MARSH

FINPRO Practice

AN OVERVIEW FOR THE DIRECTORS EDUCATION PROGRAM

D&O INSURANCE COVERAGE



Introduction

The media is full of headlines which have made corporations, and particularly their directors and officers, take notice. Recent high-profile corporate scandals, significant fines and penalties levied under Foreign Corrupt Practices legislation, the sweeping changes made by the Dodd-Frank Wall Street Reform and Consumer Protection Act and Sarbanes Oxley in the United States, Bill 198 in Ontario, and similar legislation in other provinces, as well as increased regulatory oversight have brought heightened focus to directors and officers (D&O) liabilities. These issues are shaping the way D&O liability is being handled by corporations and management. Increasingly, executives are making D&O insurance one of their top priorities.

Corporations must manage the risk of directors and officers liability through an integrated process, which includes the following:

- Understanding the risks associated with being a director or officer;
- Establishing an internal awareness and communication structure;
- Implementing a management process to address these issues and risks; and
- Considering the need for protection of the directors and officers (i.e., through indemnification and insurance).

The issues of risk management, indemnification, and insurance are complementary and not a substitute for one another.

Legal Framework

Directors and Officers Liability: Legal Framework

As shown in Figure No. 1, there are three bases by which personal liability can be imposed on directors and officers.

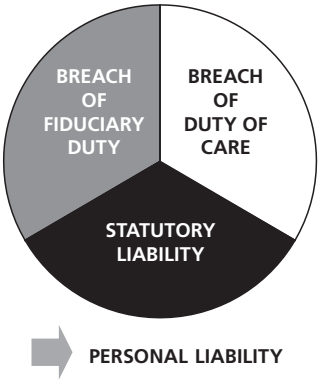


Figure No. 1

Directors and officers have two basic duties imposed on them when performing their responsibilities, a breach of which can lead to liability:

(1) Fiduciary Duty (duty of loyalty to the company); and
(2) Duty of Care.

In addition, there are estimated to be more than 100 provincial and federal statutes in Canada imposing other personal liabilities upon directors and officers.

The first two duties were developed in common law and have now been codified within the various Business Corporations Acts. They can be described as follows:

Fiduciary Duty

Directors and officers are expected to act in the best interests of the corporation and its shareholders, and not in their own interests:

> *"Every director and officer of a corporation in exercising his powers and discharging his duties shall,*
>
> *(a) act honestly and in good faith with a view to the best interests of the Corporation" (i.e., Business Corporations Act (Ontario) ("OBCA"), section 134(1), Canada Business Corporations Act ("CBCA"), section 122(1)).*

Examples of areas in which directors and officers have been held personally liable for violation of this duty include the following:

- Realizing secret profits or unfair gain through personal transactions with or on behalf of the corporation;
- Conflicts of interest;
- Competing with the corporation to its detriment;
- Realizing personal gain from the use of material, non-public corporate information (insider trading); and
- Taking personal advantage of a corporate opportunity.

Duty of Care

Directors and officers are also under a duty of care:

> *"Every director and officer of a corporation in exercising his powers and discharging his duties shall,*
>
> *(b) exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances." (i.e., OBCA, section 134(1), CBCA, section 122 (1)).*

This duty requires not only reasonable behaviour with respect to matters submitted for approval but also reasonable inquiry and monitoring of corporate affairs. Directors and officers may rely on outside expertise, but they must monitor the outside professional to ensure that the task is being completed properly.

Statutory Liabilities

The following is a sample of various federal and provincial statutes which may affect directors and officers:

Corporate and Securities Legislation:

- Bankruptcy and Insolvency Act
- Competition Act
- Ontario Securities Act*
- Investment Canada Act

Obligations to Employees:

- Employment Standards Act (Ontario)*
- Occupational Health and Safety Act (Ontario)*
- Canada Labour Code

Obligations to Government for Taxes and Source Deductions:

- Income Tax Act
- Retail Sales Tax Act (Ontario)*
- Excise Tax Act

Environmental Legislation:

- Environmental Protection Act (Ontario)*
- Ontario Water Resources Act*
- Ontario Mining Act*
- Canadian Environmental Protection Act

* and similar statutes in other provinces

Recent trends in legislation show the desire to hold directors and officers increasingly liable for their actions and the conduct of the company.

Indemnification

The various federal and provincial Business Corporations Acts generally provide that a corporation may indemnify a director or officer against all costs, charges, and expenses, including an amount paid to settle an action or satisfy a judgement, reasonably incurred by him in respect of any action or proceeding to which he was a party:

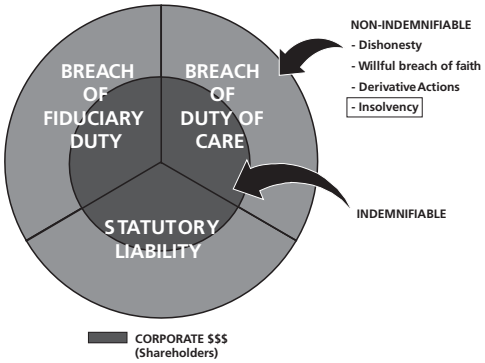


Figure No. 2

(a) In all actions, if he acted honestly and in good faith with a view to the best interests of the corporation; and

(b) In the case of a criminal action or proceeding that is enforced by a monetary penalty, if he had reasonable grounds for believing his conduct was lawful.

Referring to Figure 2, you will note that this right to be indemnified is substantially restricted in a number of areas.

Corporate indemnification does not singularly provide complete protection as it may not be available under a number of circumstances, including the following:

- The corporation becomes insolvent or does not have sufficient available cash flow to pay the losses and expenses incurred by the directors and officers.
- Indemnification is often discretionary: The composition and attitude of the board of directors may change, so that it is no longer sympathetic to an officer or director. In such circumstances, the board of directors may refuse to indemnify such officer or director.

- Public policy considerations and statutory limitations may cause some claims to be insurable but not indemnifiable, such as derivative actions. In Ontario, for example, any indemnification for derivative actions must be approved by the courts.

Personal Indemnification Agreements

Indemnification rights may be improved through personal indemnification agreements and directors and officers are increasingly obtaining such agreements. A personal indemnity agreement is a contract. As such, it is a bilateral agreement between the company and the individual director and officer that cannot be unilaterally changed by the company.
A well-crafted personal indemnity agreement has the added advantage of being able to address a number of important issues from a director and officer liability and personal protection perspective, such as timing of advancement of defence costs, selection of defence counsel, maintenance of D&O insurance, etc.

Claims Experience

The following chart indicates the typical kinds of claims that have been made against directors and officers in Canada:

Claims by Source and Allegation

Claimant	Sample Allegations
Shareholders and other investors	• Inadequate disclosures • Challenge to takeover • Merger / acquisition • Financial performance • Executive compensation • General negligence or breach of fiduciary duty
Past, current, or prospective employees	• Wrongful employee dismissal or termination • Salary, wage, or compensation dispute
Competitors, suppliers, and other contractors	• Anti-trust • Copyright / patent infringement • Contract disputes
Government and regulatory agencies	• Dishonesty / fraud • Loss or bankruptcy • Environmental safety
Other third party claimants	• Merger / acquisition / divestiture • General negligence or breach of fiduciary duty

Directors and Officers Liability Insurance Policy

D&O liability insurance policies were designed to protect directors and officers for the legal liability they may sustain when acting in their executive capacity. A policy will also reimburse or pay on behalf of the organization to the extent to which it indemnifies its directors and officers. While D&O policies are modified to address public, private, not-for-profit, and Crown exposures, the following is the typical structure of a D&O policy:

I. Insuring Agreements

The policy is typically split into three separate coverages in the insuring agreement:

Clause 1: Individual Coverage - Provides direct coverage for individual directors and officers against whom a claim has been made based on a wrongful act, and where indemnification is not provided by the organization. No deductible is applied.

Clause 2: Corporate Indemnity Coverage - Reimburses or pays on behalf of the organization amounts paid to indemnify directors and officers arising from a claim alleging their liability from a wrongful act. This is based on the requirement to indemnify contained within the company's bylaws or articles or by contractual agreement. A deductible is applied.

Clause 3: Entity Coverage - Some insurers may extend coverage to include direct claims against the entity either through the policy wording or by endorsement.

With respect to public companies, entity coverage is only extended to cover the organization's liability with respect to securities claims.

With respect to private, not-for-profit, and many Crown companies, typically coverage is extended to include direct claims against the entity for a variety of claims.

II. Limit of Liability

The policy's limit of liability typically applies to all loss, including defence costs, such that costs paid to defend a claim erode the policy limits of liability.*

III. Claims-Made Coverage and Severability

A D&O liability insurance policy is a "claims-made" policy form, meaning that coverage is triggered at the time the claim is made, regardless of when the wrongful act giving rise to the claim was committed. Claims-made coverage requires that all claims or incidents which may arise and result in a claim during the policy period be reported immediately to the insurer. Failure to comply with the claims-reporting provisions of the policy could result in the insurer denying coverage for the claim.

"Severability" in D&O liability policies refers to the issue of whether facts or information pertaining to one insured under the policy can adversely affect coverage for another insured under the same policy. Generally, severability is meant to protect innocent directors and officers from losing coverage based on wrongdoing by other culpable directors and officers. Severability may exist in regard to the D&O liability insurance application (such that any false representations made in the

application are imputed only to the person(s) having knowledge of their falsity) and with respect to the exclusions (such that only those persons to whom the exclusion directly applies will be denied coverage).

IV. Key Definitions

The policy generally includes all "Loss" associated with a claim, including defence costs, but usually excludes fines and penalties.

"Claim" is generally defined to include a written demand for monetary or non-monetary damages, civil or criminal proceedings, and administrative or regulatory proceedings.

Typically, a "Wrongful Act" for which the D&O policy provides coverage includes any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted by any director or officer in his or her insured capacity. It should also include other matters claimed solely by reason of his or her serving in such insured capacity, often encompassing statutory obligations, such as liabilities for unpaid taxes, employee wages, and vacation pay which may be imposed on directors and officers even if they did not commit a "Wrongful Act."

The definition of "Loss" typically includes damages, settlements, judgements, and defence costs.* The definition of loss does not include amounts for which the insured is not financially liable or matters deemed to be uninsurable by law.

VI. Exclusions

Matters which are typically excluded under a D&O policy can be classified into four broad categories:

1. **Insured elsewhere:**

- Bodily injury/property damage (commercial general liability);
- Pension liability (fiduciary liability);
- Pollution, except for non-indemnifiable carve-out (environmental impairment/commercial general liability);
- Prior claims notice reported under an expired policy; and
- Pending or prior litigation as of a certain date.

2. **Uninsurable by law:**

- Deliberately fraudulent acts; and
- Illegal personal profit, benefit, or advantage (e.g., insider trading, illegal remuneration).

3. **Outside the intent of the policy:**

- Organization vs. insured, with some exceptions;
- Acts outside the insured's capacity as a director or officer; and

4. **Specific risk-related exclusions, for example:**

- Major shareholder exclusion;
- Family suit exclusion;
- U.S. securities exclusion.

Conclusion

This brochure is not intended to be a complete statement on the subject of directors and officers liability, but simply a general overview of some of the key issues and considerations facing directors and officers today. With changing federal and provincial legislation and an expanding business and legal relationship between Canada and the United States, directors and officers liability is an evolving and changing field which requires constant monitoring. Marsh recognizes the importance of managing the risk associated with acting as a director or officer and has full advisory capabilities on both potential liabilities and appropriate protection.

If you are interested in obtaining additional information on the subject of directors and officers liability, please feel free to contact:

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