DIRECTORS AND OFFICERS LIABILITY INSURANCE – THE BASICS

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I. INTRODUCTION:
Individuals who sit on boards of directors or who are employed as officers of a corporation, whether for-profit or non-profit, can be exposed to personal liability as a result of their conduct in the course of their duties. For this reason, many corporations obtain directors’ and officers’ liability insurance (“D&O insurance” or a “D&O policy”) which is designed to protect these individuals from such liability, or, in some circumstances, protect the corporation against its own liability arising out of its corporate acts.

The purpose of this paper is to provide an introduction to some of the main features of D&O insurance, to highlight how these are similar to, or differ from, other types of liability insurance, and to highlight some of the common sources of personal liability to which directors and officers may be exposed.

II. WHAT IS COVERED?
Historically, a D&O policy contained two clauses, called “insuring agreements” or “insuring clauses”, which defined the scope of coverage for the persons insured under the policy. Insuring agreements are the clauses which “grant” coverage to insureds and are the starting point in any analysis of whether or not a particular claim is covered under an insurance policy.

A. COVERAGE FOR NON-INDEMNIFIED LOSS – INSURING AGREEMENT A

In situations where a corporation is financially solvent and legally permitted to do so, it will indemnify its directors and officers for amounts paid in the defence and settlement of a claim against them, or a judgment pronounced against them, arising out of their duties as directors and officers. When the corporation is insolvent or otherwise not legally permitted to indemnify the directors and officers, the first insuring agreement found in a D&O policy provides coverage to the directors and officers. Under this

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1 This paper was originally prepared for the Continuing Legal Education Society of British Columbia and presented at the Insurance Law conference on September 10, 2010.
2 For example, s. 163 of the Business Corporations Act, S.B.C. 2002, c. 57 sets out the circumstances in which a corporation is prohibited from indemnifying directors and officers for defence costs or other amounts paid to settle a claim or pay a judgment against them.
insuring agreement, the insurer will reimburse the directors and officers directly for covered defence costs and settlement or judgment amounts. This insuring agreement is typically Insuring Agreement A in a D&O policy, and is therefore commonly called “Side A” coverage.

An example of a typical Side A insuring agreement is as follows:

*The Insurer shall pay on behalf of the Directors and Officers Loss for which the Company has not indemnified them arising from any Claim for a Wrongful Act first made against the Directors and Officers during the Policy Period.*

### B. CORPORATE REIMBURSEMENT COVERAGE – INSURING AGREEMENT B

In situations where a corporation is able to indemnify its directors and officers for defence costs and settlement or judgment amounts, the second insuring agreement in a D&O policy provides reimbursement to the corporation to the extent of this indemnification. This insuring agreement is called “corporate reimbursement” coverage, and is typically contained at Insuring Agreement B of a D&O policy. Therefore, this type of coverage is also commonly referred to as “Side B” coverage.

A typical Side B insuring agreement reads:

*The Insurer shall pay on behalf of the Company Loss that the Company is required or permitted to pay as indemnification to the Directors and Officers resulting from any Claim for a Wrongful Act first made against the Directors and Officers during the Policy Period.*

The functional difference between Side A and Side B coverage was aptly explained by the U.S. Bankruptcy Court for the Eastern District of New York in *In Re First Century Financial Corp.*, 238 B.R. 9 (Bankr. E.D.N.Y. 1999) as follows (at p. 16):

[…] There is an important distinction between the individual liability and the reimbursement portions of a D&O policy. The liability portion of the policy provides coverage directly to the officers and directors, insuring the individual from personal loss for claims that are not indemnified by the corporation. Unlike an ordinary liability insurance policy, in which a corporate purchaser obtains primary protection from lawsuits, a corporation does not enjoy direct coverage under a D&O policy. It is insured indirectly for its indemnification obligations. In essence and at its core, a D&O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection.
C. COVERAGE FOR PUBLICLY TRADED COMPANIES FOR SECURITIES CLAIMS – INSURING AGREEMENT C

About 10 – 15 years ago, a third insuring agreement in D&O policies became prevalent. This insuring agreement provides coverage to a publicly traded company for its own liability arising out of a “securities claim”. A “securities claim” is a term in the D&O policy that is typically defined as a claim that alleges a violation of securities legislation or a common law cause of action arising out of the purchase or sale of the shares of a company on the open market or through a public or private offering of securities. The coverage afforded to the corporation by this third insuring agreement is usually found at Insuring Agreement C, and is commonly called “entity coverage”.

Examples of a typical insuring agreement providing entity coverage for securities claims, and a typical definition of a “securities claim”, read:

The Insurer shall pay on behalf of the Company Loss arising from a Securities Claim first made against the Company during the Policy Period for a Wrongful Act.

Securities Claim means a Claim that:

(a) a security holder of the Company brings in his or her capacity as a security holder of the Company, whether individually or by class action, which alleges any Wrongful Act by the Company or a Director and Officer; or brings derivatively on behalf of the Company alleging any Wrongful Act by any Director and Officer; or

(b) alleges that the Company or a Director and Officer violated any securities law, whether federal, provincial, territorial, state, local or foreign, or rule or regulation promulgated thereunder; or committed a Wrongful Act in connection with the purchase or sale of, or offer or solicitation of an offer to purchase or sell, any securities of the Company.

Entity coverage became a common feature of D&O policies because of a series of court decisions in the 1990’s which required D&O insurers to pay the defence costs and other liability amounts owed by the company (as an otherwise uninsured party) where those amounts could not be clearly separated from defence costs incurred, and liability amounts owed, by the directors and officers. The issue most frequently arose where

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the corporation and the directors and officers were defended by the same lawyer, and a
settlement was entered into which did not specifically break-down the amount being
paid on account of the liability of the directors and officers and the amount being paid
on account of the liability of the company. In these circumstances, the courts were
frequently finding that the D&O insurer could not allocate a percentage of incurred
defence costs and settlement amounts to the uninsured company in order to pay only
those amounts allocated to the liability of the insured directors and officers. The result
was that the D&O insurer was often required to pay all defence costs and the entire
settlement amount even where the policy did not specifically provide coverage for the
company. D&O insurers found that they were effectively providing coverage for the
company but were not collecting a premium for this additional risk.

Entity coverage for security claims is now a standard feature of D&O policies issued to
publicly traded companies; however, the coverage for publicly traded companies is
generally restricted to such claims.

D. ENTITY COVERAGE FOR PRIVATE COMPANIES

While entity coverage for securities claims in a D&O policy was designed for publicly
traded companies, modern D&O policies are increasingly providing broader protection
for the liability of private for-profit and non-profit companies.

With respect to non-profit corporations, including strata corporations and housing
cooperatives, full coverage is often provided to the entity for its own conduct. D&O
insurers recognize that it is more difficult for non-profit companies to fund litigation
against them due to budgetary constraints and are thus increasingly willing to provide
full entity coverage for these companies. D&O insurers also see non-profit companies
as posing a lower risk than for-profit corporations due to the fact that they are not
exposed to the same types of claims by disgruntled shareholders as are private for-
profit companies.

However, by reason of the increased number of D&O insurers that have entered the
Canadian market in recent years, it is not uncommon to see full entity coverage for
private for-profit companies. Due to the different underwriting considerations that go
into offering entity coverage for publicly traded companies, including the increased
exposure to securities claims, where full entity coverage is afforded to a private
company, the policy typically excludes coverage for claims arising out of securities

64 F. 3d 1282; New Zealand Forest Products Ltd. v. New Zealand Insurance Company Ltd., [1997] 1 W.L.R. 1237,
(P.C.); Coronation Insurance Co. v. Clearly Canadian Beverage Corp., 1999 BCCA 11.

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which are traded on the open market or are offered through a public or private offering. If a private company is considering going public, or has gone public, it would be required to purchase a policy designed for publicly traded companies.

An example of an insuring agreement that provides full entity coverage for a company reads:

*The Insurer agrees to pay the Loss of the Company for a Claim alleging a Wrongful Act of the Company that is first made during the Policy Period.*

Employment practices liability (“EPL”) insurance, discussed further below, is also a common feature of D&O policies that provide entity coverage for private companies for their liability for employment-related claims.

E. WHAT IS A WRONGFUL ACT?

As seen from the examples of the insuring agreements set out above, a D&O policy provides coverage for claims alleging a “wrongful act”. What then is a “wrongful act”?

A “wrongful act” is broadly defined in a D&O policy to mean any actual or alleged act, error, omission, misrepresentation, neglect or breach of duty by any director or officer while acting in his or her capacity as a director or officer of the company that purchased the policy (called the Named Insured), or any matter claimed against a director or officer solely by reason of the director or officer serving in that capacity. The only limitation that is built into the definition of a “wrongful act” is that the conduct of the person against whom the claim is made be as a result of that person’s duties as a director or officer of the Named Insured. The intention of this limitation is to prevent the D&O policy from responding to claims alleged against a director or officer because of his or her role with a company other than the Named Insured (which would be the subject of D&O insurance purchased by the other company).

For example, in *August Entertainment, Inc. v. Philadelphia Indemnity Insurance Company* (2007), 146 Cal. App. 4th 565, the appellant entered into a contract with a company to

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5 Although beyond the scope of this paper, coverage for directors and officers who also serve as directors and officers of another company (usually called an “outside entity”) at the request or direction of the Named Insured is another common feature of modern D&O policies. When offered, this “outside directorship” coverage is intended to be excess insurance to that purchased by the “outside entity” and, therefore, provide extra protection to the directors and officers of the Named Insured.
provide the distribution rights to certain motion pictures for a minimum guaranteed price. When the company defaulted on its obligation to pay this minimum guaranteed price under the contract and became insolvent, the appellant sued it and one of its officers, alleging that the officer was personally liable for the company’s contractual obligation because he entered into the contract without specifically indicating that he was doing so on behalf of the company. When the D&O insurer denied the officer’s claim for coverage, the officer entered into a settlement agreement with the appellant which included an assignment of the officer’s rights under the D&O policy. The appellant then brought an action against the D&O insurer for bad faith because of the denial of coverage to the officer.

Although this decision primarily addresses the issue of whether or not there is coverage under a D&O policy for the contractual obligations of a corporation, the California Court of Appeals also held that the officer was not entitled to coverage because an officer acting in the course of his or her office could not be personally liable for the contractual obligations of the company. The court further held that if the officer was personally liable, then such liability could only arise from acting in a personal capacity rather than an official capacity, the former of which was not covered under the D&O policy.

In light of the broad definition of a “wrongful act” in D&O policies, almost any conduct is potentially covered. The expansive concept of a “wrongful act” differs significantly to the coverage offered under commercial and personal liability policies, where the underlying conduct generally must be an accident, or some type of negligent act, in order for the policy to provide coverage. In order to limit the coverage under a D&O policy, restrictions on the coverage that would otherwise be afforded because of the definition of a “wrongful act” are contained within exclusion clauses and limitations on the definition of “Loss” covered by the policy, both of which are discussed further below.

III. WHAT TRIGGERS COVERAGE?
A “trigger” for coverage is, broadly speaking, the circumstances that must exist to require the insurer to respond to a claim. The trigger for coverage is usually set out in the insuring agreements which grant coverage under the policy.

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6 Certain types of intentional conduct are covered under commercial and/or personal liability policies through the coverage offered for “personal injuries”, such as defamation, breach of privacy, or wrongful arrest or detention.
A. “OCCURRENCE” BASED POLICIES

In commercial general liability policies and homeowners’ liability policies, coverage is usually triggered by an “occurrence” or accident causing bodily injury or property damage.

In order to determine whether this type of liability insurance policy must respond to a claim, the starting point is to look at when the “occurrence” alleged in the claim happened and when the injuries or property damage alleged in the claim occurred. If both the “occurrence” and the resulting injury or damage happened during the policy period, then coverage under this type of policy is triggered. Therefore, it is possible under occurrence based policies to have a number of policies issued over a number of years triggered where a claim involves an occurrence and damage that take place over a number of years.7

B. “CLAIMS-MADE” AND “CLAIMS-MADE AND REPORTED” POLICIES

The “trigger” for coverage under a D&O policy is significantly different than that under an occurrence based policy because D&O policies provide “claims-made” or “claims-made and reported” coverage. Specifically, the event that requires the insurer to respond to the claim is the making of a “claim” during the policy period, and frequently, the reporting of the “claim” to the D&O insurer during the policy period. The trigger for coverage under D&O policies is therefore comparable to that found in professional liability policies.

The Ontario Court of Appeal in Stuart v. Hutchins (1998), 6 C.C.L.I. (3d) 100 described the difference between “occurrence” based policies and “claims-made” policies as follows (at para. 13):

Claims-made and reported” policies are to be distinguished from “occurrence” policies. Much has been written about the defining characteristics of each [citation omitted] and there is no need to belabour the subject. A useful discussion of the origin and distinguishing features of the two types of policies is found in Pacific Employers Ins. Co. v. Superior Court (1990), 270 Cal. Rptr. 779 at 783 & 784:

Occurrence policies were developed to provide coverage for damage caused by collision, fire, war, and other identifiable events (Zuckerman v. National Union Fire Insurance Company (1985), 100 N.J. 304, 495 A.2d

7 Typical examples of claims that may trigger multiple occurrence based policies include “leaky condo” claims, pollution claims and abuse claims.
Because the occurrence of these events was relatively easy to ascertain, the insurer was able to “conduct a prompt investigation of the incident and make an early assessment of related injuries and damages with the result that actuarial considerations permitted relative certainty in estimating loss ratios, establishing reserves, and fixing premium rates.” (Stine v. Continental Cas. Co. (1984), 419 Mich. 89, 349 N.W. 2d 127, 131.) The automobile liability policies in Campbell, Abrams and Billington were classic occurrence policies where coverage attached once the “occurrence” took place even though the claim was not made for some time thereafter. Notice provisions contained in such occurrence policies were “included to aid the insurer in investigating, settling, and defending claims”, not as a definition of coverage. (Zuckerman v. National Union Fire Insurance Company, supra, 495 A.2d at p. 406.) “[T]he requirement of notice in such policies is subsidiary to the event that invokes coverage, and the conditions related to giving notice should be liberally and practically construed.” (Ibid.) (FN2)

All professional liability policies were at one time “occurrence” policies. (See Kroll, The Professional Liability Policy “Claims Made” (1978) 13 Forum 842.) Underwriters soon realized, however, that “occurrence” policies were unrealistic in the context of professional malpractice because the injury and the negligence that caused it were often not discoverable until years after the delictual act or omission. In an effort to reduce their exposure to an unpredictable and lengthy “tail” of lawsuits filed years after the occurrence they agreed to protect against, underwriters shifted to the “claims-made” policy. (Id. at p. 845) This type of policy differed materially from an “occurrence” policy in several aspects. Most notably, it was transmittal of notice of the claim to the insurer which was the event that invoked coverage. [Emphasis in original.]

The rationale for affording claims-made coverage for professionals is equally applicable to directors and officers in that the types of risks covered by a D&O policy do not lend themselves to easy detection in the same way that the risks covered by an occurrence based policy do. Similar to the acts which may form the basis of a claim against a professional, the acts of directors and officers do not necessarily manifest their undesirable results immediately, resulting in the prospect of “long tail” claims that the insurance industry sought to protect itself against by introducing claims-made coverage.

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for professionals. For this reason, many decisions interpreting the terms of a professional liability policy are applicable when interpreting a D&O policy.

C. CLAIMS-MADE V. CLAIMS-MADE AND REPORTED POLICIES

There are two variants of insurance policies that are dependant on the timing of the making of the claim as the trigger for coverage. The first variant is a “claims-made” policy and the second is a “claims-made and reported” policy.

A claims-made policy typically requires the insured to report the claim to the insurer “as soon as practicable”, without requiring that the claim be reported during the policy period. Claims-made policies also typically state that the failure to report a claim within the time frame specified in the policy will not deprive the insured of coverage unless the insurer has been prejudiced by this failure. Where an insured fails to report a claim “as soon as practicable”, the court may grant the insured relief from the forfeiture of coverage that would otherwise result, if forfeiture would be unjust in the circumstances.

A typical reporting clause in a claims-made policy reads:

The Insureds shall deliver written notice to the Insurer at the address indicated in the Declarations as soon as practicable after being made aware of a Claim for which coverage would be afforded by this policy.

Notwithstanding the aforementioned, any late notice or absence of notice is cause for forfeiture of the rights of the Insureds only if the Insurer sustains injury therefrom.

Conversely, a claims-made and reported policy requires that the claim be both made and reported to the insurer during the policy period as part of the grant of coverage.

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9 See for example, s. 10 of the B.C. Insurance Act, R.S.B.C. 1996, c. 226, which reads: If there has been imperfect compliance with a statutory condition as to the proof of loss to be given by the insured or other matter or thing required to be done or omitted by the insured with respect to the loss, and a consequent forfeiture or avoidance of the insurance in whole or in part, or if there has been a termination of the policy by a notice that was not received by the insured owing to the insured’s absence from the address to which the notice was addressed, and the court deems it inequitable that the insurance should be forfeited or avoided on that ground or terminated, the court may, on terms it deems just, relieve against the forfeiture or avoidance or, if the application for relief is made within 90 days of the date of the mailing of the notice of termination, against the termination.

Similar provisions are found in all of the provincial statutes regulating insurance coverage.

Claims-made and reported policies may allow a brief period after the expiry of the policy during which a claim that is made during the policy period can still be reported to the insurer, however, there is no similar clause permitting relief to the insured from forfeiture due to late reporting if the insurer is not prejudiced by the late reporting.

A typical insuring agreement in a claims-made and reported policy, using the example of Insuring Agreement B, will read:

The Insurer shall pay on behalf of the Company Loss that the Company is required or permitted to pay as indemnification to the Directors and Officers resulting from any Claim for a Wrongful Act first made against the Directors and Officers during the Policy Period and reported to the Insurer during the Policy Period.

In Stuart v. Hutchins, supra, the court held that relief from forfeiture for late reporting under a claims-made and reported policy was not available to the insureds because the trigger for coverage was both the making and the reporting of the claim during the policy period.\(^\text{11}\)

The vast majority of D&O policies are claims-made and reported policies. However, these policies are still frequently called claims-made policies, both in the insurance industry and by the courts. For this reason, these terms will be used interchangeably going forward, unless specifically noted otherwise.

D. WHAT IS A “CLAIM”?

One of the main disputes that can arise in the context of claims-made policies is whether or not a “claim” has actually been made against the insured. Where there is an issue of late reporting of a claim, which would disentitle the insured to coverage, the insured will frequently argue that the “claim” was not made against it until a date which would put the insured in compliance with the reporting requirements of the policy.

Where the term “claim” is not defined in the policy, Canadian courts have held that, in order for a “claim” to have been made for the purpose of claims-made policies, there must have been some form of communication to the insured of a demand for compensation or some kind of other reparation by a third party, or a communication by a third party of a clear intention to hold the insured responsible for the damages alleged by the third party.\(^\text{12}\) The Supreme Court of Canada in Reid Crowther described a “claim”

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\(^{11}\) See also Strata Plan VR414 v. Colyvan Pacific Real Estate Management Services Ltd., 2005 BCPC 592.

\(^{12}\) Reid Crowther, supra, note 7, at para. 43.
made under a claims-made policy which did not contain a specific definition of the term as follows (at paras. 44 – 46):

The authorities distinguish between a communication of a demand or assertion of liability sufficient to trigger coverage under a claims-made policy and: (1) mere requests for information; (2) filing of a lawsuit without serving it upon the insured or otherwise advising the insured of the claim embodied in the suit; and (3) expressions of dissatisfaction that are clearly not meant to convey a demand for compensation for the damages. These are sound distinctions.

The rule that a demand or assertion of liability must be communicated for a claim to be “made” leaves open the further questions, however, of what constitutes a demand or assertion of liability, and whether that demand or assertion is established on the facts. The cases in the United States and Canada referred to above which have found a claim had not been made can be distinguished on the basis of either or both of two factors: (1) the wording of the policies in question, which made it clear that “claim” meant an express demand; or (2) the fact situations, which fell short of establishing that a claim had indeed been made within the meaning of the general rule. I will address the authorities and this case in the context of these two points.

I turn first to the wording of the policies. In Safeco Title Insurance Co. v. Gannon, supra, a rather clear indication by a third party that a suit would be filed was held not to constitute a claim, where the policy expressly distinguished between “claims” and “facts and circumstances which may give rise subsequently to a claim hereunder.” Similarly, in Jensen v. Snellings, supra, Hoyt v. St. Paul Fire and Marine Insurance Co., supra, as well as in a number of other cases aside from those cited herein, the American courts have not merely stated that a claim is ordinarily understood to mean a demand of some sort, but have also gone on to say that the wording of the policy in the particular case reinforces the conclusion that the ordinary meaning was intended.

The communication may be made by a representative on behalf of the claimant, but the representative must have the consent of the claimant to make the communication.13

The debate between insurer and insured is usually over whether a particular communication by a third party “brings home” to the insured the fact that the claimant holds the insured responsible for some type of damages alleged to have been suffered by the claimant as result of the conduct of the insured.

For example, in Brelih v. St. Paul Companies Inc., [2006] O.J. No. 1369 (S.C.J.), the claimants’ lawyer sent an email to the insured real estate agent which indicated that the insured’s conduct in intentionally withholding information from the vendor in the course of negotiating the sale of a property caused the claimants substantial damages.

13 Jesuit Fathers, supra, note 7, at paras. 51 – 52.
This email also stated that the claimants were considering whether or not to commence an action against the insured. The court held that a “claim” had been made within the meaning of the policy (which did not define the term “claim”), even though no particulars of the information allegedly withheld or the damages allegedly sustained by the claimants had been provided to the insured after its requests for same.

Similarly, in Reid Crowther, the Supreme Court of Canada held that a meeting between the insured engineering firm and its client to review damage to a project that was related to the same negligent conduct alleged against the insured in a claim made, and resolved, under a prior policy, was a “claim” even though no actual demand for compensation was made by the client at this meeting. Since the insured had accepted liability for the prior claim, knew that the client was alleging new damage caused by the same negligent conduct and knew that the client would be looking to the insured to recover the costs of repairing such damage, the court determined that a claim had been made during the policy period.

Conversely, in Stevenson v. Simcoe & Erie General Insurance Co., [1981] I.L.R. para. 1-1434 (Alta. Q.B.), the insured architectural firm received a letter from its client stating that the insured had engaged in improper quality control and site supervision with respect to the construction of a youth detention centre and suggested that future work for the client would be in jeopardy if further evidence of inadequate site supervision emerged. The client’s letter did not otherwise seek compensation from the insured or threaten a lawsuit. The court held that a “claim” had not been made under a claims-made policy since there was no specific relief sought from the insured.

Where the insurance policy requires the insured to report a “suit brought” against it, then the mere filing of the suit is sufficient to amount to a claim made against the insured, even where the insured did not have notice of the suit.14 This is in contrast to a policy that requires the insured to report a “claim made” against it, without differentiating between the “making” of a claim and the “bringing” of a suit. In this case, actual communication to the insured of the claim, or the filing of the “suit”, is required before a claim will have been “made” under the policy.15

In an attempt to avoid a dispute about whether or not a “claim” has been made against an insured, D&O policies define this term to include two events:

(1) a written or oral demand for damages or other relief against an insured; or

(2) the commencement of a civil, criminal, regulatory, or arbitration proceeding against an insured in which damages or other relief may be awarded.

However, the typical definition of “claim” found in a D&O policy is still silent on whether, and what type of, notice the insured must have before the claim will have been “made”.16 As such, insureds are still reliant on the common law treatment of when a claim is made. Without specifically providing that a claim must be received by an insured to have been “made”, and based on the common law, the first event set out above would require actual notice to the insured in order to have been a claim “made”17 while the second event would only require the filing of the proceeding without requiring that the insured have received notice of the proceeding.18

Claims-made and reported policies also address the potential for this dispute to arise by requiring that an insured report a potential claim made against the insured during the policy period of which the insured becomes aware during the policy period. Reporting of potential claims is discussed further below in the context of the “prior knowledge” exclusion.

IV. SCOPE OF INDEMNITY UNDER A D&O POLICY

As shown in the sample insuring agreements set out above, the scope of indemnity owed by the insurer under a D&O policy for covered claims is embodied by the term “Loss”, which is a defined term in the policy. The concept of “Loss” under a D&O policy is different in some respects from the coverage afforded for amounts which the insured is legally obligated to pay as “damages” or “compensatory damages”, which are the terms used to set out the scope of indemnity under commercial and personal liability policies as well as most professional liability policies.

16 Some D&O policies do define the term “claim” such that communication to the insured is a requisite part of a claim having been “made”, including requiring actual service on the insured of any legal proceeding.
17 Reid Crowther, supra, note 7.
A. LOSS

Loss in a D&O policy is usually defined to include damages, settlements and defence costs incurred by the directors and officers or the company, where entity coverage is offered. As a result of this broad definition of “Loss” and the broad definition of “wrongful acts”, a D&O insurer’s exposure under a D&O policy is potentially unlimited, since it is difficult to conceive of a claim against the insureds that would not allege a breach of duty seeking damages.

For this reason, the definition of “Loss” usually contains an enumerated list of amounts that the D&O insurer is not willing to insure under the policy, notwithstanding that a claim for damages otherwise alleges a “wrongful act” that is not excluded by an exclusion clause. Broadly speaking, amounts that are contractually defined as falling outside of covered “Loss” include:

1. statutory obligations, such as payment of taxes;
2. damages assessed as a result of unethical, immoral, or illegal conduct, such as the multiplied amount of a multiple damages award, fines and penalties, and punitive damages; and
3. the cost of undertaking or implementing non-monetary relief, such as an injunction or an order for specific performance.

A typical definition of Loss, as used in a D&O policy, is as follows:

“Loss” means damages, settlements and Defence Costs incurred by any of the Directors and Officers under Insuring Agreements A or B, and the Company under Insuring Agreement C, but shall not include:

(a) that portion of any multiplied damages awarded which exceeds the amount multiplied; or
(b) taxes, criminal or civil fines or penalties imposed by law; or
(c) matters deemed uninsurable under the law pursuant to which this Policy shall be construed; or
(d) punitive or exemplary damages, except to the extent such damages are insurable under the law pursuant to which this Policy shall be construed; or
(e) non-monetary relief.

As seen in sub-paragraph (c) of the example definition of “Loss” set out above, D&O policies do not cover “matters deemed uninsurable under the law”. This phrase reflects the fact that “Loss” has been judicially restricted to exclude the repayment of amounts to which the insured was not legally entitled, and monetary obligations arising out of
breach of a “pure” contractual obligation. These judicial restrictions on what amounts to “Loss” under a D&O policy reflect the basic concept that there has to have been economic deprivation to the insured in order for the damages to be considered covered “Loss”. Repayment of amounts that the insured was not entitled to in the first place, or a payment that the insured was obligated to make because of having voluntarily undertaken the obligation to do so, are therefore not “Loss” as a matter of law.

For example, in *Level 3 Communications, Inc. v. Federal Insurance Company, 272 F.3d 908 (7th Cir. 2001)*, the underlying action against Level 3 alleged that it had acquired the plaintiffs’ company, through a share-purchase agreement, because of fraudulent representations made by some of Level 3’s officers to the plaintiffs. The plaintiffs sought the increase in the monetary value of their shares from the date of the transaction to the date of trial as damages. Level 3 settled the underlying action for $12 million and sought coverage from the D&O insurer under the corporate reimbursement coverage contained in the policy.

The court held that the relief sought by the plaintiffs in the underlying action was restitutionary in nature. Specifically, had there been no fraud, the plaintiffs would not have sold their shares to Level 3, and would have had the benefit of the increased value of these shares. Since Level 3, through its officers, effectively stole the shares from the plaintiffs, the payment to the plaintiffs of the current value of those shares was nothing more than returning amounts which Level 3 was not legally entitled to in the first place. Therefore, as a matter of law, the amounts paid by Level 3 to settle the underlying litigation were not “loss” and not covered by the D&O policy.19

Additionally, in *Université Concordia c. Cie d’assurance London Guarantee Insurance, [2002] J.Q. No. 5011 (S.C.),* Concordia University was sued by its employees for unilaterally, and without notice, amending the terms of a pension plan to allow the University to cease making its contributions to the plan for certain periods of time (called “contribution holidays”) and to use surplus funds in the plan to fund its operational expenses. The employees sought $71.6 million in damages, representing amounts that the University failed to contribute to the plan, and amounts wrongfully taken from the fund. The University was also a trustee of the pension plan and sought coverage for the underlying litigation under its fiduciary liability insurance policy which contained a definition of “Loss” similar to that contained in D&O policies.

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19 D&O policies also contain an exclusion clause, discussed further below, for amounts the insured is required to pay for the return of ill-gotten gains, but only where a court finds that the insured was not legally entitled to such amounts. In the *Level 3* case, this exclusion clause was not engaged because Level 3 settled the claim before a judgment was rendered.
The court held that the University was not entitled to coverage because the claims alleged against it in the underlying litigation related to its contractual obligations as an employer. The court further held that permitting the University to recover from insurance amounts that it was required to pay under contract would unjustly enrich the University and did not amount to “loss”, as a matter of law, under the fiduciary liability policy. As a result of this finding, the court did not consider it necessary to consider whether any of the exclusion clauses in the policy would remove coverage for the underlying litigation.

Similarly, in August Entertainment, supra, the court addressed whether amounts claimed against an officer of the company for breach of the contractual obligations of the company were insurable under a D&O policy. The court concluded that the failure of the company to pay its contractual obligation, voluntarily assumed, was not a “loss” arising from a “wrongful act”. Rather, it was an amount that the company, and allegedly the officer of the company, was required to pay because of a contract. In other words, the obligation to make the payment arose from the contract, rather than from the “wrongful act” of failing to honour the contract. The failure to honour a contractual obligation, whether because of a mistaken belief that the contract did not have to be honoured or because of a wilful breach of the contract, was not insurable as a matter of law, and thus not “loss” under the D&O policy.

The foregoing cases show that, even if the definition of “Loss” in a D&O policy did not exclude matters deemed uninsurable under law, restitutionary relief and amounts required to be paid because of pure contractual obligations would still not be covered under D&O insurance.

B. DEFENCE COSTS

A typical D&O policy is a reimbursement policy, in that it does not afford a duty on the D&O insurer to defend the insured. Rather, the policy reimburses the insured for amounts expended in the defence of covered claims. The insureds are expected to retain their own counsel, pay the legal and other costs incurred in defending the claim and then seek reimbursement for these expenditures from the D&O insurer. The policy grants the insurer the right to associate in the defence of the claim, ensuring that the insurer is kept informed and consulted during the handling of the defence.

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20 Modern D&O policies for private for-profit and non-profit companies typically include a duty to defend. However, most D&O policies on the market for publicly traded companies still afford reimbursement coverage for defence costs.
An example of a typical clause in a D&O policy pertaining to the defence and settlement of claims reads:

The Insureds, and not the Insurer, have the duty to defend any Claim made against the Insureds. The Insurer shall be entitled to effectively associate in the defence and the negotiation of any settlement of any Claim. The Insureds shall give the Insurer full cooperation and shall not admit or assume any liability, make any settlement offer, enter into any settlement agreement, stipulate to any judgment, or incur any Defence Costs without the prior written consent of the Insurer. Only those settlements, stipulated judgments and Defence Costs to which the Insurer has consented shall be recoverable as Loss under this Policy. The Insurer’s consent shall not be withheld unreasonably, provided that the Insurer shall be entitled to full information and all particulars it may reasonably request as to such Claim and shall be given a reasonable time to consider any settlements or settlement offers presented to it for its consent.

The costs of defending claims against directors and officers are often significant since the claims against them often involve economic losses that are more difficult to assess, prove and defend against. Additionally, many claims against directors and officers can negatively impact the reputation of these individuals, because they are personally identified as having committed errors in judgment in the course of carrying out their executive functions. Therefore, defence costs can be driven up where a director or officer is seeking to avenge his or her reputation which has been tarnished by the allegations in a lawsuit.

In light of these factors, defence costs are included within the definition of Loss in D&O policies, which, in turn, has the effect of making defence costs included within the limits of liability. Where defence costs are included within the limits of liability of the policy, they erode the available coverage to pay claims. In other words, the payment of defence costs leaves less money at the end of the day to pay settlements or judgments on behalf of the directors and officers for covered claims.21

Conversely, the majority of general liability policies provide for the payment of defence costs in addition to the limits of liability. This difference reflects the fact that almost all general liability policies require the insurer to defend the insured, including appointing, instructing and paying defence counsel. Where the insured has little say in who is defending him or her, and in how the defence is conducted, then it makes sense that the costs of defending the insured do not erode the protection afforded by the limits of liability paid for by the insured.

21 Policies which include defence costs within the limits of liability are also called “eroding limits policies”.

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C. SELF-INSURED RETENTION

D&O policies, and many other errors and omissions policies, require the insured to pay a certain sum in defence costs and/or Loss, before the D&O insurer’s obligation to pay under the policy incepts. This amount is called a self-insured retention (“SIR”). Some errors and omissions policies only require the SIR to be paid towards Loss, rather than defence costs. However, in the majority of D&O policies currently on the market, the SIR applies to both defence costs and Loss.

The SIR applied to claims engaging Side B and entity coverage is generally significant for publicly traded companies, and lower for private for-profit companies. For non-profit companies, there is often no SIR.

Since Side A coverage is only available to the directors and officers when the company is not legally permitted, or refuses, to indemnify them, there is no SIR for claims which engage Insuring Agreement A.

An SIR is distinguishable from a deductible, found in general liability and property policies, because the insured is generally required to pay the SIR amount “up front” and before the insurer has to pay any amount under the insurance policy. Deductibles, on the other hand, are paid by an insured only once a settlement or judgment amount has been paid by the insurer for a covered claim and do not apply to defence costs.

V. EXCLUSION CLAUSES

Exclusion clauses are clauses in an insurance policy which remove coverage for amounts that would otherwise be payable under the insuring agreements. With respect to D&O policies, the common exclusions can be categorized into three types based on their underlying rationale – claims covered by other insurance, claims for illegal conduct or dishonesty and claims brought by insureds.

A. CLAIMS COVERED BY OTHER INSURANCE

D&O insurance is a specialty product which has become common much more recently than other types of insurance. The coverage afforded under a D&O policy is designed

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22 It is not unusual for a D&O policy to contain SIR’s of $50,000 - $250,000 for smaller publicly traded companies and SIR’s of $250,000 - $1,000,000 for larger publicly traded companies.

23 Some general liability policies contain a “reimbursement clause” which is similar to an SIR because it applies to defence costs and indemnity amounts, except that the insurer still pays these amounts at first instance and looks to the insured to reimburse it after the claim is resolved.
to fill a gap and not to replace other forms of insurance. As such, claims which could and should be covered under another type of policy will generally be excluded from coverage under the D&O policy.

To some extent, the insuring agreements and the policy definitions will narrow the scope of coverage. However, it is also necessary to incorporate into a D&O policy various exclusions designed to limit the D&O coverage to its intended scope.

1. **Bodily Injury and Property Damage**

Most people are familiar with insurance policies that provide coverage for bodily injuries and property damage. The most common types of these policies include automobile insurance, commercial general insurance and homeowner’s liability insurance. Additionally, some professional liability polices provide coverage for bodily injuries and property damage, such as medical malpractice policies and architects’ and engineers’ errors and omissions policies.

For this reason, D&O policies contain a specific exclusion for claims alleging bodily injuries or property damage. An example of a typical exclusion clause reads:

*The Insurer shall not be liable to pay any Loss arising from any Claim:*

*for any actual or alleged bodily injury, mental anguish or emotional distress, sickness, disease, death of any person or damage to or destruction of any tangible property, including the loss of use thereof.*

2. **Fiduciary Liabilities**

Insurance for the liability arising from an insured’s breach of fiduciary obligations, such as those arising from the administration of a pension or benefit plan or other trust, is available to protect insureds acting in fiduciary capacities. This type of coverage entails special underwriting considerations that are unique to the particular fiduciary obligation being insured, which are not readily ascertainable in the absence of insurance applications specifically designed to elicit the information required to assess the risk.

For example, pension plans are heavily regulated under both federal and provincial legislation, as are the obligations of trustees administering a trust. In order for an insurer to adequately assess the potential liabilities being assumed under a fiduciary liability policy, specialized knowledge in pensions or trusts is required. Since these obligations are distinct from the obligations of directors and officers in governing a
corporation, a D&O insurer is unwilling to assume the risk of liability for claims alleging breach of fiduciary obligations, other than fiduciary obligations owed by the directors and officers as a result of holding these positions.

An example of a typical exclusion clause for fiduciary liabilities reads:

\textit{The Insurer shall not be liable to pay any Loss arising from any Claim:}

\hspace{1cm} based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving actual or alleged violation(s) of any of the responsibilities, obligations or duties imposed by the Pension Benefits Standards Act, 1985, R.S.C. 1985, c. 32 (2nd Supp.), the Ontario Pension Benefits Act, R.S.O. 1990, c. P.8, the United States Employee Retirement Income Security Act of 1974 (ERISA), or amendments thereto or regulations thereunder, or any similar provincial, territorial, state, local, foreign, common, or civil law.

\section{Pollution Claims}

Another specialized type of coverage available to insureds is coverage for environmental contamination or pollution. While pollution claims may be excluded by the exclusion for property damage that is found in D&O policies, the potential risk to the D&O insurer of having to cover an environmental exposure is significant enough that this a specific exclusion clause that is often contained in the D&O policy.

A typical pollution exclusion clause in a D&O policy reads:

\textit{The Insurer shall not be liable to pay any Loss arising from any Claim:}

\hspace{1cm} based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving actual or alleged seepage, pollution or contamination of any kind.

\section{Professional Services}

D&O policies typically contain an exclusion clause for claims arising out of professional services since coverage for claims against professionals is available through specialized errors and omissions policies. This exclusion clause might apply where a lawyer provides legal services for a company and is a director or officer of the company. If the lawyer is sued for the provision of legal services, then the professional services exclusion would apply to remove coverage.
Another example of where the professional services exclusion may apply in a D&O policy is where there is broad entity coverage for a company that provides professional services, such as an architectural or engineering firm or a dental practice. If the entity is sued because of its business activities, then the D&O policy will exclude claims alleging the provision of professional services.

An example of a clause in a D&O policy excluding claims for professional services reads:

*The Insurer shall not be liable to pay any Loss arising from any Claim:

arising out of, based upon, directly or indirectly resulting from, in consequence of, or in connection with or attributable to the rendering or failure to render any kind of professional service for others, either gratuitously or for a fee.*

5. **Employment Claims**

Unless the D&O policy specifically provides EPL coverage, it is common for the policy to contain an exclusion clause for employment claims, which would be covered by a stand-alone EPL policy.

An example of clause in a D&O policy excluding employment claims reads:

*The Insurer shall not be liable to pay any Loss arising from any Claim:

based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving, in whole or in part, any employment relationship or employment-related matters brought by or on behalf of any partners, officers, directors, managers, member managers, or employees, including any voluntary, seasonal, temporary, leased or independent contracted employee of the Company.*

B. **ILLEGAL OR DISHONEST CONDUCT**

As is common with most forms of insurance, D&O policies typically exclude claims alleging fraud, dishonesty or criminal acts on the part of the insured. Some policies provide for reimbursement of defence costs in the event of a judgment favourable to the insured. Other policies only exclude these claims if there is a final adjudication that the excluded conduct actually occurred.
One issue that often arises with respect to this exclusion clause is the extent to which dishonest or criminal acts of one insured are attributable to another insured for the purpose of applying the exclusion. Most D&O policies provide that the illegal or dishonest conduct of one insured will not be attributed to any other insured, in order to provide maximum protection to the directors and officers. These types of provisions are known as “severability clauses” and serve to ensure that the exclusion does not apply to “innocent insureds”.

An example of a typical exclusion clause for illegal or dishonest conduct, including a severability clause, reads:

The Insurer shall not be liable to pay any Loss arising from any Claim:

brought about or contributed to by (i) the gaining of any profit or advantage to which an Insured was not legally entitled or (ii) by the committing of any intentional criminal or deliberate fraudulent act, if such profit or advantage or intentional criminal or deliberate fraudulent act is established by a final and non-appealable adjudication.

For the purpose of applying this exclusion:

(a) any Wrongful Act of the chief executive officer or the chief financial officer of a Company shall be imputed to such Company; and

(b) with the exception of the possible imputation of Wrongful Acts described in (a) above, no Wrongful Acts of one Insured may be imputed to any other Insured.

C. INSURED V. INSURED

D&O policies typically exclude coverage for claims brought by one insured against another insured.

The underlying justification for the exclusion of “insured v. insured” claims is the lack of an “arms length” relationship between the claimant and the insured. Claims made by one insured against another insured are seen as a moral hazard, both in terms of a lack of independent judgment brought to bear in the conduct at issue and, more significantly, the possibility of actual collusion on the part of claimants and insureds.

In more recent times, D&O insurers have significantly relaxed the insured v. insured exclusion by including an ever-expanding list of exceptions to the exclusion which will restore coverage for an otherwise excluded claim. The most common exceptions to the
insured v. insured exclusion include derivative claims brought against the directors and officers where none of the directors or officers is actively participating in the prosecution of the claim, claims brought by former directors or officers where the claimant has not held the “insured position” for a certain number of years before bringing the claim, claims brought by insolvency officials and contribution and indemnity claims where the underlying claim is otherwise covered by the policy.

An example of a typical insured v. insured exclusion clause reads:

The Insurer shall not be liable to pay any Loss arising from any Claim:

by, on behalf of, or at the direction of any Insured, except that this exclusion shall not apply to:

(1) any Claim that is a derivative action brought or maintained on behalf of the Company by one or more persons who are not Directors and Officers and who bring and maintain the Claim without the active assistance or participation of, or solicitation by, any Insureds;

(2) any Claim by any Directors and Officers who have not served with, been employed by or provided consultation to the Company in any capacity for at least three (3) years prior to the date such Claim is first made;

(3) any Claim by any Insured for contribution or indemnity, where such contribution or indemnity Claim results solely from another Claim covered under this Policy; or

(4) such Claim is brought by a trustee in bankruptcy, receiver, receiver-manager, monitor, liquidator, conservator or other similar insolvency official.

Where the D&O policy also offers EPL coverage, employment practices claims are excepted from the insured v. insured exclusion clause.

D. PRIOR KNOWLEDGE

Since the main purpose of claims-made policies is to remove the risk to the insurer of the policy having to respond to claims made years after the policy has expired, these policies also contain provisions pertaining to the reporting of potential claims, or facts and circumstances which might give rise to a claim. These clauses provide that where the insured becomes aware of a potential claim, or facts and circumstances which might give rise to a potential claim, the insured may report these to the insurer during the policy period and the policy will then respond to any claim subsequently made against the insured arising from the facts disclosed by the insured in the report.
An example of clause pertaining to reporting potential claims is as follows:

If during the Policy Period or the Discovery Period (if applicable) an Insured becomes aware of any circumstances which reasonably may be expected to give rise to a Claim being made against an Insured, and gives written notice to the Insurer of the circumstances, including the anticipated alleged Wrongful Act(s), the reasons for anticipating such a Claim, and full particulars as to dates, persons and entities involved, then any Claim subsequently made against the Insureds arising out of the circumstances described in such notice shall be deemed to have been made at the time such notice was received by the Insurer.

The purpose of clauses pertaining to reporting potential claims is two-fold. First, D&O policies typically contain an exclusion clause for claims made against the insureds where the insureds knew of the existence of the potential claim before the policy period incepted. A typical “prior knowledge” exclusion clause reads:

The Insurer shall not be liable to pay any Loss arising from any Claim:

based upon, arising out of, directly or indirectly resulting from, in consequence of or connection with any Wrongful Act, or any fact, circumstance or situation which could reasonably be expected to give rise to a Claim for a Wrongful Act, of which the Insured had knowledge prior to the inception of the Policy Period.

The clause pertaining to reporting of potential claims during the policy period is aimed at preserving coverage for the insureds in circumstances where a subsequent D&O insurer might take the position that the insured’s prior knowledge of a potential claim disentitles the insured to coverage.

Second, D&O insurers want to protect themselves from having to cover claims which the insureds knew were reasonably likely to be made against them in the future. In keeping with the concept that insurance is meant to cover fortuitous losses, the “prior knowledge” exclusion clause was designed to protect the D&O insurer from “known losses”.

The decision in Stuart v. Hutchins, supra, shows the harsh consequences to an insured if the insured does not report a potential claim during the policy period in which the insured becomes aware of the potential claim. In this case, a real estate agent and brokerage who acted in the sale of a property were notified of a potential claim by the lawyer for the purchaser arising from an alleged misrepresentation made by the agent.

The notice of the potential claim was received by the insureds on December 7, 1993 and their claims-made and reported liability policy expired on December 31, 1993.
However, the insureds did not report the potential claim to the insurer until January 26, 1994. By that time, the insureds had purchased a new errors and omissions policy with a different insurer.

The insurer during the 1993 policy period denied the claim on the basis that it was not reported during the policy period. The subsequent insurer denied the claim on the basis that its policy excluded coverage for potential claims of which the insured was aware prior to the policy period. As noted above, the Ontario Court of Appeal found that the insured was not entitled to coverage under the 1993 policy period because it had failed to report the potential claim during that policy period.

A further method used by D&O insurers to cover potential gaps in coverage, and which would have protected the insured in Stuart v. Hutchins, supra, is by use of “discovery periods”. A “discovery period” is a period of time after the expiry of the policy period during which an insured can report claims that are made against the insured, or potential claims of which the insured receives notice, but only where the conduct at issue in the claim or potential claim occurred before the expiry of the policy period. A discovery period is usually available if the insurer or the insured decides not to renew the policy, and requires that the insured pay an additional premium. The discovery period then acts as extra protection for insureds where a subsequent insurer might refuse to provide coverage on the basis that the claim was made, or the potential claim was known, prior to the subsequent insurer’s policy period.

E. PRIOR REPORTING

Conditions in the D&O market over the last decade have increasingly favoured insureds. Specifically, there has been an increase in the number of insurers who are offering D&O insurance in Canada, which has in turn resulted in D&O insurers offering increasingly liberalized coverage to maintain a competitive edge and to secure an adequate market share. For this reason, modern D&O policies have been providing broader and broader coverage over time.

One of the consequences of this increasingly broadened coverage is that the prior knowledge exclusion is not necessarily a common feature of current D&O policies, especially those offered to publicly traded companies. Instead, D&O insurers rely upon an exclusion clause for actual or potential claims which have been previously reported
by the insured under another D&O policy. An example of this “prior reporting” exclusion reads:

The Insurer shall not be liable to pay any Loss arising from any Claim:

based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving:

(1) any Wrongful Act or any fact, circumstance or situation which has been the subject of any notice given prior to the Policy Period under any other similar insurance policy; or

(2) any other Wrongful Act whenever occurring, which together with a Wrongful Act which has been the subject of such prior notice, would constitute Interrelated Wrongful Acts.

This exclusion clause removes coverage where an insured has actually reported a potential claim to a prior insurer. However, it also removes coverage for claims which allege “interrelated wrongful acts”.

“Interrelated Wrongful Act” is typically defined in a D&O policy as follows:

Interrelated Wrongful Acts means any Wrongful Acts that are connected by reason of any common fact, circumstance, situation, transaction, casualty, event, decision or policy, or part of the same series of facts, circumstances, situations, transactions, casualties, events, decisions or policies.

The purpose of excluding coverage for claims alleging interrelated wrongful acts to those alleged in claims or potential claims reported to a prior insurer is to protect the D&O insurer from known losses. To offset the potential gap in coverage created by this exclusion, D&O policies specifically provide coverage for claims made after the end of the policy period where such claims allege conduct which is “interrelated” to conduct alleged in a claim made, or potential claim reported, during the currency of the policy.

The issue of what constitutes “interrelated wrongful acts” was addressed by the Ontario Court of Appeal in Chubb v. Dunn 2009 ONCA 538. In this case, two insured officers were sued in multiple proceedings arising from their role for allegedly manipulating the financial statements of Nortel Networks Corporation (“Nortel”) over a period of time stretching from 2000 to 2005. A number of civil proceedings were brought against

24 D&O insurers also rely on disclosure by the insureds in the application for the policy, usually required on a yearly basis, and incorporated by reference into the terms of the policy. The policy application typically asks if any insured is aware of any potential claims and then provides that any such claims are excluded under the policy, whether disclosed or not.
them in 2001 and 2002 for losses allegedly resulting from their wrongful conduct. The insureds were covered by a D&O policy issued by the D&O insurer with a policy period from 1999 – 2001 (the “2001 Policy”). The insurer accepted coverage under this policy and advanced defence costs to the insureds.

The D&O insurer renewed the policy for a subsequent period from November 2003 – November 2004 (the “2003 Policy”). During and after the 2003 Policy period, further proceedings were brought against the insureds alleging the same conduct at issue in the claims made under the 2001 Policy period, as well as conduct occurring after that policy expired (the “Hybrid Proceedings”). Shortly after the Hybrid Proceedings were brought, the D&O insurer voided the 2003 Policy, leaving the insureds effectively uninsured for claims made against them during that policy period.

Since the D&O insurer accepted that some of the conduct alleged in the Hybrid Proceedings was the same as conduct alleged in already covered claims, it agreed to advance 50% of the insureds’ defence costs for these proceedings. The insureds commenced coverage litigation against the D&O insurer arguing that 100% of their defence costs should be covered by the D&O insurer on the basis that the Hybrid Proceedings alleged interrelated wrongful acts to those covered by the 2001 Policy. Specifically, the insureds relied upon allegations contained in the Hybrid Proceedings that their conduct amounted to a “culture of non-compliance” and a “fraudulent accounting scheme” which started in 2000.

While the focus of the court’s decision is on the issue of allocation of defence costs for partly covered claims pursuant to endorsements attached to the 2001 Policy, the court also addressed the insured’s argument on the issue of “interrelated wrongful acts”. The court determined that the allegations in the Hybrid Proceedings which pertained to conduct occurring after the expiry of the 2001 Policy were not “interrelated wrongful acts” because they specifically referenced two separate fraudulent accounting schemes which took place at different times. Therefore, the attempt by the insureds to characterize the two separate schemes are interrelated wrongful acts was rejected by the court.

VI. EMPLOYMENT PRACTICES LIABILITY INSURANCE
In addition to the common features of a D&O policy set out above, many D&O insurers presently offer coverage for claims related to wrongful acts committed in the employment context. Even though EPL coverage is available in separate insurance policies specifically designed to cover this risk, the trend for broader coverage in the D&O market has led to EPL coverage being a common feature of modern D&O policies.
EPL policies are relatively new to Canada, having only been introduced in the last 10 years, but have been common in the U.S. for a few decades. These policies generally cover claims brought by current or former employees, or applicants for employment, which allege three types of wrongful conduct – wrongful termination, discrimination and harassment.

EPL insurance filled a gap in coverage resulting from the fact that general liability policies only cover claims for bodily injury or property damage, which are not always alleged in employment claims. However, where an employment claim does allege bodily injury, such as mental distress or humiliation, such claims are not typically covered under a general liability policy because the underlying conduct alleged to cause such damages is usually intentional conduct.

A. COVERAGE FOR WRONGFUL TERMINATION

Due to differences in employment law in Canada and the U.S., the coverage afforded for wrongful termination claims under EPL insurance in Canada is significantly different than that afforded for these claims south of the border. Specifically, in Canada, upon termination of the employment relationship and absent a fixed term of employment, there is an implied contractual obligation at common law on the employer to provide an employee with reasonable working notice or payment in lieu thereof, unless the employee is dismissed for just cause. Where an employee is dismissed without just cause or reasonable notice, the dismissal is “wrongful” under Canadian common law.

Where an employee is wrongfully dismissed, a court will award, as damages, salary in lieu of the reasonable notice that the employer did not provide to the employee when the employment relationship was terminated. Therefore, the measure of damages in a wrongful dismissal lawsuit is a payment of salary to the employee for the period of notice that the employer wrongfully failed to give the employee.

On the other hand, employees in the U.S. are generally employed “at-will”, meaning that they can be dismissed at any time by the employer, without just cause or advance notice.

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25 Allegations of mental distress and mental anguish were found to constitute “bodily injury” under a commercial general liability policy in Wellington Guarantee, a division of Wellington Insurance Co. v. Evangelical Lutheran Church in Canada (1996), 22 B.C.L.R. (3d) 352 (C.A.).
26 For example, see Liberty Mutual Insurance Co. v. Hollinger Inc. (2004), C.C.L.I. (4th) 200 (Ont. C.A.) in which a discrimination claim against the employer was found not to be covered under a commercial general liability policy because the conduct and its alleged results were both intentional.
Wrongful dismissal lawsuits in the U.S., therefore, require an employee to prove that the basis for the termination was for reasons other than the employer exercising its right to dismiss its employees at will in order to make the dismissal “wrongful”.

Given this difference between Canadian and U.S. law, damages for wrongful dismissal are not an ordinary contractual obligation of an American employer; whereas, payment in lieu of reasonable notice of dismissal is a contractual obligation of a Canadian employer. For this reason, EPL insurance in the U.S. covers damages for wrongful termination, while EPL insurance in Canada covers damages for wrongful dismissal only where additional damages are awarded beyond the employer’s contractual obligation to afford reasonable notice of dismissal.

The additional damages awarded in wrongful dismissal cases that are covered under Canadian EPL policies were known as “Wallace damages” which were intended to compensate the employee for the conduct of the employer in the manner of dismissing the employee. Wallace damages were not intended to compensate the employee for hurt feelings or distress that would ordinarily be expected to result from the exercise by the employer of its right to dismiss the employee with reasonable notice. Rather, these damages were only to be awarded where the employer acted in bad faith in the manner of dismissal, and were measured by an extension of the period of reasonable notice that the employee was otherwise entitled to under common law. These damages, which were over and above the employer’s contractual obligation to provide reasonable notice, were insured under Canadian EPL policies.

The Supreme Court of Canada decision in Keays v. Honda Canada Inc., 2008 SCC 39 recast “Wallace damages” such that bad faith conduct by the employer in the manner of dismissing of an employee which causes mental distress is to be compensated by general damages rather than an extension of the notice period. These general damages are still insured under Canadian EPL policies in wrongful termination claims.

B. DISCRIMINATION

EPL policies also cover claims alleging discrimination, which are generally defined as the making of an adverse employment decision based on the personal attributes of an employee protected by human rights legislation. Irrespective of whether or not discrimination is alleged to have resulted in wrongful termination, employees often allege damages for loss of a sense of dignity and other emotional distress because of

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employment-related discrimination, and these damages are covered under EPL insurance.

If an employee alleges wrongful dismissal because of discrimination, damages for breach of the employer’s contractual obligation to provide reasonable notice are still not covered under an EPL policy.

C. HARASSMENT

The third category of conduct covered by EPL policies is harassment. Harassment is generally defined to mean unwelcome conduct in the employment context which is based on the personal attributes protected by human rights legislation. While sexual harassment is one variant of harassment covered by EPL policies, harassment extends to conduct which is aimed at an individual because of his or her ethnic or racial status, marital status, or sexual orientation, to name some of the other more common bases alleged in harassment claims.

VII. COMMON SOURCES OF LIABILITY OF DIRECTORS AND OFFICERS

Having addressed some of the key features of D&O insurance above, the next issue to be addressed is how the insurance protects the directors and officers at a practical level. In other words, what is the point of purchasing a D&O policy?

A. BREACH OF THE STATUTORY DUTIES OF DIRECTORS AND OFFICERS

Federal and provincial business corporations’ statutes contain provisions which set out the duties owed by directors and officers acting in the course of their duties. Specifically, these individuals are required to:

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent individual would exercise in similar circumstances.29

29 See, for example, s. 142 of the Business Corporations Act, S.B.C. 2002, c. 57; s. 31 of the Strata Property Act, S.B.C. 1998, c. 43; and s. 122 of the Canada Business Corporations Act, R.S.C. 1985, c. C-44.
The first duty of the directors and officers is called the “duty of loyalty”, while the second duty is referred to as the “duty of care” expected of directors and officers in exercising their functions.30

The question of whether a third party (i.e. someone other than the corporation) can recover from the directors and officers on the basis of breach of their statutory duties was addressed by the Supreme Court of Canada in Peoples Department Stores Inc. (Trustee of) v. Wise, 2004 SCC 68.

In this case, a department store chain called Wise Stores Inc. (“Wise”) purchased Peoples Department Stores from Marks & Spencer Canada Inc. (“M&S”). Peoples was in financial trouble at the time of the purchase. To finance the sale, M&S agreed to provide financing with the assets of Peoples being held as security and subject to certain conditions relating to the financial management of the company being met. Following the purchase, three of the directors of Wise (the “Wise brothers”) also sat on the board of directors of Peoples. Both stores experienced further difficulties due to their inability to efficiently merge their respective operations. In an effort to improve the financial condition of the two companies, the Wise brothers implemented a new procedure for ordering and distributing inventory between the two stores. This new procedure had the ultimate effect of making Wise significantly indebted to Peoples, putting Peoples in breach of the covenants contained in the financing agreement with M&S.

M&S ultimately petitioned Peoples and Wise into bankruptcy. The assets of the companies were sufficient to pay much of their debt, including their obligation to M&S for the purchase price. However, a significant number of claims, primarily from trade creditors, were left unsatisfied. The bankruptcy trustee for Peoples then commenced a petition against the Wise brothers alleging that they preferred the interests of Wise over the interests Peoples, resulting in harm to Peoples creditors, and thereby breached their statutory duties contained in the Canada Business Corporations Act (the “CBCA”). In essence, the trustee alleged that the statutory duty of loyalty owed by the Wise brothers to Peoples extended to Peoples’ creditors.

At trial, the bankruptcy trustee was successful, obtaining a judgment of $4.4 million against the Wise brothers. However, the decision was overturned by the Quebec Court of Appeal and upheld by the Supreme Court of Canada.

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30 It is beyond the scope of this paper to provide a detailed analysis of the obligations of directors and officers under company law. However, a good general discussion of the nature of these duties is found in Peoples Department Stores Inc. (Trustee of) v. Wise, 2004 SCC 68 at paras. 31 – 39 and 59 – 67.
In considering the directors’ and officers’ statutory duty of loyalty, the Supreme Court of Canada found that this duty was always owed to the company, without the competing interests of one set of stakeholders, such as shareholders or creditors, necessarily “trumping” the other. This duty does not change where a company is experiencing a deterioration of its financial stability. As long as the directors and officers are trying to “create a better corporation” then the failure of their strategies to improve the financial viability of the company will not make them liable for breach of their statutory duty of loyalty.

The Supreme Court concluded that the statutory duty of loyalty owed by directors and officers did not extend to protecting the interests of the company’s creditors and held that the facts did not establish that the Wise brothers were acting for reasons other than in the best interests of Peoples.

With respect to the statutory standard of care of directors and officers, the Supreme Court stated that they are required to act prudently and on a reasonably informed basis, in light of all of the circumstances. A standard of perfection is not required and deference is to be given by a court to the judgment of the directors and officers, assuming they act with the requisite standard of care (referred to as the “business judgment rule”).

However, the Supreme Court held that, in common law provinces, the statutory duty of care did not form an independent basis for a cause of action by third parties against directors and officers. Such an action may be brought on the basis of common law negligence principles, in which case the statutory standard of care may inform the decision of whether or not the directors have acted negligently.31

Even if the directors and officers cannot be sued by someone other than the corporation for breach of the statutory duties of care, a court may permit an action in negligence to proceed against the directors and officers in certain circumstances. For example, in Festival Hall Developments Ltd. v. Wilkins (2009), 57 B.L.R. (4th) 210, the Ontario Superior Court of Justice considered an application to strike, at the pleadings stage, an action brought by the plaintiff landlord against the director of a corporate tenant. The plaintiff alleged that the defendant breached duties owed to the landlord, as a creditor of the tenant, by wrongfully stripping assets from the tenant at a time when the director knew that the tenant was on the verge of insolvency. The tenant had defaulted on a lease

31 A specific provision of the Quebec Civil Code, not paralleled in common law jurisdictions, permitted a third party to sue based on breach of the statutory duty of care set out in the Canada Business Corporations Act. This resulted in the Supreme Court analyzing whether or not the Wise brothers breached this standard of care (ultimately concluding that they did not).
with the plaintiff and had no assets to satisfy the judgment obtained by the plaintiff against it.

The court decided that sufficient circumstances were alleged in the underlying action against the director such that it was not “plain and obvious” that a duty of care at common law could not arise based on the proximity of the parties and the reasonably foreseeable harm that was suffered by the plaintiff because of the director’s alleged conduct. This conclusion was reached even though the court acknowledged that there is no general duty of care at common law owed by the directors and officers of a company to the company’s creditors.

B. OPPRESSION CLAIMS

Federal and provincial companies’ legislation contain provisions which allow certain stakeholders in the company, such as shareholders or creditors, to seek redress where the rights of the stakeholders have been unfairly affected by the conduct of the company or its directors and officers. Claims which rely upon these statutory provisions are known as “oppression claims”.

One of the most recent decisions of the Supreme Court of Canada on the oppression remedy under the CBCA is found in BCE Inc. v. 1976 Debentureholders, 2008 SCC 69. In this case, the company accepted a take-over bid from a group of purchasers which had the effect of increasing the debt of Bell Canada, a wholly-owned subsidiary. The debentureholders of Bell Canada opposed the buyout on the basis that the effect of the transaction would be to reduce the value of their bonds, relying, in part, that the oppression remedy contained in the CBCA.

The Supreme Court held that the debentureholders had to establish that their reasonable expectations were not being met because of conduct that was oppressive, caused unfair prejudice or was an unfair disregard of their interests resulting in compensable injury. Since the directors and officers of a corporation owe the duty to the corporation to act in the best interests of the corporation, it was not entirely correct to say that the directors and officers owe separate duties to the company’s various stakeholders. As long as the directors and officers treat the various stakeholders fairly and equitably, then they have met their obligations to act in the best interests of the

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32 See, for example, s. 227 of the Business Corporations Act, S.B.C. 2002, c. 57; s. 164 of the Strata Property Act, S.B.C. 1998, c. 43; and s. 241 of the Canada Business Corporations Act, R.S.C. 1985, c. C-44. The persons permitted to bring oppression actions varies from jurisdiction to jurisdiction.
company event though they may not be able to reconcile these competing interests in a manner satisfactory to all stakeholders.

With respect to the claims of the debentureholders of Bell Canada, the Supreme Court found that the directors had not acted in a manner that would permit relief under the oppression remedy of the CBCA. The directors had considered the interests of the debentureholders and determined that the best interests of the company involved moving forward with the buy-out offer which reduced the value of their bonds.

While the BCE decision, did not involve claims against the directors in a personal capacity, oppression claims do occasionally seek specific relief from the directors and officers of a corporation.33

Oppression claims against non-profit companies, and their directors and officers, are not a frequent source of potential liability unless the non-profit company is a strata corporation or housing cooperative. The legislation governing both categories of non-profit corporations contains provisions specifically allowing an owner of a strata corporation or a shareholder of a housing cooperative, to bring claims against the company as well as the directors and officers for “significantly unfair” conduct.

For strata corporations, this is one of the most common sources of claims engaging D&O insurance. These claims typically arise in situations where an owner perceives that the conduct of the strata council, as the “board of directors”, has failed to adequately resolve a particular grievance of the owner or has otherwise treated the owner unfairly. For example, in Yang v. Strata Plan LMS 4084, 2010 BCSC 453, an owner commenced a petition pursuant to s. 164 of the Strata Property Act against the strata corporation and its property manager alleging that certain conduct of these parties was significantly unfair to him and certain other unit owners in the strata complex. The strata complex consisted of three types of units – apartment-style units, townhouse units and commercial units. The petitioner alleged that the strata corporation, on the advice of its property manager, had altered the original allocation of common expenses in a manner that was significantly unfair to the townhouse unit owners, given their small number vis-à-vis the other types of units in the complex.

33 For example, in Casey v. CopperLeaf Technologies Inc., 2010 BCSC 417, the plaintiff brought a claim against the company and its directors and officers seeking to rescind a transaction which resulted in the issuance of shares to certain of the directors and officers in exchange for financing provided to the company. The plaintiff alleged that the share issuance diluted her shareholdings in the company and thus was “oppressive conduct”. The court ultimately disagreed with the plaintiff and dismissed her petition.
The court disagreed, finding that the reallocation of common expenses was done in accordance with the provisions of the Strata Property Act and the strata corporation’s by-laws.

C. DERIVATIVE CLAIMS

Federal and provincial business corporations’ legislation also contain provisions which allow certain parties to bring an action in the name of the company against persons who are alleged to have caused harm to the company, separate and apart from harm to other stakeholders of the company, in circumstances where the company (through its directors and officers) refuses to do so.34

These actions are known as “derivative actions” and require court approval for their commencement. The requirement for court approval is to ensure that the person proposing to commence the derivative proceeding is acting in good faith and the proposed proceeding appears to be in the best interests of the corporation.

Directors and officers are often the object of derivative claims, since these individuals are not often eager to authorize the company to commenced litigation against them. For example, in Discovery Enterprises Inc. v. Ebco Industries Ltd. (1997), 40 B.C.L.R. (3d) 43 (S.C.); aff’d at (1998), 50 B.C.L.R. (3d) 195 (C.A.), the court permitted a minority shareholder to commence a derivative proceeding in the name of the defendant against the two sole directors, also majority shareholders, to recover amounts paid by the defendant for the costs of an arbitration between the two individuals arising out of a shareholder dispute between them. The minority shareholder argued that the two directors breached their fiduciary obligations to the defendant by authorizing payment of the arbitration costs, in excess of $2.0 million, for what was essentially a personal dispute. Since the defendant was controlled by one of the two directors who was a proposed defendant in the derivative action at the time of the petition, the defendant refused to commence such proceedings.

D. SECURITIES CLAIMS

For the directors and officers of publicly traded companies, by far the most frequent source of potential liability arises from securities claims. Specifically, all Canadian

provinces have securities legislation which provides for personal liability of the directors and officers for misrepresentations contained in public documents that are issued in the “primary market” and “secondary market”. Generally speaking, the “primary market” involves share purchases made under an initial public offering, or similar document, whereas the “secondary market” involves share purchases and sales made in the open market, such as a stock exchange.

Prior to the enactment of these provisions, liability for misrepresentations made by companies or their directors and officers which had a negative effect on the value of a shareholder’s shares was dependent on the cause of action for negligent misrepresentation, which required each shareholder to prove reliance on the alleged misrepresentation in order to succeed in his or her claim for damages. The requirement of proving individual reliance meant that class actions were not suitable, yet the cost of prosecuting a negligent misrepresentation claim against a publicly traded company, when compared to the actual loss sustained by an individual shareholder, was practically prohibitive. The statutory causes of action do away with the need to prove individual reliance by deeming such reliance to have occurred in certain circumstances.

These claims are extremely expensive to litigate because they are often advanced as class action claims in multiple jurisdictions. They also have the potential to result in large settlement amounts.

The statutory provisions imposing liability upon companies and their directors and officers for misrepresentations made in the secondary market are relatively new to Canada. One of the first cases granting certification of a class action which alleges breaches of the secondary market liability provisions of Ontario’s Securities Act is Silver v. Imax Corp. (2009), 86 C.P.C. (6th) 273. The plaintiffs in this case alleged that the company and its directors and officers made misrepresentations in certain of the company’s public filings with respect to the extent of its compliance with Generally Accepted Accounting Principles, leading to an over-statement of revenues in 2005. When the company announced that it was responding to an informal inquiry from the U.S. Securities and Exchange Commission with respect to its revenue recognition procedures, the value of its shares dropped. The plaintiffs had purchased their IMAX shares on the Toronto Stock Exchange and sued to recover the drop in value of their shares as a result of the alleged misrepresentations.

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35 See, for example, Parts 16 and 16.1 of the Securities Act, R.S.B.C. 1996, c. 418 and Parts XXIII and XXIII.1 of the Securities Act, R.S.O. 1990, c. S.5.
36 Ontario, the first jurisdiction to enact provisions allowing for secondary market liability, did so on December 31, 2005.
The court ultimately certified the class action as a global class action, resulting in significant potential exposure to the directors and officers.

E. HUMAN RIGHTS CLAIMS

Human rights claims are also common sources of potential personal liability for the directors and officers of a company. With respect to publicly traded and private for-profit companies, these claims are most common in the employment context, and thus are generally only covered if the D&O policy includes EPL coverage.

These claims are also quite common in claims against strata corporations and members of a strata council. Federal and provincial human rights legislation prohibits discrimination against a person regarding any accommodation, service or facility customarily available to the public, which includes services provided by strata corporations to its members.37

On occasion, the allegations made by the complainant are more properly brought under the oppression remedy available under the Strata Property Act,38 or are the result of perceived injustices that do not relate to discrimination based on the personal attributes protected the human rights legislation.39

Irrespective of the merits of the underlying allegations, human rights claims are frequently expensive to defend since the claimants are often not represented by counsel. Additionally, the cost of defending these claims usually surpasses the monetary amounts claimed. Therefore, for non-profit companies, like strata corporations, D&O insurance can provide measurable protection to the corporation and its strata council members.

VIII. SUMMARY

D&O insurance is a type of specialty coverage designed to provide coverage for claims that would not otherwise be covered by other insurance. A detailed discussion of the nuances of D&O coverage, and the claims which are covered by it, could fill a textbook.

37 See, for example, the Human Rights Code, R.S.B.C. 1996, c. 210, s. 8 and the Canadian Human Rights Act, R.S.C. 1985, c. H-6, s. 5.
This paper has served to highlight the key features of these policies, compare them to other types of insurance and highlight a few of the common sources of liability of directors and officers.