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CAN A LAW FIRM BE LEGALLY LIABLE FOR A LAWYER'S WORK ON AN OUTSIDE BOARD OF DIRECTORS?

BY RYAN K. DIX

When Directors and Officers get sued they typically look to the company to pay for their legal defence costs and to indemnify them for any award of damages that may be made against them. A company's obligation to provide defence and indemnity is typically found in the corporate by-laws and sometimes in indemnity agreements entered into between the company and its Directors and Officers as part of their compensation package. Corporate governance statutes in Canada also authorize companies to indemnify and advance defence costs where the Directors and Officers have acted in good faith and in the best interests of the company, and provides a mechanism for the Directors and Officers to seek an order from the Court compelling the company to advance defence costs.

However, recent developments in Canada have potentially expanded the spectrum of liability to capture law firms whose partners serve on the Board of an outside company, and who have been sued in their capacity as a Director or Officer. Further, these developments have also limited the circumstances in which a company must indemnify its Directors or Officers when they have been sued.

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I. Exposure for Lawyers Acting on Outside Boards

A popular trend for companies has been the addition of lawyers to sit on their Board of Directors. Indeed, lawyers are often invited to sit on the Boards of companies that they or their firm provide legal services to. For the lawyer, this has the benefit of potentially strengthening the relationship with the client, and for the company they benefit from a lawyer bringing their skills, acumen, and knowledge to Board meetings, and they can assist the Board with both legal and business matters.

However, Directors and Officers are often named personally in tort actions or for an alleged breach of fiduciary duty, and can become co-defendants with the company they serve. The trend, arising from some of the large corporate scandals of the 1990's, has been towards holding Directors personally responsible for acts of the company, in an attempt to force Directors to take increased responsibility for oversight of the company's operations. In general, the types of acts that may give rise to Director and Officer liability include the failure to pay or remit: (a) back wages and accrued vacation pay; (b) income tax withheld from employee wages; (c) provincial health care premiums which the company fails to collect; (d) employee and employer contributions to the federal pension plan; (e) employment insurance remittances; and (f) federal tax. In addition, Directors face liability for misrepresentations arising out of circulars and other documents governed by provincial securities legislation.

Thus a lawyer who serves as a Director or Officer does so at their own risk, as there is no special protection given to a lawyer sitting on an outside Board and they face the same potential statutory liability as non-lawyer Board members. In addition, provincially mandated lawyer's insurance programs do not provide insurance coverage for liabilities arising as a result of a lawyer's actions when acting as a Director or Officer. Indeed, insurance policies generally only insure persons in one's "capacity" so insureds must buy differing policies when acting in different roles.

As a result, lawyers sitting as Directors on outside Boards often obtain insurance protection to govern their potential liability. Often, a company maintains D&O liability coverage for the benefit of their Directors and Officers, which is paid for by the company. Law firms may also purchase Outside Directors and Officers Liability ("ODL") policies, which may be excess or primary, and provide coverage for lawyers who act as outside Directors. There is no doubt that a lawyer can face potential exposure as a Director of an outside Board, but until recently it was not thought that a law firm could be vicariously liable for the actions of one of its lawyers who serves as an outside Director.

Vicarious liability is a special type of tort liability. It is a form of strict liability, which does not require proof that the vicariously liable party committed or aided in the commission of the wrong. The reason for imposing vicarious liability on a party who has committed no wrong is policy based, and has been further enshrined in various statutes governing the activities of partnerships[1]. Courts have long recognized that since economic activities carry a risk of harm to others, fairness requires that those responsible for such activities should be liable to persons suffering a loss from wrongs committed in the conduct of those activities.

Historically, the possibility of a law firm being vicarious liability for a partner's work while sitting on an outside Board has not arisen in Canada. Consequently, ODL policies issued to law firms have generally not excluded or limited coverage to the law firm in any way. In other words, most policies have not required that the "wrongful act" which is required to trigger coverage, be committed by the firm itself.

However, a recent decision of the Ontario Superior Court has now raised the possibility of a law firm being vicarious liability for a partner's work while sitting on an outside Board. In *Allen v. Aspen Group Resources Company*[2], the Plaintiff sued Directors of Aspen Group Resources, alleging misrepresentation and failure to disclose material facts in a take-over bid circular, and sought a statutory remedy for misrepresentation under the Ontario *Securities Act*.[3]

Seeking summary judgment, the law firm involved in this case argued strenuously that it could not be liable for the lawyer's actions when acting as a Director unless, in carrying out his duties as a Director, he was carrying on the usual and ordinary business of the law firm. The law firm

[1] *Partnerships Act,* R.S.O. 1990, c. P.5, Section 11
[2] 2012 ONSC 3498
[3] R.S.O. 1990, c S.5

expressly noted the potential "chilling effect" that could arise in the event that employers and partnerships were exposed to class-action lawsuits based on potential statutory securities liability, in that lawyers would be much less willing to act as Directors on outside Boards.

However, in a surprising decision, the Court suggested that the law firm could potentially be found vicariously liable for the acts of a partner acting in his role as a Director of the outside Board, and concluded that the lawyer was in fact working in the ordinary course of the partnership when he sat at Aspen's boardroom table and when he signed the circular. The Court also concluded that to extend liability to the partnership fulfills the principles of the *Partnership Act* in that those who are responsible for the activities of a partnership and who profit from these activities, should be held accountable to persons who suffer wrongs committed in the conduct of the business.

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WHEN IS IT OKAY FOR A COMPANY TO HANG ITS DIRECTORS AND OFFICERS OUT TO DRY?

BY JILL M. SHORE

Traditionally, there has been a generally held belief that if a company has provided a contractual indemnity to its Directors or Officers that it is not necessary to meet the test of "acting in good faith and in the best interest of the company" in order for the advancement of defence cost funding. Rather, the payments would be made subject to repayment as required by the statute in the event that a Court finds that the conduct requirement has not been met. However, in *Cytrynbaum et al v. Look et al*[4], the Ontario Superior Court considered whether or not a company can refuse to advance defence costs, even though there was a contractual indemnity agreement in place, in circumstances

[4] 2012 ONSC 4578

where a Director or Officer has not met the "good faith" test.

II. When can a Company Refuse to Advance Defence Costs?

Look Communications Inc. ("Look") was a publically listed company that distributed wireless, internet, and cable services. As part of its compensation package, Directors and Officers were provided with rights to a share option plan (the "Option Plan") and a share appreciation rights plan (the "SAR Plan") that would arise if Look sold all or substantially all of its assets, which it did in 2009. Earlier in 2008, Look's business was in serious decline and the Board decided to sell substantially all of its assets pursuant to a Court supervised plan of arrangement. The arrangement was approved by shareholders in January 2009 and Look's key assets were sold for $80 million. The Board also authorized Look to vest all unvested options under the Option Plan to permit its Directors and Officers to exercise their options, and to compensate all SARs holders using the market price of Look's shares on the date prior to the Court approval of the sale.

In total, Look's Board approved payments in the amount of $20 million dollars, which consisted of $11 million dollars in severance and bonus payments to the Directors and Officers, and payments to discharge the Directors and Officers entitlements under the Option and SAR Plan, which was valued at an inflated share price of $0.40 per share. Suffice to say that when Look's shareholders were notified of these payments, they were not happy. The Board later authorized Look to issue payments in the amount of $1.5 million to defend the very same Directors and Officers, in relation to what was perceived as impending litigation. An investigation by Look was later undertaken, and a newly elected Board commenced an action against the former Directors and Officers alleging breach of fiduciary duty and sought repayment of the $20 million dollars.

The former Directors and Officers promptly demanded that Look advance them defence costs pursuant to the Look's by-laws and the indemnity agreements in place. However, Look refused, relying on a provision contained in the *Canada Business Corporations Act ("CBCA")*[5]. Look argued that it was only required to advance defence costs when a Court approves the transfer of funds upon

[5] R.S.C. 1985, c C-44

being satisfied that the "good faith" conditions prescribed by the *CBCA* have been met. Not surprisingly, the former Directors and Officers took the traditionally held position that advancement of these funds was mandatory pursuant to the contractual indemnity agreement.

In the case involving Look, the Court held that the *CBCA* provides a complete statutory code in circumstances where a company has sued its Directors or Officers or when they have been sued in a derivative action, and that the supervisory function of the Court cannot be contracted out of nor can an indemnity agreement exclude or infringe upon the Court's discretion to approve the advancement of defence costs as required by the *CBCA*. Further, the Court noted that it plays an important role in operating to protect the interests of both the company and its Directors and Officers, stating that:

> *Actions which have no merit should not delay advancement. On the other hand, directors or officers who have engaged in misconduct towards the corporation ought not to be allowed to use corporate funds to defend themselves.*
> …
> *In my view, requiring the court to scrutinize indemnification and advances in circumstances where a corporation has sued its former directors and officers ensures corporations cannot arbitrarily avoid indemnity or advancement obligations to former directors and officers who have acted in good faith and in the best interests of the corporation, while at the same time ensuring that directors and officers that have acted [in bad faith] to harm the corporation ought not to be able to draw upon the corporation to defend themselves.*

The Court went on to conclude that if, on its face, there is strong evidence to suggest that a Director or Officer has acted in bad faith and contrary to the best interests of the company (which can include acts of fraud, recklessness, misappropriation against corporate interests, and opportunistic or self-seeking behavior that displays a type of dishonesty), then this type of conduct should not be rewarded with an advancement of defence costs. In this case, the Court concluded that Look was not required to make an advance payment of defence costs because there was sufficient evidence of bad faith as: the share price of $0.40 per share used by the Board to calculate payments was considerably higher than the market value of Look's shares during the relevant time period ($0.13 - $0.27 per share); and the decision to issue defence payments in the amount of $1.5 million was selfserving, it light of the fact that Look had received legal advice that it was not in the best interests of the company to do so.

RAMIFICATIONS FOR INSURERS

The decision of the Court in *Allen* potentially exposes law firms to a myriad of securities claims brought against partners for acts committed in their role as Directors or Officers of an outside company. In other words, a law firm (and in practice its partners) may face liability in circumstances where it is unlikely that they have any knowledge of the acts undertaken by one of their partners while sitting on an outside Board. Because potential liability of this kind had not previously arisen, ODL policies issued to law firms have generally not excluded or limited coverage to the law firm in any way. However, for ODL underwriters, the question now becomes to what extent they want to introduce a limitation in coverage relating to the potential exposure of law firms.

The decision in *Cytrynbaum* is also important for a number of reasons, as it is the first case in Canada to squarely address the issue that it did. Firstly, it represents a shift in the law which may lead to more companies refusing to indemnify its Directors or Officers where the evidence strongly suggests that they have not acted in good faith and in the best interests of the company. The decision also codifies the circumstances when it may be appropriate to refuse to indemnify. However, the practical result of this decision will be to compel more companies to purchase D&O liability insurance.

D&O liability insurance typically provides two types of indemnity: (1) it reimburses Directors and Officers for defence costs and indemnity payments made by them directly in circumstances where the company is unable or unwilling to defend or reimburse them (often referred to as "Side A" coverage); or (2) it reimburses the company for defence costs and indemnity payments that the company has incurred on behalf of its Directors and Officers (often referred to as "Side B" coverage).

Typically in Canada, insurance brokers and CFO's believed that if there is an indemnity agreement in place, then a company is required to advance defence cost funding even if the conduct requirement has not been met. This requirement, it was believed, is subject only to an undertaking to repay the defence costs in the event a Court determines that the Directors or Officers were not entitled to the advancement. This led to the conclusion that so long as a company has sufficient resources to meet the cost of these claims, D&O liability coverage was unnecessary. On the other hand, D&O liability insurers have historically taken the view that a contractual indemnity agreement does not override the need to satisfy the conduct requirements before granting an indemnity, which is why Side A coverage is necessary.

Most claims currently arising under D&O policies in Canada are for Side B reimbursement coverage. However, if the case of *Cytrynbaum* results in more companies refusing to advance defence cost funding to its Directors and Officers, brokers may start to look for stronger policy language that requires mandatory defence cost funding. Dedicated Side A policies may also become more in demand, particularly by independent Directors. Similarly, if there is an increased risk of a company refusing to advance defence costs, D&O liability insurers should expect an increase in the number of Side A claims under D&O liability policies, and a decrease in the number of Side B claims. Side A claims typically have lower or no self-insured retention, whereas Side B claims typically have a much larger self-insured retention. If there is a shift in the types of claims made under these policies, pricing and retentions may need to be changed.

Further, if a company refuses to advance defence costs, but it is ultimately determined that the Director or Officer did act in good faith and in the best interest of the company, then D&O liability insurers that have paid out Side A claims may subrogate against the company to recover the retention that would otherwise have been payable if the claim had been properly paid as a Side B claim.

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