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ENTITY COVERAGE FOR SECURITIES CLAIMS UNDER A D&O POLICY: HAVE WE COME FULL CIRCLE?

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In 2007 the D & O[1] insurance industry is slowly but surely shifting its underwriting approach in a manner last witnessed in the mid-1990's. That is so, in large part, as directors, particularly independent directors on the Board of Directors, continue to question whether they are well served by having a D & O policy that includes Entity Coverage[2] for Securities Claims.[3] Many Board members, confronted by the post-Enron reality of increased corporate accountability and the Canadian reality of class actions for statutory claims under the provincial *Securities Act*s,[4] are seriously questioning whether the proceeds of a D & O policy[5] should be diluted by legal costs and indemnity obligations confronted by the company, or, whether the proceeds should remain solely available to the directors and officers. The issue has become so acute that the past five years has witnessed the emergence of alternative insurance solutions including non-rescindable coverage, dedicated A Side policies, and excess/DIC/Side A policies to compensate for the reality of Entity Coverage for the publicly traded company.

This paper traces the historical position that existed prior to the emergence of Entity Coverage, the practical impact of introducing Entity Coverage, the impact of Entity Coverage on claim settlement, and what directors are currently seeking in purchasing a D & O product given the reality of Entity Coverage for Securities Claims.

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[1] For the purpose of this paper the use of "D & O" will denote "directors and officers".
[2] For the purpose of this paper the use of the term "Entity Coverage" will denote insurance coverage for the liability of the company as opposed to the liability of the directors and officers of the company.
[3] The term "Securities Claim", which will be examined in greater detail in Sections 10, 11 and 12 of this paper, encompasses a claim alleging a violation of any statutory provision or common law cause of action arising from the sale of shares in a company whether by means of a purchase facilitated through a stock exchange or a prospectus.
[4] *Securities Act,* R.S.B.C. 1996, c. 418, s. 131(1); *Securities Act,* R.S.A. 2000, s. S-4, s. 203(1); *Securities Act, 1988*, S.S. 1988-89, c. S-42.2. s. 137(1); *Securities Act*, R.S.M. 1998, c. S50, s. 141; *Securities Act*, R.S.O. 1990, c. S-5, s. 130(1); *Securities Act*, R.S.Q., V-1.1, ss. 217-219; *Securities Act*, S.N.B. 2004, c. S-5.5, s. 149(1); *Securities Act*, R.S.N.S. 1989, c. 418, s. 137(1); *Securities Act*, R.S.P.E.I. 1988, c. S-3, s. 16(1); *Securities Act*, R.S.N. 1990, c. S-13, s. 130(1); *Securities Act*, R.S.Y. 2002, c. 201, s. 25(1); *Securities Act*, R.S.N.W.T. 1988, c. S-5, s. 30(1).
[5] For the purpose of this paper the use of the term "D & O policy" denotes a "directors and officers liability policy".

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1. HISTORICAL LIMITATIONS ON D & O COVERAGE:

When D & O insurance was initially introduced into North America in the early 1970s it did not provide coverage for the liability of the company. This is significant since the company can potentially bear legal liability independent of any liability of the directors and officers. Most typically the company can bear potential liability, independent of the directors and officers, by reason of the acts and conduct of management who are not directors and officers.

Until the early and mid 1990's D & O insurance consisted of two separate insuring clauses. Assuming the company is solvent and legally capable of doing so, the company will indemnify the directors and officers for any legal costs incurred in the defence of a claim and any indemnity sum paid by reason of a settlement or judgment incurred by the directors and officers. In that event the D & O insurer will reimburse the company to the extent that the company has indemnified its directors and officers by means of the "corporate reimbursement" insuring clause in the D & O policy. This is typically Insuring Clause B in the D & O policy and will afford coverage in the following terms:

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

If the company is financially unable to indemnify its directors and officers, or, is legally barred from doing so, then the D & O insurer can directly reimburse the directors and officers. This is achieved by means of what is commonly referred to in the industry as the "Side A" insuring clause. This insuring clause will typically read as follows:

> *The Insurer shall pay on behalf of the Directors and Officers Loss resulting from any Claim first made during the Policy Period against the Directors and Officers, individually or otherwise, which the Directors and Officers have become legally obligated to pay as a result of or on account of a Wrongful Act for which the Company is unable or unwilling to pay on behalf of the Directors and Officers as indemnification.*

The distinction between the "Side B Corporate Reimbursement" insuring clause as opposed to the "Side A" insuring clause has been judicially commented upon in the following terms:

> *"There is an important distinction between the individual liability and the reimbursement portions of a D & O policy. The liability portion of the policy*

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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.[6]

2. PROBLEMS WHEN THE D & O INSURER PAYS "LOSS" THAT BENEFITS AN UNINSURED PARTY:

The fact that the D & O policy does not insure the company for its own independent liability potentially gives rise to allocation problems. A claimant may elect to sue only the directors and officers for misrepresentation. In that situation all of the legal costs and amounts required to settle the claim are to the account of the directors and officers and potentially fully satisfied by the D & O policy.

However, more typically, a claimant may sue *both* the directors and officers and the company for misrepresentation contending that the latter is either vicariously liable for the acts of its directors and officers, or, liable because employees of the company who are not directors and officers engaged in a misrepresentation that gives rise to liability. The company and directors and officers, believing there is no conflict, may elect to appoint one lawyer to represent both the directors and officers and the company. When the legal fees are to be paid, or, a settlement is stipulated to be on account of both the "uninsured" company and the insured directors and officers the issue necessarily arises whether all or merely a portion of the legal costs and settlement sum should be paid by the D & O insurer if a portion of those costs and indemnity amounts could fairly be said to arise by reason of the company's own independent legal liability. The problem in isolating and identifying those costs unique to the directors and officers becomes complicated if that same common legal counsel acts for other parties named in the lawsuit who potentially have their own liability. Typically that might include significant shareholders who exercised control and direction over the affairs of the company.

Each of these examples serve to illustrate that the D & O insurer is confronted with the task of apportioning any "Loss" (as defined in the D & O policy) to ensure, to the greatest degree possible, it is only burdened with the cost incidental to the directors and officers as opposed to any uninsured party. In a sense not only is this in the best interests of the D & O insurer, but as well, the directors and officers since, barring unusual considerations,

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[6] *Re First Century Financial Corp.*, 238 B.R. 9, at p. 16 (Bankr. E.D.N.Y. 1999).

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both parties are best served by maximizing the policy funds available to discharge the directors' and officers' liability as opposed to having those funds used to reimburse uninsured parties for their legal costs, or, a settlement sum that includes a portion of monies on account of "uninsured" parties.

The spectre of allocation between "uninsured" and "insured" parties spawned a period of litigation from the mid 1980's to mid 1990's during which D & O insurers and their insureds contested whether and to what extent the D & O insurers were obligated, as a practical matter, to bear either jointly incurred legal costs, or, a component of a settlement sum that could fairly be ascribed to "uninsured" parties.

3. EARLY U.S. JUDICIAL DECISIONS ON ALLOCATION:

From the mid 1980's to mid 1990's the existing U.S. jurisprudence accepted that allocation among the "insured" directors and officers and the "uninsured corporation", when both parties settled, must have regard to each party's "*relative exposure*", "*relative benefit*" and the "*facts considered applicable in the circumstances*".[7]

In effect, the "*relative exposure*" and "*relative benefit*" approach necessarily required an allocation approach dependent upon the "metaphysical underpinnings" of the underlying claim which went well beyond merely the pleadings and the evidence relevant to the matter at issue in the underlying lawsuit. This wide ranging examination of evidence extrinsic to the underlying case was, by 1995, summarized to include the following factors:

> 1) *the identity, as an individual, an entity, or as a member of a group, of each beneficiary and the likelihood of an adverse judgment against each in the underlying action;*
>
> 2) *the risks and hazards to which each beneficiary of the settlement was exposed;*
>
> 3) *the ability of each beneficiary to respond to an adverse judgment;*
>
> 4) *the burden of the litigation on each beneficiary;*

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[7] *PepsiCo, Inc. v. Continental Casualty Co.,* 640 F. Supp. 656 (S.D.N.Y. 1986); *Nodaway Valley Bank v. Continental Casualty Co.,* 715 F. Supp. 1458 (WD Mo. 1989); affirmed at 916 F. 2d 1362 (1990); *Nodaway Valley Bank v. Continental Casualty Co.,* affirmed at 916 F. 2d 1362 (1990); *Reliance Group Holdings Inc. v. National Fire Insurance Co.,* 594 N.Y.S. 2d 20 (1993); *Ameriwood Industries International Corp. v. American Casualty Co.,* 840 F. Supp. 1143 (1993); *First Fidelity Bancorporation v. National Union Fire Insurance Co.,* 1994 W.L. 11136 (E.D. Pa).

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5) *the "deep pocket" factor and its potential effect on the liability of each beneficiary;*

6) *the funding of the defense activity in the litigation and the burden of such funding;*

7) *the motivations and intentions of those who negotiated the settlement, as shown by their statements, the settlement documents and any other relevant evidence;*

8) *the benefits sought to be accomplished by the settlement as to each beneficiary, as shown by the statements of the negotiators, the settlement documents, and any other relevant evidence;*

9) *the source of the funds that paid the settlement sum;*

10) *the extent to which any individual defendants are exempted from liability by state statute or corporate charter provisions; and*

11) *such other similar matters as are peculiar to the particular litigation and settlement.*[8]

What was driving D & O insurers in striving for allocation was judicial acceptance of the concept that if the "uninsured" company receives a benefit from the D & O insurer's payment of the obligation then some portion of the defence costs and indemnity ought to be borne by the "uninsured party" that benefited from the amount paid by the D & O insurer.

Insofar as it concerned the incurring of legal and expert costs in the defence of a claim involving *both* insured and uninsured parties, that practically meant that the D & O insurer was insisting that any legal costs unique to an "uninsured party" ought to be borne by the uninsured party. However, that issue necessarily required a determination as to whether the item of cost was unique to the insured party, or, whether it could be said that the expenditure was to the mutual benefit of both the "insured" party and the "uninsured" party. Secondarily, D & O insurers questioned whether the "uninsured" party should bear that expense if it was only indirectly of benefit to the uninsured party.

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[8] Knepper, William E. & Bailey, Dan A., *Liability of Corporate Officers and Directors*, Vol. 2 (5th ed.), page 243-276; *Coronation Insurance Co. v. Clearly Canadian Beverage Corp.*, 1999 BCCA 11, [1999] 6 W.W. R. 189, 168 D.L.R. (4th) 366, 57 B.C.L.R. (3d) 303 (C.A.).

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These issues posed difficult questions for U.S. Judges confronted with the reality of these coverage issues.

The problem was of even greater monetary significance in the context of a settlement that involved D & O insurer funding in circumstances where the settling parties merely stipulated for an aggregate settlement sum and did not specify the contributions required of both insured and "uninsured" parties. This gave rise to difficult coverage issues when dealing with claims under U.S. and Canadian securities legislation. For example, in Canada, by reason of the provincial *Securities Acts*[9], there is a statutory cause of action for misrepresentation made in a prospectus. The legislative framework contemplates the potential for legal liability either as against the directors and officers, or, the company (as the "issuer") or both.

4. ALLOCATION ON CANADIAN AND U.S. SECURITIES CLAIMS:

In the context of U.S. securities legislation[10] the directors and officers could face the spectre of "concurrent" liability. In other words, depending upon the theory of liability, the monetary exposure of the directors and officers, and the "uninsured" company could be the same. Does the company obtain a benefit from the D & O insurer when the insurer discharges the entire settlement payment? When one speaks of concurrent liability in the context of a statutory securities case for misrepresentation one needs to distinguish between, on the one hand, the "direct liability" created when the conduct of the directors and officers is statutorily deemed to be acts of the corporation as opposed to any "derivative" liability which is the liability that results when the corporation is only liable for the conduct of the directors and officers by operation of common law (for example "respondent superior" liability, commonly referred to as vicarious liability).

U.S. securities legislation creates "direct" liability for the corporation based on the acts and conduct of the directors and officers; not merely vicarious liability. That is also true of those Canadian provinces that confer a statutory cause of action for misrepresentation by operation of the provincial Securities Act. Many D & O insurers, mindful of this point, were attempting to argue that if the wrongful acts in the underlying litigation consisted of acts of the directors and officers, or, other corporate representatives, that were deemed to be the acts of the corporation, (thereby giving rise to direct liability on the part of the corporation, as opposed to merely a vicarious liability), then there must be an allocation of the resulting settlement. This position was being asserted by D & O insurers borne of the realization that the "direct" liability of the corporation can arise even if the directors and

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[9] *Supra*, see footnote #4.
[10] *Securities Act of 1933,* 15 U.S.C. 77a; *Securities Exchange Act of 1934,* 15 U.S.C. 78a.

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officers are not personally liable. In contrast, vicarious liability arises by operation of law and is "visited" on the company by reason of the personal acts and conduct of the directors and officers. "Direct liability" is purely a corporate liability with the directors and officers never being exposed to legal liability.

This conceptual issue is not merely academic. The statutory cause of action for misrepresentation available under the provincial Securities Acts more often than not raises the spectre of the company having liability notwithstanding the directors and officers have a perfectly "defensible" case. That is so because, in the main, the company, as the "issuer" under the provincial securities legislation, really only has two substantive defences to a misrepresentation claim: (a) the representations are true, and (b) causation[11] (i.e. the statements are untrue but did not cause the loss). In contrast, the directors and officers can, in addition to the issuer's limited statutory defences, avail of any "due diligence" defences[12] that the "issuer" does not have. So, in practice, it is not uncommon for the directors and officers to have a complete defence to the action whereas the company confronts liability.

5. EARLY COMMONWEALTH DECISIONS ON ALLOCATION:

By 1999 the issue of whether a D & O insurer can allocate a settlement sum, or, defence costs when both insured directors and officers and an "uninsured" company confront a co-equal monetary exposure had not been squarely addressed in Canada. The Quebec Courts had examined this issue in 1994 in the context of defence costs in *Bionaire v. Calvert Insurance Company*.[13] While not a thorough review of the conceptual issues that arise, the Quebec Superior Court adopted a "relative exposure" and "relative benefit" approach to the allocation of defence costs that mirrors the approach adopted in *PepsiCo, Inc. v. Continental Casualty Co.*[14]

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[11] *Securities Act,* R.S.B.C. 1996, c. 418, s. 131(10); *Securities Act,* R.S.A. 2000, s. S-4, s. 203(9); *Securities Act, 1988*, S.S. 1988-89, c. S-42.2. s. 137(8); *Securities Act*, R.S.M. 1998, c. S50, s. 141.1(6); *Securities Act*, R.S.O. 1990, c. S-5, s. 131(9); *Securities Act*, R.S.Q., V-1.1, s.196; *Securities Act*, S.N.B. 2004, c. S-5.5, s. 149(8); *Securities Act*, R.S.N.S. 1989, c. 418, s. 137(7); *Securities Act*, R.S.P.E.I. 1988, c. S-3, s. 16(7); *Securities Act*, R.S.N. 1990, c. S-13, s.49(1); *Securities Act*, R.S.Y. 2002, c. 201, s. 46(1); *Securities Act*, R.S.N.W.T. 1988, c. S-5, s. 49(1).

[12] *Securities Act,* R.S.B.C. 1996, c. 418, s. 131(6); *Securities Act,* R.S.A. 2000, s. S-4, s. 211.04(6); *Securities Act, 1988*, S.S. 1988-89, c. S-42.2. s. 137(5); *Securities Act*, R.S.M. 1998, c. S50, s. 180; *Securities Act*, R.S.O. 1990, c. S-5, s. 130(5); *Securities Act*, R.S.Q., V-1.1, s.220; *Securities Act*, S.N.B. 2004, c. S-5.5, s. 149(5); *Securities Act*, R.S.N.S. 1989, c. 418, s. 137(4); *Securities Act*, R.S.P.E.I. 1988, c. S-3, s. 16(3); *Securities Act*, R.S.N. 1990, c. S-13, s. 49(2); *Securities Act*, R.S.Y. 2002, c. 201, s. 46(2); *Securities Act*, R.S.N.W.T. 1988, c. S-5, s. 49(2).

[13] *Bionaire v. Calvert Insurance Company* (1994), R.J.Q. 1290; varied, 1998 CanLII 12931 (QC.C.A.).

[14] *Supra,* see footnote 7..

New Zealand briefly entertained the "relative exposure" and "relative benefit" approach with a flexibility to examine the factors identified by U.S. text authors Knepper & Bailey.[15] In *New Zealand Forest Products v. New Zealand Insurance Company*,[16] the Court concluded that if the wrongful acts are deemed to be the conduct of the corporation, thereby giving rise to direct liability on the part of the company, as opposed to merely a vicarious liability, then there must necessarily be an allocation of the costs incurred in the defence of the action. The New Zealand Court of Appeal was of the view that to permit allocation in situations involving "concurrent" liability has the attraction of fairness, reflects the realities of the situation, and attributes to both the corporation and directors and officers the intention that fair and reasonable contribution should be made by "non-insured" parties that derive a benefit from the incurred expense. The Court stated:

> "*What is appropriate will be for assessment on the facts by reference to relative exposure, relative benefit and other factors as are considered applicable in the circumstances*"
>
> "*The factors appropriate for consideration as identified by Ichel and approved in the Perini case and by Knepper & Bailey as approved in the Safeway Stores Inc. case at the District Court level should be employed, although they are not claimed to be exhaustive. Like Barker, J. we consider they are appropriate for the allocation required in this case. The Knepper & Bailey list is primarily intended for allocation of settlement payments but it can be adopted to a costs allocation.*" [emphasis added][17]

However, any judicial acceptance of the "relative benefit" and "relative risk" approach to allocation was quickly put to an end by judicial developments in the United States which, with time, gained acceptance in Canada.

[15] *Supra*, see footnote #8.
[16] *New Zealand Forest Products v. New Zealand Insurance Company,* [1996] 2 N.Z.L.R. 20.
[17] *Ibid.*, p. 45.

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6. THE U.S. COURTS ADOPT THE "LARGER SETTLEMENT" RULE:

(A) SETTLEMENTS AND JUDGEMENT:

Considerations integral to "relative exposure" and "relative benefit" in allocating a settlement sum were eliminated in most U.S. jurisdictions by reason of a trilogy of cases decided in 1995.[18]

Under the "larger settlement" rule as articulated by the 9th Circuit in *Nordstrom, Inc. v. Chubb & Son, Inc.*[19] a company is entitled to reimbursement of all settlement amounts if the corporation's liability is purely "derivative" of the liability of the insured directors and officers. "Derivative" as that term was used by the Court embraces both "direct" and "vicarious" liability of the company. Provided the monetary exposure of the directors and officers was equal to the monetary exposure of the company the D & O insurer was obligated to fund 100% of any settlement. The D & O insurer was only entitled to an allocation in relation of the "uninsured" company if the D & O insurer could demonstrate that the settlement sum was *made larger* by reason of the company's role as a potentially liable party (thus the term "larger settlement" rule).

The adoption of the "larger settlement" rule in *Nordstrom* made allocation very difficult to achieve on a case by case basis. In situations with common defence counsel and an aggregate settlement sum which does not distinguish between contribution of the "insured" directors and officers and the "uninsured" company it is practically difficult to identify the amount by which the company's involvement increased the amount of the overall settlement. That could only potentially be achieved if each of the company and the directors and officers had separate counsel and the latter's legal counsel asserted that the company's potential exposure was greater than the exposure of the directors and officers. In that scenario the opportunity would exist to segregate any settlement sum as between insured and "uninsured" parties.

What animated the 9th U.S. Circuit in *Nordstrom* in adopting the "larger settlement" rule was the wording of the insuring clause in the D & O policy, and more particularly, the use of the words "*all Loss… which the Insured Person has become legally obligated to pay on account of any Claim for a Wrongful Act committed. … by such Insured Person(s) [during the Policy Period]*." The Court's focus on the selection of the words "*All Loss…*" was seen as precluding any approach to allocation that would involve considerations outside the framework of the underlying case as had been suggested in the earlier jurisprudence. The

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[18] *Nordstrom Inc. v. Chubb & Son, Inc.*, (1995), 54 F. 3d 1424; *Caterpillar Inc. v. Great American Insurance Company*, (1995) 62 F. 3d 955; *Safeway Stores Inc. v. National Union Fire Insurance*, (1995) 64 F. 3d 1282.
[19] *Ibid.*

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Court took the view that the "larger settlement" rule best effectuated the reasonable expectations of the directors and officers and the company by concluding the D & O insurer should be responsible for the *entire* settlement or judgment amount regardless of whether the company could be found concurrently liable under any independent theory of liability.

Ultimately the 9th Circuit's focus on the words "*All Loss*…" as mitigating against an expansive approach to allocation would foreshadow the approach ultimately adopted by the Judicial Committee of the Privy Council in *New Zealand Forest Products Ltd. v. New Zealand Insurance Company Ltd.*[20] and, in turn, shape the outcome in a later Canadian case on this very same issue: *Coronation Insurance Co. v. Clearly Canadian Beverage Corp.*[21]

In the aftermath of *Nordstrom* D & O insurers in other states tried to argue that the "larger settlement" rule in *Nordstrom* amounted to an unfair rationing that allowed "uninsured" parties to "piggy-back" on insured directors and officers to effectively escape from the monetary consequences of a legal exposure. Again, the thrust of the insurers' position was a recognition of the benefit derived from a payment by the D & O insurer that retired the company's "independent" liability. That plea fell on "deaf ears" in other Courts; most notably in the U.S. 7th Circuit with the decision in *Caterpillar, Inc. v. Great American Insurance Company*[22] and then in *Level 3 Communications, Inc. v. Federal Insurance Co.*[23]

Nordstrom effectively precluded any reliance on "relative benefit" or "relative risk" as a basis for allocation absent clear policy language dictating a particular formula for allocation.

More importantly, *Nordstrom* and ensuing caselaw served as a catalyst for the widespread introduction of Entity Coverage for Securities Claims for public companies. This underwriting development will be discussed later in this paper.

(B) DEFENCE COSTS:

Nordstrom was decided by the 9th Circuit in April, 1995. By August, 1995 that same Court not only affirmed its earlier position on settlement amounts but as well, adopted an approach that, to a large extent, eliminated any ability for the D & O insurer to avoid paying common incurred defence costs notwithstanding those shared defence costs afforded a benefit to the "uninsured" company. In *Safeway Stores, Inc. v. National Union Fire*

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[20] *New Zealand Forest Products Ltd. v. New Zealand Insurance Company Ltd,.* [1997] 1 W.L.R. 1237

[21] *Supra,* see footnote #8.

[22] *Caterpillar, Inc. v. Great American Insurance Company* (1995), 62 F. 3d 955

[23] *Level 3 Communications, Inc. v. Federal Insurance Co*. (1999), Not Reported in F. Supp.2d, 1999 WL 675295 (N.D.Ill.).

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Insurance Company,[24] where the insurer incurred defence costs in the defence of both the insured directors and officers and the "uninsured" company, the Court stated that defence costs are covered under a D & O policy if the item of expenditure is "reasonably related" to the defence of the insured directors and officers notwithstanding that item of expenditure may have been of benefit to the "uninsured" company.

7. THE "LARGER SETTLEMENT" RULE IS ADOPTED IN ENGLAND AND CANADA:

Prior to *Nordstrom* there had been some support in New Zealand for the "relative exposure" and "relative benefit" approach to allocation even absent an express policy requirement dictating that approach. The strongest support for that approach being evidenced by the New Zealand Court of Appeal in *New Zealand Forest Products v. New Zealand Insurance Company*.[25]

However, whatever success D & O insurers enjoyed in the aftermath of the *New Zealand Forest Products* in the New Zealand Court of Appeal was short lived. By July 1997, the Judicial Committee of the Privy Council, which hears appeals from New Zealand, had allowed the appeal from the decision of the New Zealand Court of Appeal. In issue was the allocation of defence costs in defending an action against *both* the directors and the company. This afforded the opportunity for the Law Lords to squarely address whether the approach in *Nordstrom* and its progeny of cases in the United States should be applied. Rather than refusing a "relative risk" and "relative benefit" approach to allocation on the footing that it was inconsistent with the reasonable expectations of the parties to the D & O policy (as had been the justification in the U.S. 9th Circuit) the English Law Lords concluded that this approach was dictated simply by the principles governing the interpretation of the words in the D & O policy insuring clause. The Law Lords focused upon the words in the grant of coverage which obligate the D & O insurer to reimburse for:

> "*all Loss... which such Director or Officer has become legally obligated to pay…*"

and concluded:

> *...the words by themselves fall far short of expressing the substance of what the respondents seek to establish and it seems to their Lordships that the respondent could only succeed in showing that an allocation of common costs was to be made by reading into the clause words which could have been but are not there. On the other*

[24] *Supra,* see footnote #18.
[25] *Supra,* see footnote #16.

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> *hand there are strong arguments to support the appellants' contention that no allocation is intended. On the ordinary meaning of the words which have been used it is reasonable to understand that the cover would extend to the whole costs incurred in the defence where the officer was the sole defendant. Why then should the meaning of the words change simply because there is another defendant who is not covered by the policy? Moreover if an uninsured co-defendant was bankrupt or otherwise without means it would seem an odd result of the insurance that it should not cover the whole of the officer's costs even although some of them related also to the defence of the co-defendant. Once it is accepted that the costs are not confined to those which relate solely and exclusively to the officer it is hard to find anything in the language which prevents the cover extending to all the costs which also relate to another defendant. On the contrary the language points to the conclusion that all such costs are covered. The clause expressly refers to "all" loss. And "loss" means "the total amount of Defence Costs". In contrast to such general terms there is no provision generally requiring the kind of allocation to be made for which the respondents contend. It cannot be assumed that the insurers would not have anticipated the likelihood of the company being joined as a defendant along with one of its officers and if provision of the kind contended for was intended that could readily have been included.*[26] [emphasis added]

The Law Lords did not employ the rationale used in *Nordstrom*, *Caterpillar* and *Safeway* in rejecting the use of "relative risk" and "relative benefit" as a method to determine allocation. Instead, the Law Lords adopted a strict reading of the words in the grant of coverage on the premise that literal adherence to the words "*all Loss*" dictated reimbursement. The Law Lords adopted earlier cases in the U.S. which signalled the need to give the directors and officers the full benefit of coverage notwithstanding that this approach may confer a direct or indirect benefit on "uninsured parties" who are joined in the lawsuit. In particular the Law Lords adopted with approval the views in *Continental Casualty Co. v. Board of Education of Charles County*[27] where it was said:

> *Having purchased this form of litigation insurance, the [insured] is entitled to the full benefit of its bargain. So long as an item of service or expense is reasonably related to defense of a covered claim, it may be apportioned wholly to the covered claim.*

The practical result insofar as it concerned defence costs, was that only an item of expense that was *not* reasonably related to the defence of the directors and officers dictated reimbursement by the D & O insurer. That meant if the item of expense was of benefit to

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[26] *Supra,* see footnote #20, at Para. 8

[27] *Continental Casualty Co. v. Board of Education of Charles County* 489 A. 2d 536 (U.S. Md. April 12, 1985) at p. 545, at Para. 7.

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both the insured directors and officers *and* the "uninsured" company it had to be paid in full.

Practically, that meant the D & O insurer could only achieve an allocation on defence costs, short of a forensic accounting of the legal invoices, by ensuring that the directors and officers retained their own counsel, distinct from counsel appointed to defend the company, and by directing that counsel to only incur expense to the account of the directors and officers and to not participate in, nor incur any expense that was of immediate or long term benefit to the company's defence of the lawsuit.

This approach to allocation has subsequently been affirmed in England in relation to other types of insurance policies. In *Thornton Springer* v. *NEM Insurance Co Ltd. & Ors*.,[28] a firm of accountants was confronting a liability exposure being advanced against both the firm and one of the partners. The partner's potential liability was solely in his personal capacity. The professional liability insurer sought to recover that portion of the defence costs which it said arose solely by reason of the partner's personal liability not falling under the ambit of the E & O policy.

In adopting the conceptual approach used in *New Zealand Forest Products* the English Queen's Bench stated that unless it could be shown that the item of expenditure in the defence of the action was incurred solely in connection with the partner's personal exposure the defence costs had to be borne by the E & O insurer. However, since the "theories of liability" as between the covered causes of action and the causes of action which entailed personal liability were largely interwoven the Court stated that if the item of expenditure in the defence of the action was of a "dual benefit" then it had to be paid by the insurer.

8. THE "LARGER SETTLEMENT" RULE FOR CANADIAN SECURITIES CLAIMS:

The decision of the Judicial Committee of the Privy Council in *New Zealand Forest Products* ultimately proved to be the "driver" on the first Canadian case to examine whether the "uninsured" company could benefit from a settlement that included the directors and officers.

In *Coronation Insurance Company v. Clearly Canadian Beverage Corp*.,[29] a decision of the B.C. Court of Appeal, a Canadian court was called upon to determine whether the "larger settlement" rule would be adopted in Canada, or, whether there was any latitude to use

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[28] *Thornton Springer* v. *NEM Insurance Co Ltd. & Ors*., [2000] C.L.C. 975

[29] *Supra,* see footnote #8.

the "relative risk" and "relative benefit" approach that was evident in the U.S. cases prior to *Nordstrom* and its progeny of caselaw.

The *Clearly Canadian* case is important in that it concerned a Securities Claim in which the "uninsured" company confronted potential liability as did the directors and officers. In that sense it is particularly pertinent when we turn our attention to coverage for Securities Claims advanced against the company since we have to ask whether the company should benefit from any settlement not having paid a premium for any coverage for that same Securities Claim.

In *Clearly Canadian* the D & O insurer argued that to adopt the "larger settlement" rule is to view the allocation issue from the standpoint of the claimant: a joint liability that is contiguous in monetary amount when comparing the exposure of the company and the directors and officers. However, using this perspective arguably fails to recognize that had there been no D & O insurance the company and its directors and officers would embark upon a discussion as to whether they ought to contribute to any monetary settlement as distinct from the company. The company could face liability whereas the directors and officers may have a completely "defensible" case. That paradigm, as mentioned earlier, will more frequently arise in the context of a Canadian Securities Claim in circumstances where the directors and officers have a "due diligence" defence which the company, as the "issuer", cannot avail.

In adopting the "larger settlement" rule for settlements and rejecting the "relative risk" and "relative benefit" approach evident in earlier U.S. cases, the B.C. Court of Appeal stated:

> *36 The Committee found that the Court of Appeal in New Zealand Forest Products had not made it clear why it had adopted an approach "based on the factual circumstances rather than one of the construction of the policy under the guidance of ... a strong body of authority" that supported the appellant's case. As for the Knepper and Bailey factors, the Committee acknowledged they might be relevant if one were assessing an allocation of settlement sums or finding a fair allocation of a total bill of costs as between various defendants. But again, in Lord Clyde's analysis, that was "not the problem in the present case. This case is concerned with the proper construction of the policy of insurance." Accordingly, the defence costs were to be allocated first on the basis that any item wholly and exclusively related to Mr. Taylor's defence fell within the scope of the policy; second, that any item of cost unrelated to his defence was not covered; and third, that "So far as any defence costs are concerned which reasonably relate to the defence of the claim against Mr. Taylor but do not exclusively do so, they are covered by the policy even although they also relate to the defence of some other party who is not insured." <u>The fact that an</u>*

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insured party, the corporation, would thereby benefit did not exclude the costs from coverage: "they are still costs which are reasonably related to the defence of the covered claim." *(at 9)*

37 In my view, the Judicial Committee's reasoning provides a complete answer to the two themes argued by the Insurer in the case at bar -- the theme of "unfairness" -- i.e., that it would be unfair to allow [the Company] effectively to have a "free ride" (this wording was used in Pepsico, supra, at 661) on the insurance of the D&Os -- and the theme of "reasonable expectations" -- that the parties to the policy should be taken to have expected that settlement funds would be allocated in accordance with the Knepper and Bailey factors. The latter argument involves implying a term that has no foundation in the wording of the policy. As in New Zealand Forest Products, the Insurer here agreed to cover "all Loss" which the D&Os or [the company] might become legally obligated to pay as a result of the D&Os acting as such. Clause VII(c) contemplated the allocation of defence costs and expenses on the "principal benefit" basis, but no such provision was made in respect of amounts paid to settle or pay the underlying claim. Thus I cannot agree that a right of allocation or reallocation on the basis of the Knepper and Bailey factors arises on the wording of this contract of insurance.

…

41 Ultimately, the answer to the fairness debate lies not in either party's particular view or expectations formulated after the fact, but in the parties' intentions as expressed in their contract of insurance. As I have said, the policy in this case is quite clear. The Insurer agreed to pay the D&Os the total amount of their liability (up to $5 million) unless [the Company] indemnified them, and the Insurer agreed to reimburse [the Company] for any amount it was required or permitted by law to expend in order to indemnify the D&Os. Coverage was for "all Loss" and no distinction was drawn in the policy between direct and derivative liability, or between amounts that might benefit the D&Os solely, and amounts that might benefit others. Indeed, [the Company] 's direct liability is irrelevant to the wording of the policy, which is concerned solely with the indemnification of D&Os or of [the Company] for amounts it is required or permitted to pay on behalf of the D&Os for acting as such. To repeat the words of Lord Clyde in New Zealand Forest Products:

On the ordinary meaning of the words which have been used, it is reasonable to understand that the cover would extend to the whole costs incurred in the defence where the officer was the sole defendant. Why then should the meaning of the words change simply because there was another defendant who is not covered by the policy? [at 5-6]

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> *42 In my view this approach construes the language of the policy in a manner consistent with the usual rules of construction rather than according to some inferred "expectations" not apparent on a fair reading of the document; and it provides insureds with the full benefit of their policy. It requires an insurer to state explicitly the basis, if any, on which coverage may be limited, and it avoids lengthy hearings designed to explore the "metaphysical" underpinnings of why a corporation or its directors and officers might have acted as they did: Caterpillar Inc., supra, at 962. It has now prevailed generally in the United States, there being only one lower court decision that adopts the Knepper and Bailey factors (see Liability of Corporate Officers and Directors, supra, Supp. (1996) § 21-7, at 377-381). For all these reasons, I agree with the Chambers judge that a reallocation on the basis of those factors should not be undertaken. The fact that [the Company] (assumedly) benefitted from the settlement is not, on the wording of this policy, reason to impose an obligation on the corporation to make good some or all of the amount of the indemnity paid by the Insurer on behalf of the D&Os.*
>
> *43 I agree, on the other hand, that apportionment on the basis of the larger settlement rule should take place. That rule, which was effectively adopted by the Judicial Committee in New Zealand Forest Products, is consistent with the holding of this court in Continental Insurance Co. v. Dia Met Minerals Ltd. (1996), 20 B.C.L.R. (3d) 331 (B.C. C.A.) that at least where the insurer does not have conduct of the defence, costs incurred to defend a covered claim are properly segregated from those incurred in respect of non-covered claims. Thus this matter should be remitted to the trial court for the determination of the extent, if any, to which the settlement of the underlying action was increased by the joinder of [the Company] as a defendant.*[30] [emphasis added]

So, in summary, by 1999 the position in Canada, insofar as it concerned the potential benefit accruing to an uninsured company in the context of a Securities Claim was two-fold:

(a) if the company's legal exposure was not greater than the potential exposure of its directors and officers, then the D & O insurer was obligated to reimburse 100% of the settlement; and

(b) the only defence costs not required to be paid by the D & O insurer were those defence costs which were to the sole benefit of the company. If the costs afforded a benefit to *both* the company and the

[30] *Ibid.*, at Para. 32-43

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directors and officers 100% of the defence costs were to be borne by the D & O insurer.

What this practically meant was that any claim that named *both* the "uninsured" company and its insured directors and officers would result in the claim being paid in full by the D & O insurer absent very clear evidence that somehow the company's exposure was greater by reason of the pleadings than were the theories of liability advanced against the directors and officers. In its implementation this proved difficult to demonstrate. So, in reality the company was securing the "benefit" of any defence costs and settlement notwithstanding it was not insured for this exposure.

That legal reality served to augment the business case for D & O insurers explicitly affording coverage to the company for Securities Claims since the D& O insurer would bear the financial consequences without the payment of an appropriate premium. In undertaking this step D & O insurers also recognized that affording Entity Coverage for Securities Claims avoided any allocation dispute arising during the currency of the underlying litigation.

9. IS AN EXPRESS FORMULA FOR ALLOCATION EFFECTIVE?

By 2000, D & O underwriters throughout North America were disappointed with the result in *Nordstrom* and its progeny of cases and, in turn, the adoption of the same approach in Canada with the *Clearly Canadian* decision.

However, it is important to be mindful that these cases reflect a judicial approach the Courts were required to adopt in absence of any express formula that would dictate a differing approach to allocation when an "uninsured party" gains the benefit of defence costs or a settlement incurred on behalf of the directors and officers. In *Nordstrom* there was no policy language mandating allocation and certainly no policy language that dictated a particular approach. That reality was what necessitated the Court's introduction of a suitable approach to allocation absent any express formula.

In *Clearly Canadian*, the D & O policy had a formula dictating the method of allocation for defence costs *("… Costs, Charges and Expenses for investigation or defense shall be limited to those incurred in the right of and for the principal benefit of the Directors and Officers, as distinguished from any other party or parties…"*[31]) but what was in dispute was who should bear the monetary burden of a jointly funded settlement amount. On the issue of settlement amounts the D & O policy was "silent" on any need for allocation, or, a particular formula for allocation.

[31] *Ibid.*, at Para. 3.

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In the early years some D & O insurers believed that a "best efforts" clause that read:

> *"With respect to the settlement of any claim made against the Company and the Insureds, the Company, the Insureds and the Insurer agree to use their best efforts to determine a fair and proper allocation of the settlement amount as between the Company and the Insureds."*

would necessarily lead to a monetary allocation. In fact, a "best efforts" clause to govern allocation proved to be insufficient to mandate an approach to allocation that dictated a differing result than the "larger settlement" rule. The Courts concluded a "best efforts" clause merely mandated the need for an "allocation analysis".[32] In *Owens Corning v. National Union Fire Insurance Company of Pittsburgh, Pennsylvania*[33] the U.S. 6th Circuit concluded that the use of the words "…*best efforts to determine a fair and proper allocation*" does not dictate a particular method of allocation and those words, taken alone, were ambiguous on the allocation approach to in fact be used by the Court.

Even an allocation clause that explicitly dictates the need for allocation does not necessarily displace the "larger settlement" rule. For example, some D & O policies will use "*fair and proper*" language to obtain allocation when the "uninsured" company obtains a benefit from the payment by the D & O insurer. In *Vero Insurance Limited v. Baycorp Advantage Ltd. et al,*[34] a decision of the Court of Appeal for the Supreme Court of New South Wales in Australia, the D & O insurer used an allocation clause that read:

> *"In the event that:*
>
> *(b) both an Insured Person and others (including the Insured Entity) are a party to the proceedings or demand to which a Claim relates,*
>
> *then the Insureds and the Insurer will agree on a fair and proper allocation of damages, interest, claimant's costs and expenses and Defence Costs between Loss covered by this Policy and Loss not covered by this Policy."* [emphasis added]

The company had entered into a $10 m. (Aus.) settlement and arguably it could be said that the directors and officers' potential liability was a modest $600,000, the balance being solely a corporate legal exposure. The issue then arose whether the entirety of the legal costs incurred prior to the settlement ought to be borne by the D & O insurer.

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[32] *Supra*, see footnote #18, at page 1289.
[33] *Owens Corning v. National Union Fire Insurance Company of Pittsburgh, Pennsylvania* (2001), 257 F.3d 484.
[34] *Vero Insurance Limited v. Baycorp Advantage Ltd. et al*, [2004] NSWCA 390.

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The Australian Court initially took note of the fact that the policy contemplated reimbursement for "*reasonable costs and expenses*" and that there was no language such as "*incurred solely in the defence of*" the insured directors and officers which, in the Court's view, could be a suitable restriction on recovery under the policy.

The D & O insurer contended that the result in *New Zealand Forest Products v. New Zealand Insurance Company* was driven entirely by the use of the words "*all Loss…*". Since the D & O policy in question referred to "*fair and proper*" costs that necessarily took the case outside the ambit of the "*reasonably incurred*" approach adopted by the Law Lords in *New Zealand Forest Products*. Despite the clear implication that the company would benefit from recovery of 100% of the defence costs, the Australian Court refused to depart from the approach in *New Zealand Forest Products*. In effect, as in *Caterpillar*, the Australian Court was not prepared to accept that an allocation clause premised upon "*fair and reasonable*" precluded recovery of legal costs admittedly to the direct benefit to the "uninsured" company.

In all, the "larger settlement" rule for settlements and the "relative benefit" test for recovery of defence costs were adopted by the Courts in the context of policy wordings that did not provide any express formula for dealing with allocation. In adopting these approaches the Courts in both the United States and Canada were leaving it open for D & O insurers to introduce clear language that would dictate a specific allocation approach. As we will see later, D & O insurers did respond by introducing a formula for allocation. That, in turn, proved instrumental in shaping the outcome of today's cases. It is important to note that the adoption of an express formula for allocation arose in an underwriting environment in which directors were seriously questioning whether the company's legal fees and indemnity obligation should be borne by the D & O policy.

(A) COMMON DEFENCE COSTS:

As a result of developing jurisprudence D & O insurers turned their minds to an express formula for allocating defence costs. At least one Canadian case suggests that a D & O insurer's effort to confine its "defence cost" responsibility to those amounts incurred "solely" in relation to an insured Director and Officer is sufficient to displace the "reasonably related" test mandated by *Caterpillar* and *New Zealand Forest Products*.

A D & O insurer's use of the words "*… incurred solely in the defence of the [insured directors and officers]*" can preclude recovery for costs that are other than the costs to defend a director or officer. For example, defence costs incurred to pursue contribution and indemnity and third party claims will not satisfy the language the policy requirement that the costs, charges or expenses arise "solely" from the defence of the claim. In *Sapi v.*

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American Home Assurance Company[35] a coverage dispute arose between the D & O insurer and the insured. The parties had entered into a settlement agreement that the D & O insurer would reimburse 40% of the defence costs incurred by the director to defend the claims being made against him. The settlement agreement provided that the defence costs must result "*solely from the ..... defence and appeal of any claim against the insured*."

The Ontario Superior Court concluded that any cross-claims and third party claims, even those asserting only contribution and indemnity, were separate and distinct from the defence of the actions initiated against the insured. The defence costs inherent to the cross-claims and third party claim did not fall with the ambit of "defence costs" as defined in the agreement since they were not "solely" on account of the defence of the directors and officers.

Similarly, an appeal court in Australia has suggested, in *obiter*, that the use of the words "*…. costs incurred solely in defending… a Claim*" may be sufficient to supplant the "reasonably related" rule developed in *Caterpillar* and affirmed by the Law Lords in *New Zealand Forest Products*.[36]

(B) SETTLEMENT CONFERRING A BENEFIT ON THE UNINSURED COMPANY:

Following in the wake of *Nordstrom*, D & O insurers tried differing approaches in an effort to control their overall monetary exposure. One of the earliest approaches, which continues to be favoured even to this day, is to provide for a pre-determined allocation of defence costs (commonly referred to by D & O underwriters as "pre-determined allocation").

Some D & O insurers in Canada will agree to reimburse 80% of the defence costs incurred by *both* the insured directors and the uninsured company regardless of the nature of the case while leaving open the ability of the insured to demonstrate that the D & O insurer should be required to pay more than 80% of the defence costs. Concurrently, the D & O insurer will treat any settlement or judgement amount as necessitating the "relative risk" and "relative benefit" approach that existed prior to *Nordstrom* and *Clearly Canadian*.

A typical "pre-determined allocation" policy wording that invites a pre-determined defence cost allocation, with settlements being guided by the pre-*Nordstrom* and pre-*Clearly Canadian* approach, would read:

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[35] *Sapi v. American Home Assurance Company,* [2004] I.L.R. 1-4274, 2004 Carswell Ont 368 (Ont.Sup.Ct.).
[36] *Vero Insurance Limited* v. *Baycorp Advantage Limited*, supra, at Para. 77-86.

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*If both **Loss** covered by this policy and loss not covered by this policy are incurred, either because a **Claim** against an **Insured** includes both covered and uncovered matters or because a **Claim** is made against both an **Insured** and others not covered under the policy, including the **Company**, the **Insured** and the **Underwriter** shall allocate such amount as follows:*

*(a) 80% of all **Costs, Charges and Expenses** in respect of such **Claim** shall be allocated to covered **Loss**, unless: (1) the **Insurer** and the **Insured** mutually agree to a higher percentage of **Costs, Charges and Expenses**; or (2) a Court of competent jurisdiction has decided that a higher percentage shall be covered as **Costs, Charges and Expenses** under this policy. However, no **Costs, Charges and Expenses** shall be allocated to the **Company** to the extent that it is unable to indemnify **Insured** by reason of insolvency or bankruptcy or statutory law.*

*Such allocation of **Costs, Charges and Expenses** shall be final and binding and shall not apply to or create any presumption with respect to the allocation of any other **Loss**.*

*(b) with respect to all **Loss** other than **Costs, Charges and Expenses**, the **Company** and the **Insured** shall allocate such amount based upon the relative legal exposures of the parties to such matters and the relative benefit to each party*. [emphasis added]

Since typically the "Side B Corporate Reimbursement" coverage has a significant self-retention (being a monetary sum initially being borne by the insured to its own account) whereas the "Side A" coverage frequently has no self-retention, it practically means that the directors and officers had the certainty of recovering 80% of their defence costs, unaccompanied by any dispute over allocation. Secondly, the 80% defence cost funding would incept from the "first dollar" of defence costs if the company, either due to insolvency or other legal constraint on corporate indemnification, could not in fact make the directors and officers whole for their legal costs (i.e. "Side A Coverage").

There is no Canadian case, since *Clearly Canadian*, which has examined how effective this wording will in fact be when confronted with a specific fact situation. Very recently, however, a New York Court has suggested that a properly worded "relative risk" and "relative benefit" formula for allocation will permit for an examination of the "metaphysical underpinnings" that gave rise to a settlement. In *Clifford Chance Limited*

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Liability Partnership et v. Indian Harbour Insurance Company[37], a decision of the New York Supreme Court, an E & O insurer was attempting to allocate both defence costs and a settlement sum in circumstances wherein the settlement embraced a "non-insured" party. The allocation clause in the professional liability policy read as follows:

> *If both Loss covered by this Policy and Loss not covered by this Policy are incurred, either because a Claim made against the insured contains both covered and uncovered matters, or because a Claim is made against both the Insured and others not insured under this Policy, the insured and insurer will use their best efforts to determine a fair and appropriate allocation of Loss between that portion of Loss that is covered under the Policy and that portion of Loss that is not covered under this Policy. Additionally, the Insured and the Insurer agree that in determining a fair and appropriate allocation of Loss, the parties will take into account the relative legal and financial exposures of, and relative benefits obtained in connection with the defense and/or settlement of the Claim by the Insured and others.* [Emphasis added]

The New York Court accepted that an insurer could draft appropriate language to achieve a meaningful allocation having regard to the "benefit" accruing to the non-insured party whose exposure is retired by the insurer's settlement payment. Secondly, the Court accepted that if appropriately worded the allocation clause could displace the "larger settlement" rule first articulated in *Nordstrom*. The Court stated:

> *…the Policy in this case contains bargained for language that "the parties will take into account the relative legal and financial exposures of, and relative benefits obtained in connection with the defense and/or settlement of the Claim by the Insured and others." This language specifically charts a course for application of what some courts and commentators have denominated the "relative exposure rule," as articulated by the Second Circuit in Pepsico, Inc. v. Continental Casualty Co. (640 F Supp at 662 [applying New York law]; see e.g. Caterpillar, Inc. v. Great American Ins. Co., 62 F3d at 960; Leitner, Simpson and Bjorkman, 4 Law and Practice of Ins. Coverage Litigation, § 47:44). It is not necessary, therefore, to join in the debate engaged in by the Circuit Courts on the proper application of the larger settlement rule, as it is inapplicable to this case on either the facts or the law.*[38] [Emphasis added]

A variation of this approach is to mandate that both defence costs and any settlement or judgement amount be dictated by the "relative risk" and "relative benefit" method of

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[37] *Clifford Chance Limited Liability Partnership et v. Indian Harbour Insurance Company* (2006), 14 Mis.3d 1209

[38] *Ibid.*, at 22.

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allocation. This approach to allocation is more typically used in the context of D & O for smaller private companies and non-profit entities. A sample wording could read:

> *In the event any of the **Insureds** in a **Claim** incur both **Loss** that is insured by the Policy and also loss which is not insured by the Policy, then with respect to either insured or uninsured claims or parties, the **Insureds** and the Insurer agree to use their best efforts to determine a fair and proper allocation of the amounts as between the **Insureds** and the Insurer taking into account the relative legal and financial exposures, and the relative benefits obtained by, the **Insureds**.*

For present purposes what is significant is that D & O insurers can stipulate a formula for allocation that avoids the application of the "reasonably related" approach for defence costs.

10. THE DEVELOPMENT OF ENTITY COVERAGE FOR SECURITIES CLAIMS:

With judicial acceptance of the "larger settlement" rule for settlements and the "reasonably related" rule for defence costs, D & O insurers recognized, certainly by 2000, that in the vast majority of Securities Claims the D & O insurer would have practical difficulties determining whether some portion of the monies should be borne by the "uninsured" party that benefits from a joint settlement. Secondly, there was a growing appreciation that for directors and officers to engage in litigation or an arbitration dispute over allocation, while trying to defend themselves in the underlying action, only increased the "friction points" with their D & O insurer during the currency of the underlying action. Thirdly, judicial debate over the proper allocation approach was creating commercial uncertainty for D & O insurers as they tried to wrestle with appropriate reserve levels for future exposures.

Trends in the insurance marketplace were also influencing the approach taken by D & O insurers on allocation. Generally, the latter part of the 1990's was a "soft insurance market" and adding Entity Coverage was seen as the addition of a policy coverage that would be attractive to insureds in an environment where pricing was otherwise the dominant driver in the selection of a particular D & O policy.

It was this combination of factors that initially gave rise to the introduction of Entity Coverage for Securities Claims for publicly traded companies. This paper embarked upon a discussion of this issue by stating that historically the insuring clauses in a D & O policy, consisting of the Insuring Clause B for "corporate indemnification" and the Side A Insuring Clause providing direct reimbursement to the D & O if the company is unable or unwilling to indemnify a director and officer, were never intended to confer coverage for the company's own independent liability. As we saw, however, the emergence of the

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"larger settlement" rule for settlements and the "reasonably related" rule on defence costs practically mitigated against any meaningful allocation. For the company it meant effectively the company was discharged from any potential liability by reason of the D & O insurer's payment of the claim. So, from a claims' standpoint, the D & O insurer recognized that any settlement sum accepted by the D & O insurer would retire the monetary exposure for *both* the insured directors and officers and the "uninsured" parties in the underlying claim. In effect, the D & O insurer was paying for the company's exposure without having received a premium for this risk. That commercial reality became one of the primary reasons for introducing explicit Entity Coverage for Securities Claims.

In the late 1990's, with the introduction of Entity Coverage for Securities Claims, many of the D & O policy wordings were extremely broad. When initially introduced, coverage for Securities Claims was intended to afford the company indemnity for liability pursuant to any prevailing securities legislation arising by reason of the offering of a company's shares by means of a prospectus, or, the company's shares being traded on a stock exchange.

Entity Coverage quickly became prevalent. By 2001 it was estimated that 90% of U.S. corporate insureds had purchased Entity Coverage, up from less than 30% five years earlier[39]. The prevalence of Entity Coverage for publicly traded companies in Canada likely "mirrored" the U.S. experience.

One early Securities Claim Entity Coverage insuring clause extended coverage for:

> *"… a Claim…made against an Insured…alleging a violation of any law, regulation or rule, whether statutory or common law, which is brought by any person or entity alleging, arising out of, based upon or attributable to, in part or in whole, the purchase or sale or offer or solicitation of an offer to purchase or sell, any securities of the Company…"*

This definition would potentially afford coverage to a company for the sale of the company's shares by means of a private transaction if in the course of the sale transaction misrepresentations were made that then resulted in a claim by the purchaser of the shares.

As the industry's understanding of the exposures improved over time, refinements to the definition of Securities Claim were introduced. Coverage for private shares was excluded. Current policy forms today will typically state:

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[39] Tillinghast Towers-Perrin, 2001 *Directors and Officers Liability Survey*.

> ***Securities Claim*** *means any Claim for an alleged act, error or omission, including violation of any law, regulation or rule, whether statutory or common, based upon, arising from or attributable to the claimant's purchase, ownership or sale of, or offer to purchase from or sell to the claimant, any securities of the Company, whether on the open market or in connection with a public or private offering of securities by the Company*. [emphasis added]

Yet another version currently being used in the Canadian D & O market provides Entity Coverage for Securities Claims by providing the company with coverage for "Loss" attributable to a "Corporate Act". "Corporate Act" is defined as:

> *any actual or alleged error, omission, misstatement, misleading statement, neglect or breach of duty by the Company arising from or in consequence of a Securities Law Violation.*

In turn "Securities Violation" is defined as:

> *any violation of any Canadian or United States of American Federal, Provincial, State or Territorial securities law, rules or regulations of the United States Securities and Exchange Commission, similar securities laws or regulations of any state, province, territory, or any common law relating to any transaction arising out of, involving, or relating to the purchase or sale of or offer to purchase or sell any securities, whether on the open market or through a public or private offering.*

Yet another policy wording provides:

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

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It is important to appreciate that in respect of public companies, as distinct from private companies or non-profit entities, Entity Coverage is strictly confined to Securities Claims. For claims that do not fall within the definition of a Securities Claim there necessarily has to be an allocation of any defence costs or settlement amount based upon the express formula called for in the D & O policy, or, absent an express formula, some resort to the various judicially imposed "tests" seen in the earlier American cases and *Clearly Canadian*.[40]

11. COVERAGE ISSUES ON ENTITY COVERAGE FOR SECURITIES CLAIMS:

Many publicly traded North American Fortune 1000 companies initially welcomed the introduction of Entity Coverage for Securities Claims. Assuming the claim entailed an allegation of securities fraud or a misrepresentation under U.S. securities law, or the Canadian counterpart provincial Securities Act provisions, coverage for Securities Claims meant that the entirety of the settlement and defence costs would be paid by the D & O insurer.

Generally, a company would urge a view that the claim, as pleaded, did amount to a Securities Claim to avoid the spectre of a "relative benefit" and "relative risk" analysis if the claim was not characterized as a Securities Claim. However, the introduction of Entity Coverage for Securities Claims began to raise questions as to its proper scope. Entity Coverage became a "two-edged sword". In many cases the characterization of a "claim" as being a Securities Claim, thus negating any need for allocation, also resulted in a higher self-insured retention ("S.I.R.") as many D & O insurers use a higher S.I.R. for Securities Claims.

Secondly, frequently where the claim was a Securities Claim it necessarily dictated pre-determined allocation of 70 or 80%, notwithstanding that a "reasonably related" rule for defence costs in combination with a "larger settlement" rule for the insured might have augered for 100% reimbursement. This was problematic to insureds if they purchased a policy with pre-determined allocation and were only entitled to 80% of their defence costs, notwithstanding a "larger settlement" rule might have dictated 100% reimbursement.

The introduction of coverage for Securities Claims also created new coverage issues. Certain claims can raise difficult issues. Is the claim properly a Securities Claim that affords the company reimbursement for its own liability? This section of the paper will focus on the three most frequent issues that arise in the context of Securities Claims arising in Canada.

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[40] *Supra*, see footnote #8, at 15.

The first two issues discussed below examine whether the claim is properly characterized as a Securities Claim, so as to trigger coverage for the company.

(A) A TAKEOVER BID RESULTING IN COMPULSORY ACQUISITION PROCEEDINGS:

Under Canadian company law, whether Federal[41] or Provincial[42], if a company successfully acquires 90% of the shares in a "target" company, the "takeover" company can avail itself of statutory "compulsory acquisition" rights. In effect, by statute, the "takeover" company is entitled to purchase the remaining 10% of the "target" company shares by compulsion, notwithstanding that the 10% may have refused to tender their shares as part of the "takeover" bid. The statutory remedy is "compulsory", in the sense that the remaining 10% cannot elect to retain their shares.

The right of the "takeover" company to acquire the remaining 10% permits the minority to complain about any "oppressive or unfairly prejudicial" conduct of the directors and officers of the "takeover" company that caused the shares to depreciate in value. It also permits the 10% shareholders to be compensated for the value of the shares without regard to any depreciation in value caused either by the takeover itself or improper conduct of the directors and officers.[43]

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

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[41] *Canada Business Corporations Act,* R.S.C. 1985, c. C-44, s.206.

[42] *Business Corporations Act,* S.B.C. 2002, c.57, s.300; *Business Corporations Act,* R.S.A. 2000, c. B-9, s.195; *Business Corporations Act,* R.S.S. 1978, c. B-10, s.188; *Business Corporations Act*, R.S.O. 1990, c.C.38, s.188; *Business Corporations Act*, S.N.B. 2004 1981, c. B-9.1, s.133(2); *Corporations Act*, R.S.N.L. 1990, c. C-36, s.317; *Business Corporations Act*, R.S.Y. 2002, c.20, s.197(2); *Business Corporations Act*, S.N.W.T. 1996, c.19, s.192(2).

[43] *Canada Business Corporations Act,* R.S. 1985, c. C-44, s.241; *Business Corporations Act,* S.B.C. 2002, c.57, s.227; *Business Corporations Act,* R.S.A. 2000, c. B-9, s.215; *Business Corporations Act,* R.S.S. 1978, c. B-10, s.207; *Corporations Act*, R.S.M. 1998 1987, c. C225, s.207; *Business Corporations Act*, R.S.O. 1990, c.C.38, s.161; *Business Corporations Act*, S.N.B. 2004 1981, c. B-9.1, s.166; *Corporations Act*, R.S.N.L. 1990, c. C-36, s.371; *Business Corporations Act*, R.S.Y. 2002, c.20, s.243; *Business Corporations Act*, S.N.W.T. 1996, c.19, s.243.

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"target" company will contend that they are entitled to coverage under the "takeover" company's D & O policy on the premise that the sale of the subsidiary's shares is a Securities Claim.

It is probable that in this situation the ensuing "claim", from the standpoint of the "target" company, is a Securities Claim. To avoid having the ensuing compulsory acquisition litigation characterized as a Securities Claim, the prudent step, from an underwriting standpoint, is to ensure a "carve out" from any coverage afforded to the newly-acquired subsidiary by means of an endorsement. In other words, the D & O underwriter would cover any "going forward" claims, but would expressly exclude any "claim" arising by reason of the takeover bid, including any compulsory acquisition proceedings launched by former shareholders of the subsidiary. In turn, the directors and officers of the "target company" can be suitably protected by means of a separately issued "run off" D & O policy that affords coverage for a "Wrongful Act" that is pre-takeover bid.[44]

(B) A "DELAWARE STYLE" REVERSE TAKEOVER:

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

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

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

a) the "takeover" company merges with a wholly owned subsidiary created for the purpose of the transaction;

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[44] Provided the "claim" is only "first made" subsequent to the takeover bid.

b) the "target" company issues to the shareholders in the "takeover" company shares equal to the shares held by those shareholders in the "target" company prior to the transaction;

c) the "target" company issues options to purchase shares in the "target" company to those holding options in the takeover company in exchange for the latter's stock options;

d) the "target" company issues warrants to purchase shares in the "target" company to persons holding warrants in substitution for existing warrants. This ensures, at the completion of the process, that more than 50% of the "merged" "takeover" company and "target" company would be owned by the shareholders of the "takeover" company.

It is not uncommon in Canada for a "reverse takeover" bid to result in allegations that the conduct of the directors and officers was "oppressive or unfairly prejudicial" to the shareholders. The remedy frequently sought is the company's re-purchase of the dissenting shareholders' holdings. The lawsuit will complain that the directors and officers acted solely out of their own interest without having regard to the best interests of the shareholders.

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

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

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

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The decided Canadian cases generally conclude that in a sale of goods, a "sale" for consideration other than money is merely an "exchange" and not a "sale". In transactions not involving a sale of "goods", including a sale of shares, an exchange involving consideration other than money is a "sale". The legal position is best summarized in an older case, decided in England, *The South Australian Ins. Co.* v. *Randall*[45], where it was held:

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

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

(C) SECURITIES CLAIMS NOT SUBJECT TO PRE-DETERMINED ALLOCATION:

Yet another issue that commonly arises in Canada occurs when the D & O insurer includes a pre-determined defence cost allocation but excepts from the pre-determined defence costs any "claim" that amounts to a Securities Claim. That means, in practical terms, that the insured and the D & O insurer will have to agree upon a suitable allocation approach. So, for example, if a claim alleged that a shareholder was barred from tendering its shares as part of a corporate repurchase and sustained damages by reason of that wrongful refusal, the question would arise whether that claim for damages amounts to a Securities Claim. Coverage for Securities Claims only covers the sale of shares purchased through a stock exchange or a primary offering under a prospectus.

The introduction of Entity Coverage for Securities Claims has not elimintaed every issue that could arise and in fact has spawned a new generation of coverage issues yet to be judicial examined in Canada.

[45] *The South Australian Ins. Co.* v. *Randall* (1869), L.R. 3 P.C.

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12. IS ENTITY COVERAGE FOR SECURITIES CLAIMS IN THE BEST INTERESTS OF THE D & OS?

The introduction of Entity Coverage for Securities Claims, while initially welcomed by "corporate Canada", did create problems. In fact, the problems are such that many underwriters and their insureds have moved away from Entity Coverage. While Entity Coverage was very "fashionable" in the late 1990's to 2001, the reality of Encon and Worldcom corporate collapses brought home to independent directors how problematic Entity Coverage can be.

This portion of the paper will examine the most frequent criticism of Entity Coverage for Securities Claims.

(A) DILUTION OF COVERAGE:

With the increased frequency of Securities Claims following the decline of North American stock market trading prices in 2001, directors and officers began to recognize that Entity Coverage for Securities Claims could result in an accelerated dilution of the policy limits. This dilution could occur in one or two ways. Firstly, directors noted that ongoing defence costs increased dramatically if each of the company and the directors and officers were retaining separate defence counsel. Secondly, given the limited substantive defences afforded to the "issuer" (i.e. the company) as compared with the directors and officers that had "due diligence" defences, more often than not the D & O insurer would have to make a substantial payment to resolve the company's exposure even if the directors and officers had a "defensible case".

Views differed on the wisdom of having Entity Coverage. Typically, "inside management", being officers who were named as defendants, favoured Entity Coverage since their conduct and that of their non-insured senior management group was retired by means of Entity Coverage. In contrast, "outside independent directors" did not favour Entity Coverage. Independent directors often take the view that the D & O policy should be for the sole benefit of the directors and officers to the exclusion of the company. Many independent directors believe that any corporate exposure should be paid from corporate assets and income, not from the D & O insurance policy. The problem is compounded if in the context of a single policy year there are multiple claims and some of those claims solely concern the directors whereas other claims "trigger" the Entity Coverage. If the aggregate value of the claims exceed the policy limits, the question arises as to which claims should have the benefit of the policy. Absent a priority of payments clause, and

given the Canadian adoption of the "first past the post rule"[46], the directors face the risk that the policy could be entirely expended on defence costs and settlements incurred by the company thus leaving the directors without coverage for claims that they alone confront. This is worrisome to outside directors.

(B) INCREASED RISK OF THE D & O POLICY BEING VOIDED:

By 2003 D & O insurers were generally affording full "severability" for directors and officers. "Severability" operates at two levels: in the application for D & O insurance and in the application of the policy exclusions should a claim arise. In general terms a "severability clause" is intended to ensure that a misrepresentation, policy breach, or an exclusion that may operate in relation to a particular director or officer does not cause another director or officer to lose coverage if that other director or officer is non-culpable (what some Canadian Judges refer to as an "innocent co-insured").

Severability in the application for D & O insurance can take various forms. An example of what the industry refers to as a "partial severability" clause[47] is this wording:

> *[I]n the event that the Application, including materials submitted therewith, contains misrepresentations made with the actual intent to deceive, or contains misrepresentations which materially affect either the acceptance of the risk or the hazard assumed by the INSURER under this Policy, this Policy in its entirety shall be void and of no effect whatsoever; and provided, however, that no knowledge possessed by any DIRECTOR or OFFICER shall be imputed to any other DIRECTOR or OFFICER except for material information known to the person or persons who signed the Application. In the event that any of the particulars or statements in the Application is untrue, this Policy will be voided with respect to any DIRECTOR or OFFICER who knew of such untruth.* [emphasis added]

An example of what the industry refers to as a "full severability" clause reads as follows:

> *It is further understood and agreed by the Company and the Directors and Officers that the statements in the Application Form or any information provided herewith are their representations; provided however, that expect for material facts or circumstances known to the person who subscribed this Application Form, any misstatement or omission in the Application Form or information provided herewith*

[46] *Laidlaw Inc, Re* (2003), 46 C.C.L.I. (3d) 263 (Ont.Sup.Ct.); *Solway v. Lloyd's Underwriters* (2005), 22 C.C.L.I. (4th) 138 (Ont.Sup.Ct.); *Commerce and Industry Insurance Co. Canada v. Singleton Associated Engineering Ltd.*, [2006] 6 W.W.R. 723 (Alta.Q.B.).

[47] *Cutter & Buck, Inc. v. Genesis Ins. Co.* (2004), 306 F.Supp.2d 988, W.D. Wash., 2004.

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> *in respect of a specific Wrongful Act by a particular Director or Officer or his or her cognizance of any matter which he or she has reason to believe might afford grounds for a future Claim against him or her shall not be imputed to any other Director Officer for purposes of determining the validity of this Policy as to such other Director or Officer.* [emphasis added]

Representative of a typical "severability clause" in the application of the policy exclusions is this wording:

> *Notwithstanding any contrary provisions contained in this policy, it is understood and agreed that Insuring Clause I.A. shall apply to Directors and Officers as if a separate policy was issued to the Directors and Officers and shall apply as if a separate consideration had been paid by the Directors and Officers for this policy.*

Severability operates easily with natural persons. If a D & O insurer agrees that the knowledge of one director or officer is not imputed to another director or officer in terms of any representation in an application for insurance, or, in relation to any of the "conduct exclusions" (i.e. – fraud, profit or advantage) then upon a "claim" being made the D & O insurer is merely required to determine the state of mind of each director and officer in determining whether he or she is afforded coverage. This investigative process of directors and officers has given rise to the term "white hats" and "black hats". These labels are used at the liability level, and secondly, at the coverage level with "black hats" being those directors and officers who mislead the D & O insurer either in the application, or, who are ultimately denied coverage because their conduct runs afoul of a particular "conduct exclusion" (such as fraud or the improper taking of "profit or advantage").

However, with the introduction of Entity Coverage for Securities Claims, D & O insurers had to address the issue of "*Whose knowledge is to be imputed to the company for the purpose of Entity Coverage*?" In essence, the D & O insurer, in providing Entity Coverage, has to address the range of persons whose knowledge will be imputed to the company in determining whether the company mislead the D & O underwriter in completing the application for D & O insurance. Secondly, the D & O insurer has to address whose knowledge will cause the company to lose Entity Coverage for any Securities Claims by reason of an exclusion clause.

The spectre of Entity Coverage for Securities Claims necessarily raised the issue of whether senior management's preparation and submission of knowingly untrue financial statements would cause the company to lose the benefit of any Entity Coverage. As one D & O insurer has remarked:

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"The financial soundness of a corporation is one of the most critical assumptions made in an underwriter's decision to put his/her company's capital at risk for the directors and officers for that particular corporation. Regardless of the innocence of guilt of individual directors or officers as to the accuracy of the financial statements, if the corporation's financial statements are inaccurate, then the risk as presented to the underwriter is misrepresented. As in any contract that relies upon information that was incorrect, the party relying upon that information has an obligation to its own shareholders to seek appropriate remedies, which could include rescission of the contract. The contract of D & O insurance is no different." [48] [emphasis added]

In general terms what D & O insurers have undertaken with the advent of Entity Coverage is to delineate in the D & O policy those persons within senior management whose knowledge will be imputed to the company for the purpose of determining whether the company, as distinct from its directors and officers, has mislead the D & O underwriter at the application stage either by reason of the answers to particular questions, or, by knowingly submitting false financial statements with the D & O application for insurance.

The need to delineate the management members whose knowledge is imputed to the company has become more acute as both the United States and Canada have increased the requirements for senior management to certify the accuracy of their audited financial statements. These regulatory and legislative measures, designed to protect shareholders, are increasingly being relied upon by D & O underwriters as a basis for voiding the D & O policy if in fact these statements are knowingly untrue.

Representative of some of the policy wordings that exist in the Canadian market with a "conduct exclusion" that addresses the issue of severability include the following:

"The Insurer shall not be liable to make any payment for Loss in connection with a Claim made against an Insured:

(c) arising out of, based upon or attributable to the committing in fact of any deliberate criminal or deliberate fraudulent act by the Insured."

For the purpose of the "fraud exclusion" the D & O policy then addresses the attribution of management's knowledge by stating:

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[48] American International Group, Inc., Coverage Insights-D & O First (2002) online at http://www.aig.com/boardmember/aig_do_white_paper.pdf

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"For the purposes of determining the applicability of the foregoing exclusions … the facts pertaining to and knowledge possessed by any Insured shall not be imputed to any Natural Person Insured; only facts pertaining to and knowledge possessed by any past present or future chairman of the board, president, chief executive officer, chief operating officer or chief financial officer of the Company shall be imputed to the Company."

Yet another Canadian D & O insurer uses an "attribution of knowledge" clause that reads:

*For the purposes of the coverage afforded to the **[Company]** by Insuring **Clause C** and exclusions **Clause A.** and **Clause C.** the knowledge possessed by the Chairman, Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, Chief Information Officer, Chief Legal Officer or President shall be imputed to the **[Company]** to determine if coverage is available.*

The ability of the D & O insurer to void the policy by reason of any misrepresentation attributable to the senior management, or, to void the company's coverage for any Entity Claim, or, contend that the company loses any Entity Coverage by reason of the fraud of senior management poses a significant risk to the company. It raises, as well, the spectre that those senior management members, who are also directors and officers, will lose their own coverage.

(C) PROBLEMS IN THE EVENT OF INSOLVENCY OR BANKRUPTCY:

Under Canadian bankruptcy law when a company files into bankruptcy or is placed in bankruptcy by a petitioning creditor all of the bankrupt's "property" comes under the administration of the bankruptcy trustee. At a minimum, the bankrupt's "property" includes all of the bankrupt's property, wherever situated, at the date of his bankruptcy plus whatever property may be acquired by or devolve on it before its discharge.

The scope of the Trustee's reach extends beyond merely what the bankrupt owned. Some have argued that by reason of s. 67 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985 c. B-3 that the bankruptcy trustee has no right to administer property that, at the time of bankruptcy, the bankrupt held in trust for another person. Section 67 reads in material part as follows:

"67(1) The property of a bankrupt divisible among his creditors shall not comprise

(a) property held by the bankrupt in trust for any other person,

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> *(b) any property that as against the bankrupt is exempt from execution or seizure under any laws applicable in the province within which the property is situated and within which the bankrupt resides, or*
>
> *(b.1) such goods and services tax credit payments and prescribed payments relating to the essential needs of an individual as are made in prescribed circumstances and are not property referred to in paragraph (a) or (b),*
>
> *but it shall comprise*
>
> *(c) all property wherever situated of the bankrupt at the date of his bankruptcy or that may be acquired by or devolve on him before his discharge, and*
>
> *(d) such powers in or over or in respect of the property as might have been exercised by the bankrupt for his own benefit".*

Canadian courts have concluded that although a bankruptcy trustee is not permitted to divide trust property among a bankrupt's creditors, it may still "administer" that property and in some cases obtain a charge on the trust property to ensure it is paid for doing so. In *Ramgotra (Trustee of) v. North American Life Assurance Co.*[49] the Supreme Court of Canada confirmed that trust property becomes part of the bankrupt's estate in the possession of the trustee. Similarly, in *Kingsway General Insurance Company v. Residential Warranty Company of Canada Inc. (Trustee of),*[50] the court held that a bankruptcy trustee may administer trust property and in some instances obtain a charge for doing so.

While not the subject matter of any decided cases in Canada, there is a viable argument that the proceeds of a D & O policy, including the advancement of defence costs during the currency of the administration of the bankruptcy, constitute part of the "property" of the bankrupt estate and are thus beyond the ability of the D & O insurer to administer of its own accord, or, even at the request of the directors and officers. Obviously this potential constraint only arises when it can fairly be said that the claim properly "triggers" Entity Coverage. The legal concept is that Entity Coverage is a corporate asset whereas the director and officer coverage is not a corporate asset.

Arguably, if the D & O policy and its proceeds form part of the "property" of the bankrupt under Canadian bankruptcy law it will be within the discretion of the bankruptcy Trustee, together with any judicial directions granted by the presiding bankruptcy Judge as to how these policy proceeds are to be dispersed. This can cause considerable anxiety to directors

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[49] *Ramgotra (Trustee of) v. North American Life Assurance Co.*, [1996] 1 S.C.R. 325

[50] *Residential Warranty Company of Canada Inc , Re*, 2006 ABCA 293

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and officers faced with the company's insolvency. The directors then confront the problem that their defence costs cannot be borne by the insolvent company, and secondly, the bankruptcy Trustee can exercise a discretion as to how the D & O policy proceeds are expended.

While not yet judicially considered in Canada, the dominant view in the United States is that the company's insurance policies, insofar as they afford coverage for the company (as distinct from merely the directors and officers) constitute "property" of the bankrupt.[51] In reaching this conclusion, however, the U.S. Courts have distinguished between who purchased and thereby owns the D & O policy, as distinct from who is the beneficiary of the policy proceeds. So, it creates a paradigm in which the Court is examining whether the proceeds are being paid on account of the company by reason of an Entity Coverage claim, or whether the policy are proceeds merely being paid to the company to reimburse the company for "Loss" that the company is obligated to pay to its directors and officers on account of the latter's own liability.[52]

Admittedly, there are exceptions to this general rule in the United States. For example, if the D & O policy includes Entity Coverage for Securities Claims and the company becomes insolvent a bankruptcy Court may not view any prospective "Loss" as constituting "property" of the bankrupt if in fact there is no immediate prospect of "Loss" being paid on account of a Securities Claim.[53] So, simply put, there is an argument that while the "Side A" coverage is the property of the directors and officers, the "Entity Coverage" is the property of the insolvent company and, possibly, any "corporate reimbursement" rights by reason of the Side B coverage.

In the Canadian context the last thing a director and officer wishes to confront when the company is in bankruptcy is the spectre of the Trustee in Bankruptcy issuing a directive to the D & O insurer not to expend any monies available under the D & O policy on the premise that they may constitute "property" of the bankrupt. It is exactly this situation in which directors and officers are most needing of defence cost funding. Its absence at the direction of the Bankruptcy Trustee will, in many cases, make it very difficult for directors and officers to defend themselves against allegations that may entail personal liability.

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[51] *Re Youngstown Osteopathic Hosp Ass'n*, 271 B.R. 544 (Bankr. N.D. Oh. 2002), *Re Chiles Power Supply Co*., 264 B.R. 533 (Bankr. W.D. Mo. 2001); *In re First Central Financial Group* 238 B.R. 9 (Bkrtcy E.D.NY., 1999) at 16, affirmed 2002 U.S. Dist. LEXIS 22005 (E.D.N.Y. 2000).; *In re Minoco Group of Companies., Ltd., 799 F.2d 517 (C.A. 9 (Cal), 1986).*

[52] *Duval v. Gleason*, No. C-90-0242-DLJ, 1990 U.S. Dist. LEXIS 18398 (N.D. Cal. 1990); In *re Daisy Sys. Sec. Litig*. 132 B.R. 752 (N.D. Cal. 1991); In *re Florian* 233 B.R. 25 (Bankr. Conn. 1999)

[53] *In re First Central Financial Corp*., *supra*.

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This aspect of Entity Coverage is more than an academic concern since Canadian insolvency and bankruptcy law, in some circumstances, permits claimants to continue their claim against the directors and officers notwithstanding that there may exist a stay of proceedings that as against the insolvent or bankrupt company. For that reason it is instructive to examine recent Canadian cases on this point.

(i) Bankruptcy is a bar to suing the directors and officers:

The Ontario Superior Court has considered various provisions of the *Companies Creditors Arrangement Act* ("*CCAA*")[54] in *Coopers & Lybrand Ltd.* v. *Canadian Imperial Bank of Commerce*[55] in examining this issue. In that case, the directors and officers of the insolvent company were named as third parties for losses due to allegedly unauthorized pledges or promises of shares and other assets of the company undertaken by the directors and officers as security for personal loans. The proposal, which contained various compromises of creditors' claims, including those in respect of the subject shares, was approved by court order.

The Court concluded that since the proposal had been approved all of the creditors and classes of creditors were bound by its terms. The Court further determined that it would be inappropriate for the claimants to be allowed to continue their action against the directors and officers as this would potentially result in double recovery.

Greer J. did not refer specifically to the stay provisions of the *CCAA* when denying the claimants the opportunity to recover from the third party directors and officers. However, the case can be seen as authority for the view that a *CCAA* proposal can bar the claims against the directors and officers.

(ii) Bankruptcy is not a bar to suing the directors and officers:

The Ontario Court of Appeal considered Section 5.1(2) of the *CCAA* and Section 50(14) of the *BIA* in *NBD Bank, Canada* v. *Dofasco Inc.* (*"NBD Bank"*).[56]

The *NBD Bank* case involved a situation where a company and one of its officers were sued by a bank for negligent misrepresentation. The company and the officer had deceived the bank into believing they had assets to repay the loan for which they were applying. The bank relied on those untruthful statements in issuing the loan. When the

[54] *Companies Creditors Agreement Act*, R.S.C. 1985, c. B-3.
[55] *Coopers & Lybrand Ltd.* v. *Canadian Imperial Bank of Commerce,* [1999] O.J. No. 4274, 1999 CarswellOnt 3571 (Sup.Ct.).
[56] *NBD Bank, Canada* v. *Dofasco Inc.* (1999), 181 D.L.R. (4th) 37, [1999] O.J. No. 4749 (Q.L.)(C.A.)

company was subsequently restructured under the *CCAA*, the bank was unable to recover the loan proceeds. Under the restructuring plan the bank was barred from bringing an action for misrepresentation against the corporate defendant. The officer also sought to have the action against him barred on the grounds that if it were to proceed, the restructuring process would be subverted.

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

> …*[The CCAA and the BIA] contemplate that an arrangement or proposal may include a term for compromise of certain types of claims against directors of the company except claims that "are based on allegations of misrepresentations by directors". L.W. Houlden and C.H. Morawetz, the editors of The 2000 Annotated Bankruptcy and Insolvency Act (Toronto: Carswell, 1999) at p. 192, are of the view that the policy behind the provision[s] is to encourage directors of an insolvent corporation to remain in office so that the affairs of the corporation can be reorganized. I can see no similar policy interest in barring an action against an officer of the company who, prior to the insolvency, has misrepresented the financial affairs of the corporation to its creditors.*[57] [emphasis added]

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

> … *it would seem to me that it would be contrary to good policy to immunize officers from the consequences of their negligent statements which might otherwise be made in anticipation of being forgiven under a subsequent corporate proposal or arrangement.*[58]

The Court, therefore, allowed the action against the insolvent company's officer to continue despite the insolvency of the company.

When one examines both of these decisions, the approach adopted by the Ontario Courts would suggest that generally a stay can be obtained in favour of a director and officer unless the Court is satisfied that the directors' and officers' potential liability was

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[57] *NBD Bank, Canada* v. *Dofasco Inc.* (1999), *supra*, at para. 54.
[58] *Ibid*, at para.54.

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undertaken in contemplation of an insolvency, and in the expectation that the tort liability would be eliminated by reason of the company's insolvency.

13. AVOIDING THE PROBLEMS STEMMING FROM A CORPORATE INSOLVENCY:

D & O insurers in the United States have been fairly creative in developing new approaches to overcome the problems inherent in the accelerated dilution of policy limits created by Entity Coverage, and secondly, insolvency impediments to defence cost funding. This portion of the paper will review the most common D & O policy provisions designed to guard against these problems.

(A) THE USE OF A "PRIORITY OF PAYMENTS" CLAUSE IN THE D & O POLICY:

To minimize the likelihood of the D & O policy proceeds being dissipated by Entity Coverage for Securities Claims, particularly if there are multiple claims in a single policy year that collectively exceed the policy limits, directors and officers can request that the D & O policy include a "priority of payments" clause (sometimes referred to as an "order of payments" clause). A "priority of payments" clause permits a bankruptcy trustee or a Judge to make a determination that the "non-entity" claims ought to be paid in priority to any Entity Claims. The need for a "priority of payments" clause is particularly acute with the Canadian judicial adoption of the "first past the post" approach when multiple claims arise.[59]

Generally, by 2001 most D & O insurers implemented policy wordings that ensured any "Loss" was paid first on account of the directors and officers, secondly on account of any "B side" corporate reimbursement claims and, thirdly, for the company's own "Loss" on account of any Securities Claims. A typical "priority of payments" clause that accords priority to the "non-entity" claims will read:

> ***IN CONSIDERATION*** *of the premium charged for this Policy and the Directors & Officers and Insured Organization Coverage Section (this "Coverage Section"), it is hereby understood and agreed that payment under the Policy shall occur as follows:*
>
> *1. In the event of* ***Loss*** *on account of a* ***Claim(s)*** *for which payment is due under this Policy and this Coverage Section which in the aggregate exceeds the*

[59] *Laidlaw Inc, Re,* supra; *Solway v. Lloyd's Underwriters*; *Commerce and Industry Insurance Co. Canada v. Singleton Associated Engineering Ltd.*, all *supra*.

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available or remaining available Limit of Liability, the Insurer shall pay such ***Loss*** *under this Policy and this Coverage Section in the following priority:*

(i) *first to satisfy* ***Loss****, if any, on account of a* ***Claim(s)*** *for which coverage is provided under Insuring Clause A of this Coverage Section;*

(ii) *secondly to satisfy* ***Loss****, if any, on account of a* ***Claim(s)*** *for which coverage is provided under Insuring Clause B of this Coverage Section; and*

(iii) *if there is a remaining amount of the Limits of Liability available after payment of any such* ***Loss****, pursuant to either subparagraphs 1(i) and (ii) above, if any, to satisfy any* ***Claim(s)*** *for which coverage is provided under Insuring Clause C of this Coverage Section.*

The risk inherent to a "priority of payments" clause is that a Judge will view the clause as giving the directors and officers a preference in relation to any "non-entity" claims by subordinating any claims triggering Entity Coverage. To the limited extent that the U.S. Courts have examined this issue there is an indication that a priority of payments clause can be effective in a situation involving a bankrupt company.

In *Re Enron Corp.*,[60] which has wide notoriety in business circles, the issue arose as to whether a U.S. bankruptcy court would give effect to a "priority of payments" clause in circumstances wherein the bankrupt company had the benefit of Entity Coverage. The primary D & O insurer agreed to advance defence costs to the directors and officers conditional upon approval by the bankruptcy court. Enron's creditors' committee, however, opposed the advancement of defence costs to the directors and officers. They took the position that the Entity Coverage practically meant that the directors and officers were dissipating the property of the bankrupt company. The primary D & O policy contained a "priority of payments" clause requiring that A side claims be paid ahead of any "Loss" otherwise payable to the bankrupt company on account of a Securities Claim.

Notwithstanding the objections of the creditors' committee on behalf of the bankrupt company, the Court granted an Order permitting the advancement of defence costs to the outside directors and officers.[61] Similarly, in the high profile insolvency of Adelphia Communications the bankruptcy court permitted the advancement of defence costs.[62]

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[60] *In re Enron Corp*. 2002 Extra LEXIS 411 (Bankr. S.D.N.Y.)
[61] *Ibid*
[62] *In re Adelphia Communications Corp*. 285 B.R. 580 (Bankr. S.D.N.Y. 2002)

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(B) THE USE OF A "WAIVER OF STAY" CLAUSE IN A D & O POLICY:

Yet another approach to minimize the risk that directors and officers will lose defence cost funding in the event of a bankruptcy or insolvency, in the context of a policy that includes Entity Coverage, is to include a "waiver of stay" clause in the D & O policy. The purpose of this type of clause is to have the company agree, when the policy is issued and prior to any bankruptcy or insolvency, to waive any substantive provisions incidental to bankruptcy law with respect to the D & O policy.

Canadian courts have not examined whether such a clause could be effective in the face of any substantive provisions in the *BIA,* so its effectiveness is yet unclear in Canada.

A typical "waiver of stay" clause will read:

> *"If the Company is rendered bankrupt or insolvent either by reason of the Bankruptcy and Insolvency Act, R.S.C., or, by reason of proceedings under the Companies Creditors Arrangement Act, R.S.C., the Insureds hereby waive any stay of proceedings afforded by reason of this legislation and agree not to oppose or object to any efforts by the Insurer or any Insureds to obtain mandatory defence cost reimbursement in the event of a covered Claim."*

There is a significant body of U.S. caselaw which invites the conclusion that a "waiver of stay" clause will be enforced by a bankruptcy court.[63] However, there exists a minority of U.S. cases that have reached the opposite conclusion.[64] To the knowledge of the writer this issue has not yet been clearly examined by a Canadian Judge. However, as insolvency trustees in Canada become increasingly aware of some of the same D & O insurance issues emerging in the U.S. market it is reasonable to expect that a Canadian Court will be required to examine this issue in the not too distant future.

14. IS ENTITY COVERAGE FOR SECURITIES CLAIMS NECESSARILY "LOSS" AS DEFINED IN THE POLICY?

In the context of a Securities Claim there is the spectre of a legal exposure for the purpose of the D & O policy in an underlying action seeking monetary recovery which do not

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[63] I*n re Excelsior Henderson Motorcycle Mfg. Co., Inc*. 273 B.R. 920 (Bankr. S.D. Fla. 2002); *In re Shady Grove Tech Ctr. Assocs. Ltd. Partnership*, 216 B.R. 386 (Bankr. D. Md. 1998); *In re Merridale Gardens Ltd. Partnership*, 1996 U.S. Dist. LEXIS 22042 (D. Md. 1996); *In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994).

[64] *In re Trans World Airlines, Inc*. 261 B.R. 103 (Bankr. D. Del. 2001); In *re Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996); *In re Jenkins Court Assocs. Ltd. Partnership*, 181 B.R. 33 (Bankr. E.D. Pa. 1995).

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constitute "Loss" (as that term is defined in the D & O policy) despite the characterization of the underlying action as a Securities Claim.

From a claims' standpoint, the most common problems arise from the following situations:

(a) a Securities Claim that seeks disgorgement from the company and its directors and officers, including a judicial requirement to return the original share purchase proceeds;

(b) situations involving private companies that make a misrepresentation when selling their shares and the purchaser seeks the return of the original purchase price and consequential loss as damages, including (i) the assumption of bank debt, and (ii) recovery of taxes paid; and

(c) companies improperly divesting the proceeds from a share transaction to third parties and having to return the monies on the basis of a fraudulent conveyance or fraudulent preference.

Both Canadian and U.S. Courts have examined whether restitutionary claims are properly "Loss" (as defined in the D & O policy) even if they amount to a Securities Claim. In general terms the dominant approach is that claims entailing the payment of damages borne by the company do amount to "Loss". However, if the company is, in substance, merely returning monies or property to which was not entitled to from the outset, then such restitutionary relief does not amount to "Loss" under the D & O policy.

Typically the definition of "Loss" in a D & O policy reads:

> *"**Loss**" shall mean compensatory damages, punitive or exemplary damages, the multiple portion of any multiplied damage award, settlements and **Costs of Defense**, provided, however, **Loss** shall not include criminal or civil fines or penalties imposed by law, taxes, or any matter which may be deemed uninsurable under the law pursuant to which this Policy shall be construed. It is understood and agreed that the enforceability of the foregoing coverage shall be governed by such applicable law which most favors coverage for punitive or exemplary damages or the multiple portion of any multiplied damage award. **Loss** shall also not include any portion of damages, judgments or settlements arising out of any **Claim** alleging that the **Company** paid an inadequate price or consideration for the purchase of the **Company's** securities.*

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"Loss" as defined in a D & O policy differs materially from any concept of indemnity used in more traditional indemnity policies. In the context of a general liability policy the obligation to indemnify generally arises if the insured is "obligated by law" to pay "damages" (or "compensatory damages") caused by an "occurrence". This formulation of words is generally accorded a much wider meaning than the term "Loss" as used in a D & O policy.

The concept of "Loss" in a D & O policy needs to be understood from the standpoint of traditional principles of Canadian insurance law. Among the basic tenets of insurance law is that losses must be both fortuitous and contingent to be capable of indemnity. As the Supreme Court of Canada stated in *Lloyd's of London v. Scalera*:[65]

> *"Insurance is a mechanism for transferring fortuitous contingent risks. Losses that are neither fortuitous nor contingent cannot economically be transferred because the premium would have to be greater than the value of the subject matter in order to provide for marketing and adjusting costs and a profit for the insurer. It follows therefore that where the literal wording of a policy might appear to cover certain losses, it does not, in fact, do so if (1) the loss is from the inherent nature of the subject matter being insured, or (2) it results from the intentional acts of the insured."*

The meaning of "Loss" for D & O claims is crucial, as the term "Loss" is usually the trigger for reimbursement under a D & O policy. The Courts have refined what "Loss" includes and stated that it requires that the damages claimed flow from a "Claim" that truly entails an economic deprivation to the insured.

In the United States insurers have successfully persuaded the courts that certain indemnity or reimbursement exposures resulting from misrepresentation are restitutionary in nature and, thus, not "Loss". The underlying rationale is that if the damages sought are merely a method for purging a profit which was wrongfully obtained by the insured through its own conduct, then the insured should not be reimbursed or "compensated" by the insurer for this activity. Essentially, if the insurer were to pay the claim, the effect would be to allow the insured to profit from its wrongful action. Therefore, an insured would have an incentive to lie, cheat and steal, as it would recover any potential profit whereas any potential risk would be passed off to the D & O insurer. One author stated:

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[65] *Lloyd's of London v. Scalera* (2000), 185 DLR (4th) 1 (S.C.C.), 2000 SCC 24, [2000] 1 S.C.R. 551.

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"This argument is based on the principle that a settlement that merely returns an amount improperly obtained by the insured – an "ill-gotten gain" – should not be a covered loss."[66]

In *Level 3 Communications, Inc. v Federal Insurance Company*,[67] the United States Court of Appeals concluded that the D & O insurer was not responsible for the settlement of a Securities Claim as the settlement monies "*represent[ed] the disgorgement of profits to which insured corporation was never entitled*."

In a fiduciary liability context, the Quebec Superior Court in *Universite Concordia v Compagnie D'Assurance London Guarantee*[68] applied the same doctrine. The University had made unilateral changes to its employee pension plan which reduced benefits and created a $71 million surplus that the University appropriated. When the employees sued to recover the pension surplus the University turned to its liability insurer for coverage against the claim. The Court concluded that the claim could not be considered a "Loss" (as defined in the policy) for insurance purposes since there were no damages flowing from a fortuitous event. The Court explained that the goal of insurance was to compensate insureds for losses suffered by them, not to enrich them, and concluded that to allow coverage for this claim would permit the University to finance its pension plan by means of its insurer.

It is important to appreciate that the extension of Entity Coverage for Securities Claims does not invite the conclusion that all Canadian statutory Securities Claims are necessarily entirely within coverage, notwithstanding that the entity has coverage for such claims. Damage claims are properly "Loss" but not necessarily restitutionary claims.

15. HOW ARE CANADIAN DIRECTORS AND OFFICERS RESPONDING TO ENTITY COVERAGE?

Earlier in this paper it was noted that Entity Coverage is losing popularity. Increasingly outside directors, who are assuming responsibility for the D & O insurance program from "inside management", are questioning whether a D & O policy should be used to retire a purely corporate exposure as opposed to the directors' and officers' personal liability.

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[66] Black Jr., John E. and Ellen D. Jenkins, Policy Limitations on Coverage: A D&O Trend in a Hard Market from the International Risk Management Institute, http://www.irmi.com/Expert/Articles/2003/Black04.aspx, citing *Central Dauphin School District v American Casualty Co.*, 426 A.2d 94 (Pa., 1981).
[67] *Level 3 Communications, Inc. v Federal Insurance Company*, 272 F3d 908 (C.A.7 (Ill.) 2001)
[68] *Universite Concordia v Compagnie D'Assurance London Guarantee*, 34 C.C.P.B. 112, [2002] R.R.A. 1212 (Que.S.C.)

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Compounding the problem is the reality that in the context of a Securities Claim the entire policy proceeds can be dissipated solely on account of the company's legal costs without regard to what costs might be incurred by the directors' and officers' separate legal counsel. It forces a "race of the swiftest" to see who can avail themselves of the available policy proceeds. The directors and officers could find that the settlement of an Entity Claim exhausts the entire policy proceeds even before consideration has been given to the directors' and officers' legal costs.

In response to these growing concerns the D & O insurance industry has developed three differing solutions (short of not purchasing Entity Coverage). These solutions will be briefly outlined below.

(A) PURCHASING NON-RESCINDABLE SIDE A COVERAGE:

One of the more significant "drivers" in removing or limiting Entity Coverage is the spectre that the D & O policy could be voided by reason of a misrepresentation or non-disclosure by the senior management team. While "severability" clauses tend to soften the blow, no independent outside director who was not a party to a misrepresentation or non-disclosure wants to run the risk of losing coverage in this manner.

In response to this risk some Canadian insurers are stipulating, for a premium amount, that the "Side A" coverage is incapable of being rescinded (or voided). The wording of such a clause could read as follows:

> *In consideration of the premium charged for this Policy, it is hereby understood and agreed that this Policy shall be non-rescindable with respect to Insuring Clause A.*

In practical terms this permits the D & O insurer to potentially void, solely in relation to the Entity Coverage, by reason of non-disclosure by the senior management team. It does not detract from the outside directors' ability to obtain Side A reimbursement for their personal liability. This feature proves very attractive if the policy is voided as to the Entity Coverage, and as well, the company, due to solvency constraints, is in fact unable to indemnify the directors.

(B) PURCHASING A SEPARATE SIDE A POLICY:

Yet another option for directors and officers concerned about potential dilution of policy limits by reason of the Entity Coverage, is to purchase their own dedicated "A side" policy that is issued separately from the company's D & O policy. The only "insureds" under a

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dedicated A side policy are the directors (not the officers). Some policy forms only insure the outside independent directors.

Customarily a dedicated "stand alone" Side A D & O policy will have a single insuring clause that provides:

> *"The Insurer will pay all **Contingent Loss** on behalf of any Independent Directors arising from any Claim first made against them during the Policy Period for any Wrongful Act committed by them in their capacity as Independent Directors."*

"Independent Director" is then defined as:

> *(a) any natural person who has been, now is or shall become a director of the **Company**, but who has not been, is not or does not become an officer or **Employee** of the **Company**, including de facto and shadow directors who are natural persons;*
>
> *(b) the estate, heirs and legal representatives of any **Independent Directors** in the event of their death, incapacity or bankruptcy in respect of any **Claim** against such **Independent Directors** otherwise covered under this policy; or*
>
> *(c) the lawful spouse or common law partner of any **Independent Director**, but only to the extent the spouse or common law partner is a party to any **Claim** solely in his or her capacity as spouse or common law partner of any such **Independent Director** and only for the purposes of any **Claim** seeking damages recoverable from marital community property, property jointly held by any such **Independent Director** and the spouse or common law partner, or property transferred from any such **Independent Director** to the spouse or common law partner, including their estates, heirs, legal representatives or assigns in the event of their death, incapacity, insolvency or bankruptcy.*

Generally the term "Contingent Loss" (or a similar term) will cover "Loss" that falls within the following parameters:

> (a) which the company is legally prevented from indemnifying the Independent Directors;
>
> (b) which the company is incapable of indemnifying the Independent Directors by reason of the company's own insolvency; or

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(c) which is in excess of the policy limits of the company's underlying D & O policy, and for which there is no other insurance.

Side A policies typically contain severability clauses and are not rescindable, thereby providing added protection for directors. They do not, however, typically provide "drop down" coverage in circumstances where there is no coverage available from the underlying D & O primary insurer.

The primary benefit to directors or independent directors in purchasing a Side A policy is that there remains a separate, dedicated pool of insurance monies that will not be eroded by the entity's liability for a Securities Claim.

(C) PURCHASING A SEPARATE EXCESS, DIFFERENCE IN CONDITIONS ("DIC") SIDE A POLICY:

A relatively recent development, largely in response to the wide scale securities fraud cases including Enron and Worldcom, is an excess DIC Side A policy. The features in this policy overcome many of the concerns inherent in Entity Coverage.

The most common characteristic of this type of policy is that the policy proceeds are exclusively for the benefit of the directors and officers and are not available for any Entity Coverage. Secondly, the policy will typically contain a provision that it can be invoked notwithstanding an insolvency of the company or an insolvency of the company's D & O insurer.

Not unlike the "pure side A form", this type of policy ensures that there is a dedicated set of limits for claims that are not capable of indemnification under the company's D & O policy whether by reason of prior Entity Claims or exhaustion of the underlying D & O policy limits due to defence costs and other claims payments.

While the product offerings in the Canadian market vary to some degree typical features include the following:

(a) is incapable of being voided

(b) does not assume that the company can, in fact, indemnify its directors and officers thereby avoiding the requirement that the directors and

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officers look firstly for corporate indemnification to secure defence costs

(c) removes some common exclusions including the (a) bodily injury and property damage exclusion, and (b) the pollution exclusion to the extent that the claim entails a "pollution claim"

(d) provides for defence costs even if some of the "conduct exclusions", including fraud, would otherwise apply to the claim

(e) affords a liberalization of the "insured v. insured" exclusion

(f) removes the need to obtain the insurer's consent on issues such as the selection of defence counsel

(g) provides an excess layer of insurance over and above the company's D & O policy limits

(h) provides reimbursement if the company's D & O insurer refuses or is unable to pay the "Loss" (upon condition that the Side A/DIC insurer is subrogated to the rights of the directors and officers and can pursue recovery from the company's D & O insurer)

In its implementation, the policy wording will require that the policy "drop down" and reimburse the directors and officers for certain exposures that are otherwise excluded under the company's underlying D & O policy by reason of an exclusion. The extent to which the policy will "fill the coverage gap" varies from insurer to insurer.

Obviously this form of separate policy coverage is of particular interest to "outside" or "independent" directors who are concerned that Entity Coverage will unnecessarily dissipate the company's D & O policy proceeds.

16. SUMMARY AND CONCLUSIONS:

When the D & O policy was initially introduced into the North American market in the early 1970's, it was intended to merely afford coverage for the directors and officers of the company on the assumption that the company should use its own assets and income to satisfy any corporate legal liability. However, that supposition did not in fact prove to be true as many companies, faced with a legal exposure, elected to use a common defence counsel to defend both the company and the directors and officers. Secondly, and of greater financial significance, this assumption did not address whether any amount paid

by the D & O insurer on account of the directors and officers was intended to retire any concurrent or "overlapping" legal exposure faced by the company. Since the D & O insurers had not foreseen this problem by incorporating express allocation formulas into the D & O policy, we witnessed a decade of coverage litigation ending in the mid 1990's in which the Courts increasingly required the D & O insurers to retire the entire cost of a settlement or judgment even if the company incidentally benefitted by the removed of its legal exposure.

Faced with judicial results that directly or indirectly conferred a benefit to the company, D & O insurers began to expressly grant coverage for the company on account of Securities Claims. However, what the insurance industry could not foresee was directors and officers concerned that Entity Coverage, particularly for Securities Claims, would result in the dissipation of the policy proceeds at the expense of the directors and officers. Today many directors and officers in Canadian publicly traded companies share the view that the D & O policy was never intended to expressly confer coverage for the company and to do so reduces the policy's potential to act solely for the financial benefit of the directors and officers. In response to this concern, D & O insurers today are being asked to provide a wider range of insurance products to counteract the increasing reality of the D & O policy being used to retire any corporate legal exposure. Many within the industry view the next decade as a period in which dedicated Side A policies, and a combination of dedicated excess Side A policies with a "DIC feature", will serve as the long term solution for directors and officers who want to ensure that there are dedicated policy limits available only to those responsible for corporate governance.

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