of negligent misrepresentation will likely confront the same objections. The cases allege that Nortel misrepresented its financial situation – and did so deliberately – prior to its US$1.5 billion bond issue in February 2001, and while it was negotiating the acquisition of JDS Uniphase for US$1.5 billion payable in Nortel common shares. It is alleged that Nortel had an incentive to suppress unfavourable reports while these transactions were underway. The lawsuits also claim that just before Nortel's profit warning in mid-February that sent its share price tumbling, senior executives sold millions in Nortel stock.

Before the advent of modern class action proceedings in Canada in the mid to late 1990's, claims such as these had been made by unhappy investors. They were simply fewer in number and the monetary stakes were considerably lower since, practically, only institutional shareholders with large shareholdings could afford to commence and maintain litigation. The recent cases, sought to be certified as class actions, do not mean that the floodgates have opened in the area of securities litigation. Certification will, practically, be difficult if not impossible unless the class of shareholders can clearly plead and establish the existence of a "common misrepresentation" that all investors potentially relied upon, in conjunction with the statutory provision, common to most Provincial Securities Acts, that shareholders are "deemed" to have relied upon the provisions in a prospectus.

However, protection against the potential for indeterminate liability to a nearly indeterminate class of claimants in the area of securities litigation may soon emerge in Canada, because of draft legislation proposed by the Canadian Securities Administrators (CSA) in June of 1998. At that time, the CSA published a proposal, based on the recommendations of the Allen Committee, to introduce a limited statutory civil liability regime for continuous disclosure. The underlying aim of the proposal was that *"quality of continuous disclosure in Canada can and should be improved"* and brought in line with the disclosure requirements in the primary market where securities are issued under a prospectus. If those recommendations are implemented in legislative form, then presumably the Canadian securities' market will benefit from increased disclosure with, hopefully, a corresponding reduction in the monetary severity of the claims as "statutory caps" are placed on damage awards.

The CSA's proposal, from a D & O insurers' standpoint, is not entirely "good news" in that the proposed legislation will witness some incremental developments into areas of potential liability that have not previously existed in Canada, including the following key provisions:

> *a)* *The proposed legislative remedy would provide secondary market investors with a limited right of action against an issuer of securities, its directors, responsible senior officers, "influential person", auditors and other responsible experts. Secondary market investors would have the right to seek limited compensation for damages suffered at a time when the issuer had made, and not corrected, public disclosure that contained an untrue statement of a material fact or failed to make required material disclosure.*
>
> *b)* *Investors would have the right to sue whether or not they actually relied on the misrepresentation or failure to make timely disclosure.*

These changes, if adopted into law by the Canadian Provincial Legislatures, may enable class action lawyers, in cooperation with "professional plaintiffs" holding even a few shares of large Canadian corporations, to launch speculative class action suits based upon any movement of stock prices. However, for reasons which are discussed below, Canada may be a jurisdiction in which "strike suits" can be judicially curtailed.

C. HOW CANADIAN COURTS HAVE IMPLEMENTED CLASS ACTION REFORM BY REJECTING "STRIKE SUITS"

The United States is the most "mature" judicial arena for "strike suits" in the area of securities fraud litigation. Indeed, many "foreign" companies (that is companies domiciled outside of the United States) view D & O insurance as necessary only by reason of U.S. laws and the possibility that they will be named as defendants in a lawsuit commenced in the United States. With the introduction of the North American Free Trade Agreement between the United States, Canada and Mexico, there has been a marked increased in the number and range of Canadian companies that have entered the U.S. securities market in a bid to access increased capital. That has meant, for the first time, that there is an increased number of Canadian companies that are potentially vulnerable to U.S. based "strike suits".

In response to unrepresentative and potentially abusive class action legislation, the U.S. Congress introduced "class action reform" to curb the clear abuses of "strike suits". Some commentators believe that Congressional reform has not "solved" the problem, but rather, moved the "problem" from the Federal Court to the state level courts. Notwithstanding that emerging problem, Canadian Courts, painfully aware of the perceived "excesses" of U.S. securities litigation, have also been eager to suppress vexatious securities class actions, or "strike suits" similar to those seen in the United States.

Since class action legislation has only recently been introduced into Canada, we do not have a significant "track record" on judicial supervision of securities fraud cases, nor do we know whether and to what extent Canadian Judges will be willing to "police" abusive class action proceedings. The early signs, however, are very encouraging and should provide some relief to otherwise apprehensive D & O insurers who may share a concern that they inevitably will have to reimburse for even the most unmeritorious securities' class action proceeding in an effort to avoid defence costs that could exceed any possible indemnity exposure.

We now have the benefit of the first Canadian judicial response to an unwarranted "strike suit". In *Epstein v. First Marathon Inc.*[5], the Ontario Superior Court of Justice considered a case wherein the "strike" litigant - or perhaps more accurately put, the "strike" legal counsel - had the company over a "time barrel", seeking court approval of a settlement agreement whereby everyone (but strike counsel, who had protected his fees and disbursements of $190,000) would have been in a considerably worse position.

[5] [2000] O.J. No. 452

First Marathon Inc. ("First Marathon"), a publicly traded financial services corporation, and the National Bank of Canada ("National Bank") announced a merger agreement to take effect on June 17, 1999. It was a "friendly takeover" of First Marathon by National Bank for approximately $712 million. National Bank would purchase all the shares of First Marathon and then merge the acquired corporation with a wholly owned subsidiary, Levesque Beaubien Geoffrion Inc. Shareholders of First Marathon would receive shares or cash at their option.

The overall transaction was to be structured as an "arrangement" under s. 182 of the *Ontario Business Corporations Act*. First Marathon had taken steps to initiate the Arrangement proceedings by calling and holding a special meeting of shareholders to consider passing a special resolution approving the Plan of Arrangement. At that time, the Plaintiff, Stephen Epstein ("Epstein"), who owned only a nominal number of non-voting common shares of First Marathon, commenced a class action proceeding against First Marathon and its directors on behalf of all minority shareholders.

The Statement of Claim alleged a breach of fiduciary duty and minority shareholder oppression against First Marathon and its' directors and officers and sought damages in the amount of $300 million on the basis that the price offered by National Bank in the proposed takeover of First Marathon was insufficient.

Epstein also brought an application to set aside or vary a Court Order approving the Plan of Arrangement, and seeking an Order appointing the firm of Klein Lyons as counsel to represent all minority shareholders. Epstein sought to have First Marathon pay the Plaintiffs' law firm fees and disbursements, and alleged that the Management Information Circular had made inadequate disclosure to shareholders. At the special meeting of the shareholders of First Marathon held on August 10, 1999, the proposed transaction was approved by the majority of shareholders.

In dismissing the application for class certification, the Court pointed out that if the Information Circular was inadequate, then that would be a factor for the Court to consider at the "fairness hearing" when determining whether the Arrangement would be sanctioned. At the application for certification, the Plaintiff shareholder did not adduce any evidence which suggested that the disclosure in the circular was inadequate.

The Settlement Agreement, which the Ontario Court was asked to approve, provided for the following:

> *$190,000.00 will be paid to [the Plaintiff's law firm] on account of fees and disbursements; the action will be dismissed without costs; releases will be executed by [the Plaintiff's law firm] and*

> *Mr. Epstein; and the parties will keep the terms of the settlement confidential. Payment of the $190,000 is conditional not only upon [the Plaintiff's law firm] and Mr. Epstein fulfilling their obligations under the Settlement Agreement, but also upon the dismissal of the class proceeding. Neither you [being the Plaintiff's counsel] nor any other representatives of [the Plaintiff's law firm], or Mr. Epstein will attend at the hearing of the Application scheduled for August 11, 1999 for the purpose of objecting, dissenting and/or in any way opposing the approval of the Plan of Arrangement.*

In refusing to approve the Settlement Agreement, the Ontario Court concluded that the settlement did not confer any benefit on any shareholder of First Marathon, including Epstein, nor did it bind any person except the parties to the agreement. No part of the monies to be paid to Klein Lyons was to come from First Marathon, the National Bank or any of their affiliates. The $190,000.00 to be paid to Klein Lyons was to come from the pockets of certain persons who were principals of First Marathon and who had a financial interest in seeing that the merger was successfully completed. The settlement agreement, when closely examined, merely paid for the Plaintiff's legal fees. It did not provide any monetary relief to any shareholders.

The evidence established that the immediate parties to this litigation arrived at the settlement a few hours in advance of the "fairness hearing" on August 11, 1999, a hearing whose purpose was to get court approval for the merger. Plaintiff's counsel threatened not only to raise his concerns about the Plan of Arrangement to the court at that hearing, but also to seek a delay in court approval. This risk provided an inducement for the D & O's to settle.

The Ontario Court concluded that a court's approval of a settlement agreement in the context of a class action, from the perspective of the class members, should ensure that the representative Plaintiff is not settling for improper or inadequate reasons, such as "fatigue" (for counsel, or, the representative Plaintiff), lucrative side deals, or other considerations which might contribute to a representative plaintiff deciding to "cash in the chips" and settle. The Ontario Court stated that "*the court must find that in all the circumstances the settlement is fair, reasonable and in the best interests of those affected by it.*"

In conclusion, the Court expressed its' desire that the abuses of the American class action regime not be imported into Canada. Interestingly, the Canadian Judge made explicit reference to the recent history of securities "strike suits" in American courts by stating:

> *a relatively small number of plaintiff's attorneys regularly were filing class actions only hours or days after the disclosure of information that precipitated a major move in the price of a corporation's stock. It seemed apparent, even to people sympathetic to claims of open market fraud, that the moving force behind most class actions was not investors aggrieved by the*

defendants' alleged misrepresentations, but plaintiffs' attorneys seeking to earn potentially large contingent fees.

The practical result of this initial case suggests that Canadian Courts will be extremely vigilant in guarding against the certification of and class approval of a settlement that reflects no more than a "strike suit", in which the imperatives to a settlement are predominantly governed by considerations unrelated to the overall soundness of the proposal from the standpoint of the class of members generally, as opposed to the nominal Plaintiff, or, the Plaintiff's legal counsel. This development should be comforting to Canadian D & O insurers concerned about the potential for unwarranted U.S. style "strike suits".

D. THE RULES ON JOINT AND SEVERAL LIABILITY IN CANADA - IS IT REALLY NECESSARY TO ADD THE DIRECTORS/OFFICERS TO A LAWSUIT AGAINST THE ENTITY?

The practical reality in Canada is that frequently D & O lawsuits emerge in the aftermath of a company insolvency. In that scenario, the D & O's and, more particularly, the presence of D & O insurance, may be the only "deep pocket" in terms of monetary recovery. Equally, too, liability primarily rests with management for which the now insolvent company bears a vicarious liability, but the now insolvent company cannot monetarily satisfy the claim. So, from a Plaintiff's standpoint, it is strategically important to ensure that the D & O's be jointly and severally liable with the company so that the Plaintiff can recover that portion of the "fault" assigned to management from the D & O's.

It is important to appreciate that Canadian provincial "comparative fault" legislation "deems" parties who contribute to the same "harm" be "jointly and severally" liable for the entire loss. This overcomes the English common law strictures, adopted before the turn of the last century, that parties were only severally liable for the harm they caused. With the introduction of statutory "comparative fault" legislation 100 years ago, in combination with the evolution of lawsuits against D & O's that was embarked upon commencing in the 1970's, both Plaintiffs' and defence counsel inevitably had to determine whether the D & O's could, from a tort standpoint, be required to pay for the tortious fault of the company and management notwithstanding that the directors and officers were not independently at "fault" for that failing.

In embarking upon this analysis, it is important to appreciate that our discussion is confined to an analysis of tort liability as opposed to contractual liability. Generally, in the law of contract, directors and officers are not personally liable for a corporate obligation. However, contractual liability is rarely the touchstone for liability against directors and officers since Plaintiffs invariably resort to some aspect of tort law to circumnavigate the strictures of contract law (including the doctrine of privity) and thereby impose liability on the directors and officers. So, from a D & O insurers' standpoint, it is necessary to understand whether and to what extent the D & O's can be practically compelled to pay for a damage award that flows, in part, from the failings of the company and management which is unrelated to any "fault" by the directors and officers.

For reasons which will be outlined in this section of the paper, the judicial response differs from Province to Province. Generally, D & O insurers are better served in Provinces such as British Columbia, as opposed to, for example, Ontario. In British Columbia, unlike Ontario or Alberta, D & O's are not jointly and severally liable with the entity and management if there is some element of contributory negligence on the part of the Plaintiff. That is a striking difference, as in many lawsuits against D & O's in Canada, framed in tort, it is not difficult for defence counsel to demonstrate an element of contributory negligence on the part of the plaintiff. In some provinces, even a finding of 1% of contributory negligence by the plaintiff guards against the spectre of the D & O's being jointly liable with the entity and its management. That is important for D & O insurers, since reserving does not have to take into account liability unrelated to the D & O's. In contrast, if the D & O's are jointly and severally liable with other parties (including even the auditors) then the monetary exposure can, practically, exceed the true liability of the D & O's from a "comparative fault" standpoint.

With those introductory remarks it is instructive to examine the comparative jurisprudence across Canada.

D & O insurers are often confronted with either the reality or the prospect of multi-party litigation. The ensuing issues of joint and several liability, third party proceedings and costs apportionment can be daunting to insurers vested with the responsibility of instructing or reimbursing appointed defence counsel. This is so not only because the issues are complex, but because the law is constantly evolving and the decisions to be made are rife with strategic considerations.

First, some definitions that may be of assistance to D & O insurers:

> ***Joint concurrent Tortfeasors*** - tortfeasors whose acts concur (run together) to produce the same damage.
>
> ***Several concurrent Tortfeasors*** - independent tortfeasors whose separate actions combine to cause the same damage but a separate injury.

Several Tortfeasors - independent tortfeasors where there is no concerted action and each act of each tortfeasor causes different injury and different damages.

Contribution – is a claim by a tortfeasor liable to the plaintiff for damages to recover a share of the damages from another individual.

Indemnity – is a claim by a tortfeasor liable to the plaintiff for damages to recover the entire amount from another individual.

Provincial and Territorial legislation in Canada provides for indemnity or contribution among joint tortfeasors. For example, *Section 4* of the BC *Negligence Act*[6], provides:

Liability and right of contribution

4(1) If damage or loss has been caused by the fault of 2 or more persons, the Court must determine the degree to which each person was at fault.

(2) Except as provided in section 5, if 2 or more persons are found at fault:

(a) they are jointly and severally liable to the person suffering the damage or loss, and

(b) as between themselves, in the absence of a contract express or implied, they are liable to contribute to and indemnify each other in the degree in which they are respectively found to be at fault.

What this means, in practice, is where two or more persons have caused a plaintiff's loss, the Court will find the defendants jointly and severally liable for the plaintiff's damages. In a practical sense, this means that the plaintiff is entitled to collect the entire judgement from *either* defendant, and that the defendant who pays the plaintiff can then *seek reimbursement* from the other defendant(s) for their proportionate share of the loss. The plaintiff's ability to recover the full amount from any defendant is of obvious importance when one defendant has no funds from which to pay a judgment, such as a situation where an insolvent company without assets is found at fault, but company directors with personal assets have also been named personally in the action. It is also the reason why plaintiff's counsel try to ensure that even just 1% liability rests on an insured defendant.

[6] R.S.B.C. 1996, c. 333

Where a plaintiff is found to be partly at fault for his/her loss (*contributorily* negligent), the law in British Columbia differs from the law in Ontario and many other Canadian jurisdictions. In the result, defendants in British Columbia have a potential advantage compared to defendants in the other jurisdictions. In B.C., when a plaintiff is contributorily negligent, the defendants are only severally liable and not jointly liable- this means that a defendant is then only exposed to the plaintiff for the portion of damages caused by it and not any of the damages caused by the co-defendants or other parties. (See *Leischner et al. v. West Kootenay Power and Light Company et al.*[7] (the "*Leischner*" case)). Because of this rule in B.C., it is very important for all B.C. plaintiffs who are likely to be found partly at fault to ensure that all potential tortfeasors are named as defendants, so that maximum recovery can be made. This is not the case in many other Canadian jurisdictions. In the remaining provinces, under the same circumstances, the defendants would remain jointly and severally liable to the plaintiff.

Here is an example of how this works:

A B.C. Plaintiff is found 30% contributorily negligent for a lack of due diligence in her investment in a company which loses significant value. The Defendant A, an outside Director from Manitoba, is found 50% negligent. The Defendant B, an insured corporation, is found 20% at fault. Pursuant to the British Columbia ruling in the *Leischner* case, the plaintiff can only seek 20% of her judgment from Defendant B, the insured corporation. The Plaintiff must seek the remaining 50% from the Defendant A, the outside director. In this scenario, presuming the outside director has no funds from which to pay his 50% of the judgment, the Plaintiff is left with no recourse.

In Ontario and Alberta however, the Plaintiff would be free to collect 70% of the judgment from the Defendant B, the insured corporation, even though Defendant B was only 20% at fault.

The practical result of this differing Provincial legislation is that some Provinces are more "favourable" jurisdictions to litigate a D & O dispute than other Provinces, from a reserving standpoint. An appreciation of that reality is particularly important, from a strategic standpoint, when the D & O insurer has the ability to litigate and settle the same dispute in two or more Provinces. D & O insurers, through their coverage and monitoring counsel, have to be particularly alert for opportunities to settle a case in a Province where the comparative fault rules favour the D & O's. The spectre of a joint and several award, in a lawsuit wherein only the D & O's have money or insurance, can result in damages well in excess of your insured's exposure. Moving that dispute into a Province where the D & O insurer only bears a monetary exposure for the portion of

[7] (1986) 70 B.C.L.R. 145 (C.A.)

"fault" attributable to the D & O's can, in many cases, substantially reduce a D & O insurer's reimbursement obligation.

E. WHEN ARE D & O'S PERSONALLY LIABLE IN TORT?

D & O's are often named personally in tort actions and for any alleged breach of fiduciary duty, and become co-defendants with the companies they serve. While D & O's can be named as parties, procedurally, the fundamental question D & O underwriters have is whether and to what extent the D & O's can ultimately be found personally liable, separate from the corporate entity. The answer to that question dictates to what extent the D & O policy will have to reimburse for an indemnity exposure (separate and apart from a mere vicarious liability).

The law in Canada is very clear: D & O's are responsible for their personal tortious conduct causing injury, loss, or damage, even where their actions are pursuant to duties owed to the corporation.

1. POLICY CONCERNS BEHIND THE DEVELOPMENT OF THE LAW IN CANADA

Over the past ten years, the Courts at all levels in Canada have often considered the issue of the liability of D & O's for acts done in pursuance of a corporate purpose, as a result of the numerous claims against D & O's where they have been included in the action in the interests of some party gaining an advantage in the litigation process. The courts are alive to the inefficiencies and difficulties businesses would encounter if D & O's were to become inhibited in performing their business duties based on fears of becoming unfairly ensnared in lawsuits. In response, the jurisprudence in Canada has been carefully developed on a principled basis.

2. THE CASE AGAINST D & O'S

One of the leading cases on the issue of personal tort liability of a D & O is from the Ontario Court of Appeal, *ADGA Systems International Ltd. v. Valcom Ltd. et al*[8] (the "*ADGA*" case). The *ADGA* case was an appeal to determine whether a director and two employees could be sued personally for their actions as individuals, assuming those

[8] (1999) 43 O.R. (3d) 101

actions were genuinely directed to the best interests of their corporate employer, and where the company had allegedly committed the same tort against the plaintiff.

In that case, ADGA and Valcom were competitors providing technical support and maintenance of security systems for large companies and governmental agencies. ADGA and Valcom bid for the same contract that ADGA had been servicing for years, when it eventually came up for renewal. However, in order to fulfil the tender requirements, names and qualifications of the proposed technical staff had to be provided. The defendant director and two employees of Valcom lured almost every person listed on ADGA's proposal to be listed on Valcom's tender offering, and to work for Valcom if it won the bid. Valcom's bid was accepted over ADGA's.

The Ontario Court of Appeal decided that the action in tort framed personally against the defendant director and two employees could proceed, despite the fact that their conduct was in pursuance of the interests of Valcom. In coming to this determination, the Court of Appeal reviewed the historical development of tort law in the corporate setting.

(i) Historical Principles of Liability

It is well understood that a company has a distinct legal personality. As such, it must be treated like any other person, with rights and liabilities appropriate to itself. This basic premise was established by the English House of Lords' decision in *Salomon v. Salomon & Co. Ltd.*[9].

While it has been tempting for litigants to try and sue principals of companies for what are properly the obligations of the corporation, the courts have carefully applied their discretion in lifting the "corporate veil", only in circumstances where an independent cause of action against the principals does not exist.

Another significant case is the English King's Bench decision in *Said v. Butt*[10], where the plaintiff was suing the defendant for the defendant employee's refusal to allow the plaintiff to attend an opera performance, despite the fact that the plaintiff had bought a ticket from the defendant's agent. The court created an exception to the principal that an individual is responsible for his or her own conduct, with the following reasoning (per McCardie J.):

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9 [1985-9] All E.R. 33 (H.L.)
10 [1920] 3 K.B. 497

> *I hold that if a servant acting bona fide within the scope of his authority procures or causes the breach of a contract between his employer and a third person, he does not thereby become liable to an action of tort at the suit of the person whose contract has thereby been broken. … Nothing that I have said today is, I hope, inconsistent with the rule that* ***a director or a servant who actually takes part in or actually authorizes such torts as assault, trespass to property, nuisance, or the like may be liable in damages as a joint participant in one of such recognized heads of tortious wrong.***

In creating this exception, the Court in the *ADGA* case noted that the law operates to ensure that people who deal with a limited company accept its limited liability, and will not have the right to claim both for breach of contract against the company and also for tortious conduct of the company's director(s), with damages assessed on a different basis.

(ii) "Acting in the Bests Interests of the Company" Defined

The Court in the *ADGA* case also noted that the exception created in the *Said v. Butt* decision does not apply where a D & O does not act *bona fide* in the interests of the company.

The Ontario Court of Appeal's decision in *Kepic v. Tecumseh Road Builders*[11] provides a clear definition of *"acting in the best interests of the company"*:

> *It is well established that the directors of a corporation will not be liable for inducing that corporation to breach its' contract when they are performing bona fide their functions as corporate officers. … This is not the case where a director acts in a fraudulent manner: Fraudulent efforts by a director of a corporation to increase the revenue of that body cannot be said to be bona fide in its best interest. …*

(iii) The Courts' Approach To Making Findings of Personal Liability

In the *ADGA* case, the Court further held *"the courts can only be scrupulous in weeding out claims that are improperly pleaded or where the evidence does not justify an allegation of a personal tort."* In so noting, the Court underscored that D & O's should be found personally liable <u>only</u> where their actions are themselves tortious or exhibit a separate identity or interest from that of the company, so as to make the act or conduct complained of their own.

[11] (1987) 18 C.C.E.L. 218

(iv) The American Approach

The Canadian approach as outlined in the *ADGA* case is similar to that taken in the United States. For instance, the California Court of Appeal, Second District, considered a fact situation very similar to that in the *ADGA* case in its' 1967 decision *Golden v. Anderson*[12]. The opinion of Jefferson J. included the following:

> *The court found that, since the evidence showed these three defendants were acting in their representative capacities as managing agents of the defendant corporations, they were immune from liability. The court erred in so concluding. Plaintiff's action is for an intentional tort. All persons who are shown to have participated are liable for the full amount of the damages suffered. … When conspiring corporate officials act tortiously and individuals are injured as a proximate result, such tortfeasors are liable to the injured persons even though the corporation may also be liable …*

F. DOES BANKRUPTCY OR INSOLVENCY PRECLUDE OR END AN ACTION AGAINST A D & O?

The past decade has witnessed significant change in Canadian insolvency laws and D & O insurers have been slow to recognize the impact these changes could have in terms of the likelihood of a lawsuit being commenced, or, maintained if the company becomes insolvent and avails of Federal legislation.

What is important for D & O insurers to appreciate is the "interplay" between the insolvency rules governing the continuation of a lawsuit against an insolvent company's directors and officers and how those provisions can be used to guard against a reimbursement exposure if third parties wish to commence or maintain a claim against the directors and officers.

1. FEDERAL LEGISLATION

In Canada, there are two statues that govern corporate reorganizations and bankruptcy. One is called the *Bankruptcy and Insolvency Act*[13], (the "*BIA*"), and the other is entitled the *Companies' Creditors Arrangements Act*[14], (the "*CCAA*"). Together, they form a parallel regime for the rehabilitation of corporate debtors.

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[12] 64 Cal. Rptr. 404
[13] R.S.C. 1985, c. B-3
[14] R.S.C. 1985, c. C-36

i) The BIA

The *BIA* is chosen by small or medium sized insolvent companies that intend to reorganize. In 1992, revisions were made to the *BIA* so that companies electing to be governed by this regime would be able to "fend off" it's creditors from taking enforcement action by filing a proposal, or simply a notice of intention to make a proposal, under the *BIA*.

Personal claims against directors, including for unpaid wages and taxes, can now be compromised in the debtor company's proposal. Thus, claims against directors that are embodied in an accepted proposal will be governed by the terms of the proposal. This means, in practical terms, that D & O insurers and their coverage/monitoring counsel need to work closely with insolvency officials in ensuring that any potential or actual "claims" made against the directors and officers are dealt with by means of the company's proposal. Secondly, D & O insurers need to ensure that the bankruptcy official makes adequate allowance in the proposal to satisfy third party claimants to ensure, that as a term of the proposal, any claims against the directors and officers are barred from proceeding.

Of significance is the fact that where a notice of intention to file a proposal has been filed, a third party may *not* start or continue any action against a D& O on any claim against a D & O that arose before the insolvency proceedings were commenced. Therefore, all actions (except for relief on a guarantee or injunctive relief) are automatically stayed until both the creditors vote on the proposal, and the court approves the proposal. In the event the court rejects the proposal, any claims against the directors will be allowed to proceed since the company is deemed to have made an assignment in bankruptcy.

Where an action has been automatically stayed, a creditor or any third party may apply to the court for relief from the stay. The *BIA* sets out the guidelines the court is to follow in making its' determination, which are:

a) whether the creditor or third party is likely to be materially prejudiced by the stay; or
b) whether there are other equitable grounds for granting relief from the stay.

Critical to a Court's consideration of these factors is the extent to which the bankruptcy trustee has made suitable provision to deal with these claims such that it would be equitable that any ancillary claim against the directors and officers is stayed.

ii) The CCAA

The *CCAA* dates back to the 1930's. It specifically governs the restructuring process, and is intended to encourage rehabilitation of companies which could still prosper after restructuring its debt load. It is favoured over the *BIA* by companies undergoing large and complex reorganizations, as it contains fewer rules to be complied with.

The *CCAA* has, over the past fifteen years, been favoured by companies that need to use the "insolvency shield" to gain additional time to reorganize their debt structure and have a prospect of carrying on business if the company's debt load is adjusted without threat of litigation by creditors.

These same kinds of claims against directors can be compromised in the proposal as under the *BIA*.

However, the automatic stay of all proceedings applicable under the *BIA* is not available under the *CCAA*. Instead, a court application for a stay is required for any action against a D & O. Claims that are exempt from being stayed under this discretionary provision are those of a quasi-criminal or criminal nature, environmental claims, or for relief on a guarantee or injunctive relief. Again, in practical terms, given the nature of any monetary claims against the directors and officers, it is critical that the D & O insurer (a) ensure that the company's insolvency officials make allowance for the corporation's exposure, and (b) work closely with the insolvency officials to ensure that a stay is secured to guard against proceedings against the D & O's.

2. CASELAW

(i) Bankruptcy is a Bar

The Ontario Superior Court of Justice considered various provisions of the *CCAA* in its' 1999 decision in *Coopers & Lybrand Ltd. v. Canadian Imperial Bank of Commerce*[15].

In that case, the D & O's of the insolvent company were named as third parties for losses due to allegedly unauthorized pledges or promises in respect to the use of shares and other assets of the company that had been made by the D & O's as security for personal loans. The proposal, which contained various compromises of creditors' claims, including in respect to the subject shares, was approved by court order.

[15] [1999] O.J. No. 4274

Greer J. found that since the proposal had been approved, all creditors and classes of creditors were bound by its' terms. The Court further determined that it would be inappropriate for the plaintiffs to be allowed to continue their action in respect to the pledges against the D & O's, as this would result in double recovery.

Although Greer J. did not refer specifically to the stay provisions of the *CCAA*, or any policy considerations behind the relevant amendments introduced with *Bill C-5*, his decision denying the plaintiffs the opportunity to recover from the third party D & O's, as a result of the terms of the proposal governing the compromised claims, can be seen as authority for the view that a bankruptcy or a proposal in bankruptcy bars the claims against the D & O's. It is also an instructive example of how a D & O insurer, working with insolvency officials, can work cooperatively together to guard against unwarranted litigation against the directors and officers.

(ii) Bankruptcy is Not a Bar

The Ontario Court of Appeal considered Section 5.1(2) of the *CCAA* and Section 50(14) of the *BIA* in its 1999 decision in *NBD Bank, Canada v. Dofasco Inc. (the "NBD Bank* case*")*[16].

The *NBD Bank* case involved a situation where a company and its' officer were sued by a bank for damages flowing from negligent misrepresentation. The defendants had deceived the bank into believing they had assets to repay the loan for which they were applying. The bank relied on those untruthful statements and issued the loan requested by the defendants. When the company was subsequently restructured under the *CCAA*, the bank was unable to recover the loan proceeds. Under the restructuring plan, the bank was barred from bringing an action for misrepresentation against the corporate defendant. The personal defendant, the officer, also sought to have the action against him barred on the grounds that if it were to proceed, the restructuring process would be subverted.

The Ontario Court of Appeal reviewed the policy considerations inherent to the *CCAA*, and stated as follows in respect to Section 5.1(2) and Section 50(14):

> …***[The CCAA and the BIA] contemplate that an arrangement or proposal may include a term for compromise of certain types of claims against directors of the company except claims that "are based on allegations of misrepresentations by***

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[16] (1999), 181 D.L.R. (4th) 37

> ***directors".*** *L.W. Houlden and G.H. Morawetz, the editors of The 2000 Annotated Bankruptcy and Insolvency Act (Toronto: Carswell, 1999) at p. 192, are of the view that the policy behind the provisions is to encourage directors of an insolvent corporation to remain in office so that the affairs of the corporation can be reorganized.* ***I can see no similar policy interest in barring an action against an officer of the company who, prior to the insolvency, has misrepresented the financial affairs of the corporation to its creditors.***

The Court went on to reject the officer's argument that the proceeding against him should be barred as a result of the restructuring process, and in so doing, accepted that, in order to achieve the goals of successful reorganization which underlie the *CCAA* and the *BIA*, it may be necessary to compromise a claim against the debtor corporation. However, Rosenberg J.A., when specifically refusing to apply that principle to individual D & O's, stated as follows:

> *… it would seem to me that it would be contrary to good policy to immunize officers from the consequences of their negligent statements which might otherwise be made in anticipation of being forgiven under a subsequent corporate proposal or arrangement.*

The Court thus allowed the action brought against the defendant officer to continue despite the insolvency of the company.

When one examines both of these decisions, the approach adopted by the Ontario Courts would suggest that generally a stay can be obtained in favour of a director and officer unless the Court is satisfied that the D & O's "independent" ground for potential liability was undertaken in contemplation of an insolvency and in the expectation that the tort liability would be eliminated by reason of the company's insolvency. Since the vast majority of the third party claims directors and officers will encounter are not undertaken in contemplation of an insolvency, there is clearly ample room for creative D & O coverage/monitoring counsel to work constructively with the insolvency officials to ensure that the proposal (a) adequately protects third party claimants, and (b) ensures a stay is in place against continuing legal proceedings against the directors and officers.

3. SUMMARY

Claims against D & O's can be included in proposals submitted by insolvent companies, and if accepted by the creditors of the company, can result in a discontinuance or stay of any legal action against the directors and officers. If approved, those claims are governed by the terms of the proposal and it is not open for the claimants to sue the directors and officers.

Under the *BIA*, actions against directors are automatically stayed but can be allowed to continue by way of court application. Under the *CCAA*, actions against directors are not stayed except by way of court order. However, unless the D & O was engaged in tortious activity, with a view to eliminating the exposure by the act of insolvency on the part of the company, generally, the claims against the directors and officers should be stayed as part of any bankruptcy.

G. CORPORATE REIMBURSEMENT

FEDERALLY INCORPORATED COMPANIES

There is a variety of means by which corporations are permitted to indemnify their D & O's facing substantive liability claims. Among those methods are:

(a) the use of contractual indemnity between the corporation and the D & O's without any constraints being imposed by the incorporating statute of the corporation's domicile;

(b) regulation by means of the corporation's incorporating statute so that indemnification of D & O's, as permitted by statute, is "permissive" and, as a result, the corporation can, by means of its incorporating documents (typically the Articles of Association) authorize reimbursement either upon approval by the shareholders or other "disinterested" directors; and

(c) the necessity of judicial approval without regard to the corporation's "internal constitution".

The recent adoption of new Federal legislation has resulted in a differing approach for corporate indemnification among Federally incorporated companies. Corporate reimbursement for federally incorporated companies in Canada has been dramatically altered by the enactment *Bill S-11, An Act to amend the Canada Business Corporations Act,* and to amend other Acts in consequence.

Bill S-11 became federal law effective June 14, 2001. There are two sections of *Bill S-11* that directly impact corporate reimbursement of D & O's by D & O insurers in the event of a covered claim.

(i) Expanded Definition of Officer – Section 1(5)

At the outset it should be noted, for the benefit of D & O underwriters, that the statutory definition of who is an "officer" for the purpose of the *Canada Business Corporations Act* (the "*CBCA*") has been significantly expanded. The definition of "officer" in Section 1(5) has been enlarged upon to include not only the usual range of corporate executives, but also, the corporate (general) counsel, the general manager, a managing director, and any other individual who performs functions similar to those normally performed by an individual occupying any of those offices.

(ii) Discretionary Indemnity & Advancement of Defence Costs With No Judicial Approval – Section 51(1) – (4)

Section 51 of *Bill-S-11* regulates the extent to which and the circumstances in which a federal company may reimburse a D & O for either legal costs or indemnity.

Section 51(1) provides that a corporation is permitted to reimburse a D & O for all costs and charges, including a settlement amount or judgment, incurred in the course of any civil, criminal, civil, administrative, investigative or other proceeding in which the D & O has been named by virtue of holding that position with the corporation. Most importantly, Section 124(1) provides for such full and complete indemnity without the need for judicial approval.

Section 51(3) specifies that the corporation may provide the requested indemnity unless the D & O:

a) did not act honestly and in good faith with a view to the best interests of the corporation; or
b) in the case of a criminal or administrative action or proceeding that can impose a fine or other such monetary penalty, did not have reasonable grounds for believing that his or her conduct was lawful.

In addition, and unlike before, a D & O can now be relieved of the financial burden of defending a liability claim by receiving advances from the corporation for defence costs and expenses as provided in Section 51(2). This is especially significant in the context of investigative proceedings, which are typically expensive and protracted. The D & O would have to pay such an advance back if he or she contravenes the fiduciary standards of Section 51(3). The foregoing is a summary of the "permissive" terms of Section 51.

Notwithstanding the permissive provisions in Section 51, it remains open to the corporation to refuse indemnity to a director or officer in circumstances where the corporation doubts the D & O would be able to repay the indemnity in the event that he or she is found to be liable in the action or proceeding. Moreover, the standards a D & O must meet in respect to fiduciary integrity before voluntary indemnity will be granted are the same as would be applied by a court or other competent authority in the context of judicial approval.

(iii) Mandatory Indemnity Where D & O Not Liable – Section 51(5)

This section of *Bill S-11* also contains provisions specifying the circumstances for mandatory indemnity of a D & O. In particular, a D & O is entitled to full indemnity by way of corporate reimbursement under Section 51(5) in the event that the D & O is both exonerated of personal liability by a court or other competent authority deciding the merits of the claim against the D & O, and meets the fiduciary standards in Section 51(3).

(iv) Judicial Review Still Available – Section 51(7) – (9)

In addition to creating statutory authority for voluntary corporate reimbursement not involving the courts, *Bill S-11* contains terms providing for judicial review of a proposed indemnity. The corporation or the D & O may make the necessary court application for approval as set out in Section 51(7).

The changes introduced by *Bill S-11*, allowing for voluntary corporate reimbursement, will impact the insurer's advancement of defence costs (in the event of a covered claim) insofar as there will likely be a greater number of claims for those costs since the transaction cost and inconvenience associated with judicial approval have been eliminated.

(v) No Statutory Restriction on Insurance – Section 51(6)

Federal corporations are now unfettered by statutory restrictions as to the type of insurance they may purchase for the benefit of D & O's. Section 51(6) provides that corporations may obtain coverage against <u>any</u> liability incurred by a D & O (or other individual defined in Section 51(1)), in the individual's capacity as a director or officer.

Of course, it remains to be seen whether the marketplace will respond by underwriting risks such as bad faith or intentional wrongdoing that were formerly prohibited under the *CBCA*.

2. BRITISH COLUMBIA COMPANIES:

On October 31, 2002, British Columbia's new *Business Corporations Act*, S.B.C. 2002, c. 57 (the "BCBCA"), received Royal Accent. The BCBCA took over 14 years to develop and is the first major change to the law governing British Columbia companies in over 30 years. Although the BCBCA has not been proclaimed into force and is therefore not a law, the BCBCA is expected to come into force by regulation in the fall of 2003.

Prior to the introduction of the BCBCA, British Columbia's *Company Act*, R.S.B.C. 1996, c. 62, was the only remaining Provincial legislation in Canada that required a company to obtain judicial approval in advance of indemnifying or reimbursing a D & O for legal expenses, costs and charges associated with a proceeding or settlement.

Division 5 - *Indemnification of Directors and Officers and Payment of Expenses* of the BCBCA ("Division 5"), provides a comprehensive code of general application by which the indemnification of an eligible party is regulated.[17] Division 5 establishes not only the circumstances under which a company may, with and without court approval, indemnify an eligible party, but also the circumstances under which indemnification is mandatory. By implication, Division 5 also establishes the circumstance under which indemnification is prohibited.

(i) Indemnification and Payment Permitted Without Judicial Approval - Section 160 (a) - (b)

As a general rule, s. 160 of the BCBCA permits a company to indemnify a judgement, penalty, or fine that is awarded or imposed in a settlement or judgement; or pay costs, charges, and expenses including legal and other fees actually or reasonably incurred to

[17] "Eligible party", in relation to a company, means an individual who (a) is or was a director or officer of the company, (b) is or was a director or officer of another corporation (i) at a time when the corporation is or was an affiliate of the company, or (ii) at the request of the company, or (c) at the request of the company, is or was, or holds or held a position equivalent to that of, a director or officer of a partnership, trust, joint venture or other incorporated entity.

resolve an eligible proceeding without judicial approval, provided that indemnification is not prohibited under s. 163 of the BCBCA.[18]

(ii) Mandatory Payment of Expenses - Section 161(a) – (b)

Pursuant to s. 161 of the BCBCA, a company *must* pay an eligible party for expenses actually and reasonably incurred by an eligible party in respect of a proceeding if, after the final disposition of the eligible proceeding, the eligible party was *wholly or substantially* successful on the merits in the outcome.

In contrast to the BCBCA, s. 51(5) of *Bill S-11* states that a D & O is *not* entitled to a full indemnity by way of a corporate reimbursement unless the D & O is both exonerated of personal liability and meets the fiduciary standards in s. 51(3) of *Bill S-11*.

(iii) Authority to Advance Expenses - Section 162(1) – (2)

Section 162 of the BCBCA provides that a company may pay an eligible party for expenses incurred in advance of the final disposition of an eligible proceeding provided that the company first receives a written undertaking from the eligible party agreeing to repay any amounts advanced to him or her in the event it is ultimately determined that the payment of those expenses was prohibited by section 163 of the BCBCA.

According to most Canadian corporate legislative schemes, including the BCBCA, a D & O is personally liable to repay costs charges, and expenses erroneously advanced to an eligible party before the final disposition of a matter, if the payment is prohibited by statutory criteria. Section 162 of the BCBCA neutralises a D & O's personal liability to repay expenses erroneously advanced to an eligible party.

[18] "Eligible proceeding" means a proceeding in which an eligible party or any of the heirs and personal or other legal representative of the eligible party, by reason of the eligible party being or having been a director or officer of, or holding or having held a position equivalent to that of a director or officer of the company, or associated corporation (a) is or may be joined as a party, or (b) is or may be liable for or in respect of a judgement, penalty or fine in, or expense s related to, the proceeding.

(iv) Indemnification Prohibited Section – 163(1) – (2)

Section 163(1) prohibits the indemnification of an eligible party under s. 160(a) or the payment of the expenses of an eligible party under s. 160(b), 161 or 162 of the BCBCA if any of the following circumstances apply:

> *(a) if the indemnity or payment is made under an earlier agreement to indemnify or pay expense and, at the time that the agreement to indemnity or payment is made, the company was prohibited from giving indemnity or paying the expense by its memorandum or articles;*
>
> *(b) if the indemnity or payment is made otherwise than under an earlier agreement to indemnify or pay expense and, at the time that the agreement to indemnity or payment is made, the company was prohibited from giving indemnity or paying the expense by its memorandum or articles;*
>
> *(c) if **in relation to the subject matter of the eligible proceeding,** the eligible party did not act honestly and in good faith with a view to the best interests of the company or the associated corporation, as the case may be;*
>
> *(d) in the case of an eligible proceeding other than a civil proceeding if the eligible party did not have reasonable grounds for believing that the eligible party's conduct **in respect of which the proceeding was brought** was lawful.*

Section 163(2) provides that a company cannot indemnify or pay the expenses of an eligible party, if the eligible proceeding brought against the eligible party is by or on behalf of the company or associated corporation. Accordingly, the eligible party is not entitled to corporate reimbursement for derivative or oppression litigation.

(v) Court Ordered Indemnification Section – 164(a) – (e)

Despite whether payment of expense or indemnification has been sought, authorized, or decided, as per s. 164 of the BCBCA, a company or eligible party, may apply to court for an order for indemnification; the payment of some or all of the expenses incurred by an eligible party in respect of an eligible proceeding; or enforcement of an agreement of indemnification entered into by a company.

On application to a court for an order under s. 164, by a company or eligible party, the court may make any order it considers appropriate, including an award for the costs incurred to obtain the order.

3. COMPARATIVE CORPORATE REIMBURSEMENT PROVISIONS IN ONTARIO AND ALBERTA

Unlike any other legislative scheme in Canada, Division 5 of the BCBCA separates the definition of who is eligible for indemnification and what that entitlement includes, from the circumstances in which a company *must not indemnify* an eligible party or pay the expenses actually or reasonably incurred by an eligible party in respect of a proceeding.

For example, in contrast to the BCBCA, s. 136 of the Ontario *Business Corporations Act* R.S.O. 1990, c. B.16 (the "OBCA"), and s. 124 of the Alberta *Business Corporations Act* RSA 2000, c. B-9 (the "ABCA") combine who, when, and for what indemnification or payment *may* be granted. Both the OBCA and ABCA provide:

> *"…A corporation **may indemnify** a director or officer of the corporation, a former director or officer of the corporation or a person who acts or acted at the corporation's request as a director or officer of a body corporate of which the corporation is or was a shareholder or creditor, and his or her heirs and legal representatives, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgement, reasonably incurred by him or her in respect of any civil, criminal or administrative action or proceeding to which he or she is made a party by reason of being or having been a director or officer of such corporation or body corporate, if,*
>
> *(a)* ***he or she acted honestly and in good faith with a view to the best interests of the corporation; and***
>
> *(b)* ***in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, he or she had reasonable grounds for believing that his or her conduct was lawful.****"*

As drafted, s. 136 of the OBCA and s. 124 of the ABCA, are restrictive in nature. A corporation may only indemnify or make payments if certain conditions are first met. Division 5 of the BCBCA is permissive: Indemnification or the payment of expense is flexible and permitted *unless* otherwise prohibited.

Greater flexibility to permit corporate reimbursement is also achieved in the BCBCA by clarifying when corporate reimbursement is prohibited. Section 163 (1)(c) and (d) of the BCBCA, unlike s. 136 of the OBCA and 124 of the ABCA, make it clear that the behaviour or actions of an eligible party are only relevant to corporate reimbursement when they relate to the subject matter of an eligible proceeding.

In an era where corporate governance is under great scrutiny, the BCBCA couples personal liability protection for D & O's with responsible corporate governance. Unlike the OBCA and ABCA, the BCBCA only authorizes a corporate director or officer to advance expenses to an eligible party if the eligible party agrees to repay any amounts advanced to him or her in the event it is ultimately determined that the payment of those expenses was prohibited by section 163 of the BCBCA. Alternatively, if a director or officer agrees to indemnify or pay the expenses of an eligible party, and the company at the time the agreement was made was prohibited from giving the indemnity or paying the expense by its memorandum of articles, he or she will be personally responsible to repay the company.

H. THE "INSURED *V.* INSURED" EXCLUSION IN AN INSOLVENCY CONTEXT

In Canada, we have only had one definitive case which has examined the "*insured versus insured*" exclusion. That is somewhat ironic, in that Canadian D & O underwriters have been undertaking a "relaxation" in the "*Insured versus Insured*" exclusion for the past five years, simply on the premise that Canadian jurisprudence on the exclusion would "imitate" results in the United States.

Generally, in the United States, the Courts have been reluctant to enforce the "*Insured versus Insured*" exclusion if the litigation in not inherently "collusive" and there is an element of true adversity as between the "real Plaintiff" and the directors and officers. Canadian D & O underwriters have merely assumed that Canadian courts would take a similar approach, and that being so, have introduced a significant "liberalization" in the "*Insured versus Insured*" exclusion without really knowing how a Canadian Court would respond.

The early judicial results in Canada suggest that the underwriters' intuitive response was correct. The first comprehensive case involving the "*Insured versus Insured*" exclusion, decided in Quebec, suggests that the Canadian Judges are quite willing to adopt the comparable U.S. cases on the operation of the exclusion.

The only Canadian coverage case that squarely deals with the "*Insured versus Insured*" exclusion concerns a case in which the "true Plaintiff" was an insolvency official; in this case a Trustee in Bankruptcy appointed pursuant to Federal bankruptcy legislation.

In *Peoples Department Stores (Trustee of) v. Wise*[19] (the *"Peoples"* case), the Quebec Superior Court was asked to examine a case wherein a national department store chain entered into bankruptcy protection with over $4.0 million in taxes, debts and employee wages outstanding.

Chubb had issued a policy to *"the store, its' subsidiaries, and any person who had been, was then or shall become a duly elected director or duly elected or appointed officer of the insured organization."* Chubb conceded that the policy was in force at the time of the bankruptcy and that the directors were "Insureds" pursuant to the terms of the D & O policy.

The directors sought coverage for a claim for wages advanced on behalf of the employees, albeit the legal action was being commenced and maintained by the Trustee in Bankruptcy. Unfortunately, in the reported Reasons for Judgment, the wording of the "Insured versus Insured" exclusion is not identified. However, it has to be assumed, for the purpose of the analysis, that the exclusion was a "simple" "*Insured versus Insured*" exclusion without the benefit of any "liberalization" relating to proceedings by a bankruptcy or insolvency official.

The D & O insurer maintained that the claim against the directors was excluded in this *"Insured versus Insured"* wording, as the Trustee *"stands in the legal shoes of"*, and is for all legal purposes the continuation of the insolvent entity.

The rationale which underlies the "*Insured versus Insured"* exclusion is that the insured presenting the claim is not truly in an adversarial position vis-à-vis the insured against whom/or which the claim is made, and the exclusion therefore prevents collusion among co-insureds.

In the *Peoples* case, the Court found that this rationale for adoption of the exclusion is not relevant when the claim is made by a Receiver or Trustee in bankruptcy of insolvency proceedings. This reasoning is in line with the thrust of the comparable decisions of the American courts. The Quebec Court stated:

> *if we pause to analyze and characterize in depth the quality in which a Trustee in Bankruptcy acts, we find that he or it is not acting only as the continuation of the legal personality of the Bankrupt, having stepped into its "legal shoes", but acts also as the representative of the creditors of the Bankrupt. The Trustee is more than the simple continuation of the legal personality of the Bankrupt. A Trustee in Bankruptcy is in the same possession of the assets of the Bankrupt as if he were a receiver of the property appointed by the Court, and a receiver is an officer of the Court appointed for the benefit of all parties to the proceedings.*

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[18] (1998) 23 C.B.R. (4th) 200

Furthermore, when examining the "*Insured versus Insured*" exclusion in respect of a Bankruptcy Trustee as the representative of the creditors of the bankrupt, the Court noted that the case of *Dartmouth (City) v. Barclays Bank of Canada*[20], in which the Court of Appeal of Nova Scotia reconfirmed that the *BIA* provides a regime whereby the creditors of a Bankrupt will pursue their claims by collective action through the Trustee. This again supports the concept that the Trustee acts in that additional quality as the general representative of the creditors of the Bankrupt, and is an officer of the Court and should impartially represent the interests of creditors. That being so, the proceeding is qualitatively different that merely a lawsuit brought by the entity against its own directors and officers.

Thus, the Court disagreed with the D & O's characterization of the "*Insured versus Insured"* exclusion vis-à-vis the Trustee and concluded that the D & O insurers was liable for the unpaid wages being claimed by the Trustee in Bankruptcy on behalf of the unpaid employees of the entity. This case underscores the willingness of Canadian Judges to adopt the dominant U.S. approach on the operation of a D & O exclusion; in this case the "*Insured versus Insured"* exclusion. It also inferentially signals that D & O coverage counsel need to be increasingly selective in the cases that they seek to have judicially decided for coverage purposes.

I. SCOPE OF A "SECURITIES CLAIM" IN CANADIAN D & O POLICIES

Historically, D & O policies only afforded coverage to the Directors and Officers. If the entity was named along with the D & O's, then D & O insurers would attempt to undertake an allocation to reflect the relative portion of legal costs and indemnity exposure that was attributable to the company as opposed to the Directors and Officers.

In the United States, with the *Nordstrom*, *Caterpillar* and *Safeway* decisions, the Courts developed the "larger settlement" rule. In essence, the collective impact of these cases is that the D & O insurer bears the entire reimbursement exposure unless the D & O insurer can clearly demonstrate that the company bore a liability that was monetarily greater than the D & O's own exposure. In *Coronation Insurance Company v. Clearly Canadian Beverage Company* [21] the B.C. Court of Appeal adopted the U.S. approach to the issue of allocation in the context of a securities fraud case that was being conducted in the United States.

[19] (1996) 151 N.S.R. (2nd) 264

[21] (1999) 168 D.L.R. (4d) at 366; 57 B.C.L.R. (3d) at 303

In response to *Nordstrom et. al.*, most D & O insurers in the United States and Canada began to grant entity coverage for "Securities Claims". In doing so, they recognized that, for all practical purposes, the doctrine of allocation meant that the D & O insurer had to pay for the concurrent legal exposure of the entity.

There is some variation in the definition of a "Securities Claim" among various Canadian D & O insurers. For example, one wording is:

> *"Securities Claim" means a Claim (including a civil lawsuit or proceeding brought by any provincial securities commission) made against an Insured and brought anywhere in the word alleging a violation of any law, regulation or rule, whether statutory or common law, which is:*
>
> *(1) brought by any person or entity alleging, arising out of, based upon or attributable to, in part or in whole, the purchase or sale of or offer or solicitation of an offer to purchase or sell, any securities of the Organization;*
> *(2) in the form of a securities holder derivative claim brought on behalf of the Organization, or*
> *(3) brought by a securities holder of an Organization, with respect to such securities holder's interest in such securities of such Organization, whether directly or indirectly or by class action."*

Yet another wording provides:

> ***"Securities Claim"*** *shall mean any* ***Claim*** *(including a civil lawsuit or criminal proceeding brought by the Securities and Exchange Commission) made against an* ***Insured*** <u>*alleging a violation of any law, regulation or rule, whether statutory or common law*</u>*, which is:*
>
> *(1) brought by any person or entity alleging,* <u>*arising out of, based upon or attributable to, in part or in whole, the: (a) purchase or sale of*</u>*, or (b) offer or solicitation of an offer to purchase or sell, any securities of the* ***Company****, or*
>
> *(2) brought by a security holder of the* ***Company****, arising solely with respect to such security holder's interest in such securities of the* ***Company****, whether directly, by class action, or derivatively on behalf of the* ***Company****.*

And another wording states:

> *"****Securities Transaction*** *means the purchase or sale of, or offer or solicitation of an offer to purchase or sell,* <u>*any securities of the Company*</u>*, whether on the open market or in connection with a public or private offering of securities* <u>*by the* ***Company***</u>*."* (emphasis added)

Increasingly, two types of "claims" raise difficult conceptual issues as to whether the "claim" is property characterized as a *"Securities Claim"* so as to "trigger" coverage for the company. Broadly speaking, the issue arises in the context of two types of corporate transactions:

1. A "TAKE OVER" BID RESULTING IN COMPULSORY ACQUISITION PROCEEDINGS

Under Canadian company law, whether Federal or Provincial, if a company successfully acquires 90% of the shares in a "target company", the "take over" company can avail of statutory "compulsory acquisition" rights. In effect, by statute, the "take over" company is entitled to purchase the remaining 10% of the "take over" company shares by compulsion, notwithstanding that the 10% may have refused to tender their shares as part of the "take over" bid. The statutory remedy is "compulsory", in the sense that the remaining 10% cannot elect to retain their shares.

The right of the "take over" company to acquire the remaining 10% permits the minority to complain about any "oppressive or unfairly prejudicial" conduct of the directors and officers of the take over company that caused the shares to depreciate in value, and it also permits the 10% to be compensated on the value of the shares without regard to any depreciation in value caused either by the take over itself, or, improper conduct by the directors and officers.

It is not uncommon, in the context of any litigation concerning the valuation of the remaining 10% share holdings, to name both the "take over" company and its officers and directors together with the directors and officers of the "target" company. So, the question that arises, assuming litigation occurs, is whether the inclusion of the directors and officers in the "target company" entails a *"Securities Claim"*, in that the definition of the "entity" is, by the terms of the D & O policy, defined to include any "subsidiary". Once the take over bid succeeds, albeit not with 90% control, the "target company" becomes a "subsidiary" of the "take over" company (assuming underwriting concerns as to proper notice and additional premium are dealt with). If the lawsuit ensues weeks or months later, then the directors and officers in the "target company" will contend that they are entitled to coverage on the premise that the sale of the subsidiary's shares is a *"Securities Claim"*.

It is probable that in this situation, the ensuing "claim", from the standpoint of the "target" company, is a *"Securities Claim"*. To avoid any characterization that the ensuing compulsory acquisition litigation is in fact a *"Securities Claim"*, the prudent step, from an underwriting standpoint, is to ensure a "carve out" from any coverage afforded the newly-acquired subsidiary by means of an endorsement. In other words, the D & O underwriter would cover any "going forward" claims, but would expressly exclude any "claim" arising by reason of the take over bid, including any compulsory acquisition proceedings launched by the former shareholders of the subsidiary. In turn, the D & O's of the "target company" can be suitably protected by means of a separately issued "run off" D & O policy that affords coverage for a "Wrongful Act" that is pre-take over bid, from a temporal standpoint, which "claim" is only "first made" subsequent to the take over bid.

2. A "DELAWARE STYLE" REVERSE TAKE OVER

Recently, in Canada, it has become fairly common for public companies to undergo a change in control by means of a "Delaware style" reverse take over bid. This entails, typically, a smaller public company effectively acquiring a much larger public "target" company by using the latter's more substantial assets to, in part, finance the acquisition.

Apart from corporate concerns centering on the ability of a purchaser to use a company's assets to purchase the company, there is a more fundamental concern. Courts are concerned that the purpose of the "reverse take over" may be to avoid judicial scrutiny of the transaction insofar as judicial approval is required, and secondly, a concern that the directors and officers, in undertaking the transaction, are doing so for their own bests interests, rather than in the best interests of the shareholders of the company. Often there may be the suggestion that the "reverse take over" is really being done simply to ensure that the incumbent management and directors retain control of the company, notwithstanding adverse economic results.

The essential elements of a "Delaware style" take over bid, entailing a merger, consist of the following:

a) the take over company merges with a wholly owned subsidiary created for the purpose of the transaction;
b) the "target" company would issue to the shareholders in the "take over" company shares equal to the shares held by those shareholders in the "target" company prior to the transaction;
c) the target company would issue options to purchase shares in the target company to those holding options in the take over company in exchange for the latter's stock options;
d) the target company would issue warrants to purchase shares in the target company to persons holding warrants in substitution for existing warrants. This ensures, at the completion of the process,

> that more than 50% of the "merged" take over company and target company would be owned by the shareholders of the take over company.

It is not uncommon, in Canada, for a reverse take over bid to result in allegations that the conduct of the directors and officers was "oppressive or unfairly prejudicial" to the shareholders. While frequently the remedy sought is the company's re-purchase of the dissenting shareholders' holdings, the primary relief complains that the directors and officers are acting solely out of their own interest and not having regard to what is best for shareholders.

So, for analytical purposes, the question is whether any litigation arising at the hands of the dissident shareholders entails a *"Securities Claim"*, notwithstanding that the "Delaware style" reverse take over does not entail an exchange of money, but rather, a "share for share" exchange.

To some degree, the answer will depend upon the manner in which the term *"Securities Claim"* has been defined. However, the common element among most policy wordings is *"the sale"* of any *"securities"* of the entity. Secondly, most D & O policies, in purporting to define a *"Securities Claim"*, broaden the definition by stating it merely be *"…based upon or attributable to, in part or in whole…."* the purchase and sale of *"securities"* of the entity.

Hence, the narrow question for consideration is whether the term "*sale of shares*" necessarily denotes a "sale" for cash, or, whether a "sale" occurs if the stated consideration is shares rather than cash. This is of some practical consequence, for the reasons illustrated above, in that many take over bids, in effect, occur as a result of a "share for share" exchange with no cash changing hands. A Canadian Judge examining this problem could well conclude that a "share for share" exchange in the "take over" company does entail a "sale", notwithstanding that the stated consideration is not cash.

The decided Canadian cases, when examined together, generally conclude that in a sale of goods, a "sale" for consideration other than money is merely an "exchange" and not a "sale". In transactions not involving a sale of "goods", including a sale of shares, an exchange involving consideration other than money <u>is</u> a "sale". The legal position is best summarized in a famous case, decided in England, *The South Australian Ins. Co. v. Randall*[22], where it was held:

[22] (1869) L.R. 3 P.C.

> *Wherever there is a delivery of property on a contract for an equivalent in money* ***or some other valuable commodity ... it is a sale.***

Entity coverage for *"Securities Claims"* is a relatively recent development in Canadian D & O underwriting. Given the broad range of claims that could potentially fall within the ambit of the definition of a *"Securities Claim"*, it is predicted that while entity coverage for *"Securities Claims"* will remain a continuing feature of D & O policies, the ambit of the entity coverage will be increasingly narrowed in scope so that Canadian D & O underwriters are not confronted with the reality of "claims" that bear little or no resemblance to "true" securities claims.

J. CAN D & O'S BE RELIEVED FROM THE REPORTING REQUIREMENTS ON "CLAIMS MADE AND REPORTED" POLICIES?

Insurers who write "claims made and reported" D & O policies are often concerned about the possibility of an insured being relieved of the applicable notice requirements, so as to obtain coverage where there has been a failure by the insured to report a claim during the policy period. In general, as long as the policy wording in respect to notice is viewed as a condition precedent to coverage, insurers need not be concerned.

1. POLICY WORDING IS STRICTLY APPLIED

Before 1998, the "claims made and reported" language in insurers' D & O/E & O policies was not interpreted in the insurers' favour if the wording could be interpreted as other than a condition precedent to coverage. For example, the wordings "claims made" and "as soon as practicable report" were frequently not characterized by the courts as a condition precedent that precluded an insured from obtaining relief from forfeiture, as exemplified in the case of *McNish and McNish v. American Home Assurance Company*[23].

As a result, insurers undertook underwriting changes so as to include the words "condition precedent" to denote the characterization which they placed on the reporting requirements.

In 1998, this revised wording was examined by the Ontario Court of Appeal in *Stuart v. Hutchins et al*[24]. *Stuart* was a motion for a declaration that E & O insurer owed a duty to

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[23] (1989) 68 O.R. (2d) 365 (Ontario High Court of Justice)

[24] (1998), 164 D.L.R. (4th) 67

defend an action commenced against a real estate broker by reason of an E & O policy. The policy at issue was a "claims made and reported" policy which provided that:

> *…The Insured shall, as a* ***condition precedent*** *to the availability of the rights provided under [the] policy, give written notice to the [Insurer] as soon as practicable during the Policy Period, or during the extended reporting period (if applicable), of any Claim against the Insured….[emphasis added]*

The insured in that case received notice of the Claim during the policy period, but did not report the claim to the E & O insurer until after the policy period had expired. In addition, the insured took no steps to renew its policy with the E & O insurer, nor had the insured applied for the "extended reporting coverage" available under the policy. The Ontario Court of Appeal concluded that the "claim" had to be reported within the necessary time period for coverage to exist, stating:

> *To do so otherwise would be to distort the plain meaning of the contract and require the insurer to provide coverage for an event outside the scope of the policy which it had not agreed to cover and for which it had received no remuneration.*

Since *Stuart*, some E & O/D & O insurers have further revised their policy wording to include a "grace period" for reporting a claim. This wording is distinct from extended or "discovery period" coverage that would ensure, for an additional premium, that any claim reported subsequent to the lapse of the policy term would be treated as a claim, and is illustrated with the following example:

> *…(a) The Company or the Insureds shall,* ***as a condition precedent to the obligations of the Insurer under this policy****, give written notice to the Insurer of a Claim made against an Insured as soon as practicable and either:*
>
> *(1) anytime during the Policy Period . . ; or*
>
> *(2) within 30 days after the end of the Policy Period …,* ***as long as such Claim(s) is reported no later than 30 days after the date such Claim was first made*** *against an Insured."* [emphasis added]

In effect, this *"claims made and reported"* wording affords an additional "window of time" in which to report a *"Claim"* of which the insured is aware within 30 days following the lapse of the policy, provided that this step is undertaken by the insured within thirty (30) days of the *"Claim" being "first made"* against the insured. It is yet unclear in Canada whether a failure to observe the "30 day" requirement will permit a D & O to obtain relief from forfeiture.

It has been suggested that the "30 day requirement" should be reworded to make clear that the "grace period" has, as a condition precedent, strict compliance with that time limit.

2. STATUTORY AUTHORITY FOR RELIEF FROM FORFEITURE

(i) Provincial Insurance Acts

A D & O who has failed to report a claim during the policy period, as in *Stuart*, can look to our provincial Insurance Acts for relief from forfeiture of coverage. The essence of those statutory provisions is to exempt the insured from the effects of a strict application of the wording of the policy.

In *Stuart*, the Ontario Court of Appeal considered the distinction between "occurrence" based insurance policies, and "claims made and reported" policies, then stated as follows:

> *… the answer to the central issue lies in the proper characterization of [the insured's] failure to provide [American Home] with written notice of the potential … Claim during the policy period. To be precise, can it be said that [the insured's] failure in this regard* ***constituted imperfect compliance with a term of the policy*** *, such that s. 129 of the Act could be invoked,* ***or, did it amount to non-compliance with a condition precedent to coverage****, thereby foreclosing the availability of s. 129? [emphasis added]*

In considering the applicability of the relevant provision, namely Section 129 of the Ontario *Insurance Act,* the Court of Appeal in *Stuart* held as follows:

> *To the extent that the wording in a contract of insurance is found to be ambiguous, it is accepted that the ambiguity will generally be resolved in favour of the insured.* ***This rule, however, has no application where the wording of the policy is plain on its face and capable of only one meaning****…*
>
> *Trite though it may be,* ***an insurer has the right to limit coverage in a policy issued by it and when it does so, the plain language of the limitation must be respected****.…*
>
> *[American Home] contracted to provide [the insured] with coverage for potential claims made and reported during the policy period.* ***It did not agree to provide [the insured] with coverage for potential claims made but not reported during the policy period and it does not lie with the court to rewrite the policy as if it did.****"* [emphasis added]

(ii) Provincial "Interests of Justice" Legislation

There is still further relief available to a D & O who has failed to report a claim during the policy period as provided in our provincial statutes, granting Courts wide-ranging discretionary powers in the interests of accomplishing justice.

However, in *Stuart*, the Ontario Court of Appeal decided that the applicable statutory provision does not "reach beyond" the relevant provision of the *Insurance Act* to relieve against forfeiture in circumstances where a breach (failure to notify) amounts to non-compliance with a condition precedent to coverage.

The Ontario Court of Appeal in *Stuart* concluded that American Home's reporting requirements necessitated full compliance for coverage.

Thus, in order for D & O's to be relieved of the notice requirements on a "claims made and reported" form so as to extend coverage beyond the terms of the policy, it is essential that their failure be viewed as imperfect compliance with a term of the policy. If, instead, their failure is viewed as non-compliance with a condition precedent to coverage, they will not be entitled to coverage or statutory relief from forfeiture provided by our provincial Insurance Acts.

K. HOW THE D & O INSURER CAN "CLAW BACK" ANY REIMBURSEMENT MADE ON BEHALF OF THE D & O'S FOR STATUTORY CLAIMS INVOLVING UNPAID TAXES OR EMPLOYEE WAGES – THE *BLUE RANGE* AND *MERIT ENERGY* CASES.

Canadian D & O insurers have traditionally recognized that one of the single largest source for D & O claims is the statutory liability imposed upon directors and officers for unpaid entity financial obligations to remit payroll source deductions and retail taxes.

If the entity becomes insolvent, then the various levels of Provincial and Federal Government have a statutory cause of action against the directors and officers for liability in an amount equal to the entity's financial obligation. In the context of larger public companies, with many employees or a significant level of retail sales, the potential financial exposure can vastly exceed even the "highest" excess D & O policy limits. That financial reality has resulted in an increased willingness of directors in public companies to resign at the first signs of an imminent insolvency.

If the D & O insurer is left "holding the bag" (to use an expression), the question is what secondary relief can the D & O obtain to recoup claims that may result from strict statutory liability accompanied with few if any defences.

Effective D & O coverage counsel can be particularly creative in the context of these claims. Potentially, coverage counsel has two "weapons" at his or her disposal; either the use of subrogation rights (conferred by the terms of the D & O policy), and secondly, the D & O insurer's obtaining, from the claimant, a contractual assignment of the claimant's rights in an effort to recover any reimbursement exposure that should properly and ultimately rest with the entity, or, its insolvent estate.

It is important to recognize that a Canadian D & O's statutory responsibility for monetary obligations that are primarily a corporate obligation should, in theory, result in a "claim over" against the entity. If the company is solvent, then the D & O insurer can use its subrogation rights to file a claim in the insolvent estate relying upon the D & O's right of indemnity pursuant to the entity's articles, bylaws and internal "corporate constitution". That necessarily raises the novel question of whether and to what extent a directors and officers' right of indemnity from the entity is a claim that can be advanced against the insolvent estate. That issue will be examined in this portion of the paper.

Secondly, setting aside rights of subrogation that enure by reason of the terms of the D & O policy, it is generally open to a D & O insurer to settle a claim brought by either employees (for unpaid wages), or, a taxing body (for unremitted source obligations) upon condition that the D & O insurer obtains an assignment of the claimants' right to recover in bankruptcy. Usually, claimants engage in the simple expedient of suing the directors and officers, since it is the "line of least resistance" and avoids the spectre of complex, time consuming proceedings in bankruptcy which may, at its conclusion, only result in a nominal financial recovery. Claimants prefer to sue the directors and officers confident in the knowledge that there is a D & O policy with limits more than sufficient to pay the claim in its entirety. This raises the novel question of whether and to what extent the D & O insurer can, upon settling the claim, obtain an assignment of the claimants' rights so as to participate in the insolvency proceedings and thus recover a portion of its' paid loss.

The reality of "clawing back" monies, by reason of a "claim" initially paid by the D & O insurer subsequently through the insolvency proceedings, is particularly viable in the context of either a Receiver Manager being appointed, or, in the context of the *CCAA*. In the latter proceedings, it is contemplated that ultimately the entity will survive insolvency proceedings and in so doing honour at least a portion of the claims that existed at the outset of the insolvency. That being so, the D & O insurer has potential opportunities for recovering all or a portion of a long since "paid claim" if coverage counsel is resourceful.

It is perhaps instructive to examine the common source for a director and officers' statutory liability to pay an obligation which, at the outset, was merely a monetary obligation of the entity. This discussion will necessarily be brief and only highlight some of the more common sources for a directors and officers' statutory liability.

Under Section 227.1 of the Federal *Income Tax Act*[25], directors of a corporation may be found personally liable for the failure of the corporation to remit and withhold taxes to Revenue Canada during the period that the directors held office. If the corporation is guilty of an offence under the *Income Tax Act*, any director or officer who participated or acquiesced in the commission of the offence is also guilty of the offence and may be prosecuted whether or not the corporation has been prosecuted or convicted.

Civil exposure for directors under Section 227.1 of the *Income Tax Act,* through execution proceedings commenced by the Federal Government, is likely to arise should the company be rendered insolvent.

Directors have available a "due diligence" defence. A director will be excused for the corporation's failure to remit or withhold taxes if he has exercised the care and due diligence that a reasonably prudent person would have exercised in comparable circumstances.

With respect to liability for outstanding employee wages, S. 114(1) of the *Canada Business Corporations Act* S.C. 1985, c. C-44[26] provides that directors of a corporation are jointly and severally liable to employees of the corporation for all debts not exceeding six months wages. Representative of comparable provincial legislation, the *Employment Standards Act of British Columbia*[27], provides that directors of a corporation are personally liable for arrears of up to 2 months wages in the event they are not paid by the corporation.

Having briefly touched upon the source for liabilities, the next issue to examine is whether either a shareholders' or a directors and officers' relationship with a company is such that they can participate in a company insolvency for indemnity purposes.

[25] S.C. 197O-7l-72 c.63
[26] S.C. 1985, c. C-44
[27] RSBC 1996, C. 113

The initial issue that was tackled by the Canadian Judges was whether and to what extent a corporate shareholder, claiming damages against its wholly owned subsidiary, could participate in the subsidiary's insolvency assuming liability existed. That issue was first determined in *Re: Blue Range Resource Corp.*[28] (the *"Blue Range" case),* in which the Alberta Courts considered a case wherein one oil & gas company, Big Bear Exploration Ltd. ("Big Bear"), completed a hostile takeover of all of the shares of another, Blue Range Resource Corporation ("Blue Range"). After the takeover was completed, Big Bear alleged that the publicly disclosed information upon which it had relied in purchasing the Blue Range shares was misleading and that the shares were worthless. As sole shareholder, Big Bear authorized Blue Range to commence bankruptcy proceedings and then submitted a claim as an unsecured creditor, based on the damages it alleged it had suffered as a result of Blue Range's misrepresentations.

The Court rejected Big Bear's attempt to prove as an unsecured creditor and concluded that Big Bear's claim was "in substance" a shareholder claim for a return of an equity investment and therefore ranked after the claims of unsecured creditors according to the general principles of corporate law, insolvency law and equity. The Court stated that:

> *The very core of the claim is the acquisition of Blue Range shares by Big Bear and whether the consideration paid for such shares was based on misrepresentation. Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder, as it suffered no damage until it acquired such shares. This tort claim derives from Big Bear's status as shareholder, and not from a tort unrelated to that status. I find that the alleged share exchange loss derives from and is inextricably intertwined with Big Bear's shareholder interest in Blue Range. The nature of the claim is in substance a claim by a shareholder for a return of what it invested qua shareholder, rather than an ordinary tort claim.*

The Court went on to describe five policy reasons which justified the conclusion that a shareholder's claim for damages against the company should rank behind the claims of unsecured creditors of the company:

a) the claims of shareholders rank behind the claims of creditors in insolvency;
b) creditors do business on the assumption that they will rank ahead of shareholders in the event of their debtor's insolvency;
c) shareholders are not entitled to rescind their shares on the basis of misrepresentation after the company has become insolvent;
d) United States jurisprudence supports the priority of creditors in "stockholder fraud" cases; and

[28] (2000), 15 C.B.R. (4th) 169

e) to allow the shareholders to rank equally with the unsecured creditors could open the floodgates to aggrieved shareholders launching misrepresentation actions.

The practical result of the decision in the *Blue Range* case is that a claim for damages by a shareholder ranks below the secured, preferred and unsecured creditors of an insolvent company. That means it will be an infrequent case in which a shareholder, having a claim for damages (for example, a claim for damages for securities fraud) will ever be able to share monetarily in the event of the company's insolvency.

That issue having been decided, the next question for Canadian Courts was whether a director and officer, having incurred legal fees in the defence of an action brought against them, or, potentially having incurred an indemnity exposure for liability, is entitled to indemnity from the company and thereby share in the assets of the insolvent company and thus monetarily "claim back" the monies the director/officer paid. That determination is of significant for D & O insurers since, using the subrogation clause inherent to virtually every D & O policy, the D & O insurer (having paid the claim), can then use its subrogation clause to submit a claim in the insolvency proceedings and thus be reimbursed for its initial outlay at the "claims" stage.

The question of whether a D & O's right to indemnity from the company is a claim recoverable in bankruptcy or other insolvency proceedings was considered just this year by the Alberta Courts in another oil & gas case, *National Bank et al v. Merit Energy*[29] (the *"Merit Energy"* case). In that case, the directors and officers of Merit Energy applied to the Alberta Court to determine whether they were recognized as ordinary creditors of the corporate entity in the bankruptcy proceedings of the company, so that they could share in the proceeds remaining after its' dissolution. They did so on the basis of their right of indemnity conferred by reason of the company's internal bylaws.

Merit and its' directors and officers were named as defendants in several actions commenced throughout Canada by or on behalf of various shareholders, alleging that each of the directors and officers was responsible for misrepresentations made in the Prospectus. The Directors and Officers had previously entered into indemnity agreements with Merit.

In response, the Trustee in Bankruptcy of Merit Energy took the position that all of the claims were, in substance, claims by shareholders for the return of equity and, on the basis of the decision in *Blue Range*, must rank behind the claims of Merit's unsecured creditors. If the Trustee in Bankruptcy had prevailed in its' argument, it meant, to the

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extent the D & O's confronted any liability for the "security fraud" cases they were defending, that they could never be reimbursed either for defence costs, or, any ensuing settlement or Judgment at trial. Since D & O insurance existed it meant the D & O insurer would bear the loss entirely.

The Court considered the claims in light of the decision in the *Blue Range* case and concluded that:

a) The decision in the *Blue Range* case was applicable to the claims of Merit's flow-through shareholders. These claims were subordinate to the unsecured creditors, as they were in substance shareholder claims for the return of an equity investment; and

b) The *Blue Range* case did not apply to the claims of the Underwriters, Directors and Officers. These claims were not subordinate to the unsecured creditors, as they are in substance claims for damages for breach of contract, *i.e.* the indemnity agreements.

It was found that the Trustee's argument attempted to shift the focus from the Directors and Officers' claim against Merit, to the claim being asserted by the flow-through shareholders. It was noted by the Court that the flow-through shareholders' cause of action against the Directors and Officers was predicated on the alleged failure to discharge a statutory duty, and the liability was not contingent in any way on a successful claim against Merit under an indemnity agreement. In contrast, the Directors and Officers indemnity claims against Merit were not made as shareholders or for any return of investment made in Merit. Rather, they were based on contractual, legal and equitable duties owed directly by Merit under the company's indemnity granted to the directors and officers by reason of the company's bylaws.

The Court stated:

> *The ultimate success or failure of the Flow-Through Shareholders' claims makes no difference to the existence and enforceability of this right against Merit.*

As such, the Directors and Officers were found to have creditors' claims entitled to rank with Merit's other unsecured creditors. The appeal brought by the Trustee to the Alberta Court of Appeal was dismissed for the same reasons.

While in the context of the *Merit Energy* case the practical result, from the standpoint of the D & O insurer, did not differ since the underlying actions entailed a "Securities

Claim", the implications of the decision are significant for other cases that D & O insurers confront.

In the context of statutory claims, discussed above, the obligation is "purely" a monetary obligation of the entity. It is only by reason of a statute that the D & O's have indemnity for the corporation's obligation. Since D & O insurers have the benefit of a subrogation clause, having paid the statutory obligation, the D & O insurer can "step into the shoes" of the Directors and Officers and, using the decision in the *Merit Energy* case, file a Proof of Loss in the insolvency proceedings to recover all or a portion of the paid "claim". While typically in an insolvency proceeding there is little or no prospect of recovering 100% of a paid claim, there is the very real likelihood of recovering a portion of the loss; particularly in the context of *CCAA* proceedings or a receivership, as opposed to a "true bankruptcy" that entails a liquidation of the company's assets.

Secondly, and perhaps of equal practical importance, a D & O insurer's rights in Canada are not confined merely to a subrogation clause. The D & O insurer's coverage/monitoring coverage counsel, confronted with the spectre of unpaid employees, or, an unpaid government agency, will pay the D & O's exposure but stipulate for a contractual assignment of the creditors' rights to thereby, in a like manner as that adopted in the *Merit Energy* case, prove yourself as a creditor in the bankruptcy. This is particularly significant in the context of unpaid employee wages, since that claim, in the insolvency context, ranks as a "preferred" claim that permits the D & O insurer to "claw back" a paid "claim" in priority to other unsecured creditors pari passu with the other preferred creditors. So, in practice what would occur is that the D & O insurer would initially pay the claim and then, using its right of assignment, "perfect" its claim in the insolvency proceeding to thereby await full or partial reimbursement from the insolvency official handling the estate of the bankrupt or insolvent entity.

The recent judicial pronouncements in the *Blue Range* and *Merit Energy* cases underscores that D & O insurers in Canada now have "new" opportunities for recovering reimbursement on paid "claims" in the context of exposures which are, essentially, "purely" corporate obligations and not merely D & O claims. Coverage counsel acting for D & O insurers needs to be both vigilant and creative in reducing the overall exposure to D & O insurers.