Document généré le 21 fév. 2025 12:20

Assurances

Assurances

DIRECTORS AND OFFICERS INSURANCE DEMYSTIFIED

G. B. Maughan

Volume 63, numéro 3, 1995

URI : https://id.erudit.org/iderudit/1105044ar
DOI : https://doi.org/10.7202/1105044ar

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Éditeur(s)

HEC Montréal

ISSN

0004-6027 (imprimé)
2817-3465 (numérique)

Découvrir la revue

Citer cet article

Maughan, G. (1995). DIRECTORS AND OFFICERS INSURANCE DEMYSTIFIED. *Assurances*, *63*(3), 335–369. https://doi.org/10.7202/1105044ar

Résumé de l'article

Nous remercions l'auteur ainsi que la faculté de droit de l'université McGill d'avoir bien voulu accepter d'offrir aux lecteurs de la revue le texte d'une conférence présentée en mai dernier à l'occasion des lectures Meredith. Voici les parties II, III et IV de l'étude, la première ayant été publié dans le numéro de juillet 1995. L'auteur passe en revue les éléments essentiels de l'assurance de responsabilité civile des administrateurs.

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Directors and Officers Insurance Demystified

by

G.B. Maughan*

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PART II: D&O LIABILITY - THE BASIC POLICY

1. The Parties

A D&O policy is a tripartite contract which brings together the insurer, the corporation and its directors and officers. It is essential to note, however, that the corporation itself is **not** an insured under a D&O liability policy. It is the directors and officers themselves who enjoy coverage. The only entitlement that the corporation has is for reimbursement of any indemnity paid to an insured for losses resulting from the commission of wrongful acts under the policy. The importance of this distinction is at its most salient when both the corporation and one or more of its directors and/or officers are joined as

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* Senior partner, Ogilvy Renault, Montréal. The author wishes to express his gratitude to his partner André Legrand and Leigh Crestohl, LL.B., B.C.L. for their contributions to this article, prepared for The Meredith Lectures presented by McGill University, Faculty of Law, on May 26, 1995.

defendants in the same action. At the end of the day some of those costs will be covered while others, to the extent that they were incurred by an uncovered party, will not. We will return to this topic when we discuss defence considerations below.[1]

Some further clarification should be made with respect to the definition of "corporation" for the purposes of a D&O policy. While the object of the contract is to stipulate coverage for a company's board of directors and officers, it would also be prudent to consider those implicated in the administration of its subsidiaries. Typically, therefore, a D&O liability policy will define the corporation as including all of its present and future subsidiaries. A typical clause of this nature reads:

"Company" shall mean:

(1) the Company named in Item A of the Declarations;

(2) any subsidiary of the Company which existed prior to or at the inception date of this policy;

(3) any subsidiary of the Company which is acquired or created subsequent to the inception date of this policy, subject to the provision of paragraph IX(b).[2]

For their part, the Directors and Officers are often defined as a function of their appointment.

"Director or Officer" shall mean:

Any **duly elected** Director or **duly elected or appointed** Officer of the Company named in Item 1 of the Declarations except as noted under Item 6 of the Declaration. Coverage will automatically apply to all newly created Directors and Officers after the inception date of this policy subject to:

[1] Part IV, *infra*.

[2] The additional provision mentioned relates to premium adjustments made when coverage is adjusted to take new subsidiaries into account.

(i) Written notice of all such changes to the Insurer, within thirty (30) days after each anniversary date, or the termination date, whichever is sooner, and,

(ii) payment of any additional premium required.

(emphasis added)

Definitions contained in the corporate statutes therefore continue to be relevant.

Careful consideration should be given to the temporal dimension in the definition of directors and officers. The reality often is that a claim does not in fact arise until after the corporation falls upon hard times or the director has otherwise left the board; this is particularly so in the case of the statutory liability for unpaid wages. The prudent director will therefore ensure that the corporation procures coverage, not only for current and future directors, but for those that have left the board as well. Apart from the temporal dimension, there is also a **capacity** question. Crucial to coverage under any D&O policy is that the director or officer who committed a wrongful act have done so in his capacity as a director. The significance of this point is brought to the fore by the example of corporate counsel who also wear a director's hat. There are many situations where it may be difficult to distinguish in what capacity he is acting. An example might be board decisions to terminate an employee. Advice may be tendered as to legal consequences, notice requirements and so on. Where that employee subsequently sues for wrongful dismissal, how is the liability of the lawyer-director to be assessed? Is he liable with the other directors for wrongful dismissal, or is he liable for professional negligence in his capacity as a lawyer? Situations may also arise where a director with a substantial share holding acts as a shareholder rather than a director. Here too coverage will not be available.[3] The capacity question is a crucial one for the outcome determines the extent of coverage, if any.

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[3]*Olson* v. *Federal Insurance Co.*, 219 Cal. App. 3d 252 (2d Distr. Calif Ct. of App. 1990).

One might also ask how the question of outside directorships are to be viewed. When a corporation places a director on the board of another corporation or subsidiary, be it to ensure control or otherwise, the director is still acting with a view to the best interest of the first corporation. Nevertheless, unless the policy clearly encompasses directors acting in this capacity, these individuals would not be covered under the first company's D&O policy. It may therefore be necessary to add an endorsement[4] to cover liability in cases where a director is, at the request of the corporation, sitting on the board of another corporation.[5]

As a final observation on this question, one might also note the technical definition given to "director" and "officer" in standard D&O policies as being "duly elected" or "appointed" under the applicable corporate statute and articles. What of the director whose appointment is tainted by an irregularity? While the law is clear to the effect that a director does not evade liability to third parties merely by setting up irregularities in his appointment,[6] for coverage purposes a claim could, in theory, be open to a contention by the insurer that coverage should be denied because of an irregularity in the assured's appointment.[7]

2. The Contract

When assessing the extent of coverage under any form of liability policy, the full range of the contract which binds the parties must be considered. This involves a fairly detailed analysis of not only the basic policy but all of the insuring agreements, exclusions, riders, endorsements, declarations and

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[4]Some insurers now provide separate Outside Director Liability (ODL) policies.

[5]Note that indemnification under such a circumstance is permitted under s.124(1) *C.B.C.A.*, s. 136 *O.B.C.A.* and s.123.89 *Q.C.A.* as long as it is at the request of the corporation and the corporation is either a shareholder or creditor of the other entity.

[6]s. 116, *C.B.C.A.*, s. 128, *O.B.C.A.*; *Morris* v. *Kanssen*, [1946] A.C. 459, 1 All E.R. 586 (H.L.).

[7]H. Silber, "Directors' and Officers' Liability Coverage: Directors' Liability and the Scope of Policy Exclusions in Canada", (1991) 9 *Can. J. of Insur. Law* 1 at 4.

conditions.[8] For our present purposes, we need only consider the policy itself.

The typical D&O policy currently available on the market is divided into two distinct portions. The first is known as the Directors' and Officers' Liability portion which extends coverage to them for losses which they suffer in consequence of their wrongful acts. The second portion of the policy takes the form of the Corporate Reimbursement portion which allows the corporation to recover amounts which it pays by way of indemnity to any of the insureds. Because it is the directors and officers whose conduct triggers liability, that portion is usually the more detailed of the two, setting out in greater detail the parameters of coverage and exclusions.

3. Indemnity vs. Liability Policies

In the United States and the common law provinces it is possible for a corporation to procure D&O indemnity insurance. In other words, when faced with a lawsuit the directors have the advantage of selecting their own counsel and proceeding to defend the action. Once a judgment adverse to the directors is paid, a "loss" is deemed to have been suffered and the insurer will then reimburse the directors in the amount of the award and its costs up to the policy limit. This is to be contrasted with liability policies where the insurer assumes the obligation to pay all "losses" on behalf of the directors rather than reimbursing them. The insurer's obligations under a liability policy are triggered by an assertion of liability against the insured by a third-party plaintiff.[9] Practically speaking, the distinction is best illustrated by looking to how defence costs are handled. Under an indemnity policy, the insurer would only become liable to satisfy its insured's claim for the reimbursement of costs after a final judgment or, at the very least, after they are incurred. By that point much time and money will have been expended

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[8] Paul Bates & Simon A. Clements, "Liability Insurance Coverage Disputes: Acting for the Insured" (1994) 16 *Advocates' Q.* 169 at 173.

[9] G. Hilliker, *Liability Insurance Law in Canada*, (Vancouver: Butterworths, 1991), at 5.

directly out of the corporation's coffers. Were the policy written on a liability basis, however, the defence costs would be paid directly as they fell due.[10] This results from the terms of the policy itself which counterbalances the duty on the part of the insurer to defend its insured with its right to choose the defence counsel and control the conduct of the defence. Both of these important elements of the insurer-insured relationship will be discussed in greater detail below.

Although indemnity policies are available on the insurance market in Quebec, they are of questionable validity given article 2503 of the *Civil Code.*

> **2503.** The insurer is bound to take up the interest of any person entitled to the benefit of the insurance and assume his defence in any action brought against him.
>
> Costs and expenses resulting from actions against the insured, including those of the defence, and interest on the proceeds of the insurance are borne by the insurer over and above the proceeds of the insurance.

This latter article imposes on insurers the duty to defend their insureds, an obligation which article 2414 *C.C.Q.* declares to be of public order. Consequently, any clause in a contract of insurance which purports to derogate from the insurer's **absolute**[11] duty to provide a defence is susceptible of being declared void.[12] Once a lawsuit is instituted against one or several of the directors and/or officers of a corporation, the obligation falls to their insurer to take up their defence. Less certain, however, is the scope of this duty.

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[10] *Little* v. *MGIC Indem. Corp.*, 836 F.2d 789 (3d. Cir. 1987) at 793 cited in *National Union Fire Insurance Co.* v. *Brown*, 787 F.Supp. 1424 (S.D. Fla 1991) at 1429.

[11] This was the interpretation given by Gratton, J.C.S. in v. *La Sécurité, Cie d'assurances générales du Canada* v. *Filion*, [1986] R.J.Q. 1449 (C.S.), appeal dismissed, [1990] R.J.Q. 349, [1990] R.R.A. 515, (C.A.), [hereinafter *Filion*].

[12] *Bionaire Inc.* v. *Calvert Insurance Co.*, [1994] R.J.Q. 1290 at 1296-1297, [1994] R.R.A. 342 (C.S.), appeal pending, [hereinafter *Bionaire* cited to R.J.Q.].

4. The Insurer's Duty to Defend

Despite the fact that most standard D&O forms impose a duty to defend on the insurer,[13] the scope of this duty is a constant source of conflict and litigation between the parties to the contract, a problem which is by no means isolated to the D&O context. A consideration of the question involves intertwining two distinct duties: that of the insurer to indemnify the losses of its insured and its duty to defend. The nub of the duty to defend problem is the appropriate relationship between these two duties. *Bacon* v. *McBride*[14] is traditionally cited as the authoritative precedent on the question. In that case, Wallace J. pointed to the pleadings as the point of departure. In other words, reference must first be made to the allegations which are set out in the claim:

> If the claim alleges a state of facts which, if proven, would fall within the coverage of the policy the insurer is obliged to defend the suit regardless of the truth or falsity of such allegations. If the allegations do not come within the policy coverage the insurer has no such obligation. In this respect the duty to defend may well be broader than the insurer's obligation to indemnify the insured for liability imposed by law. The insurer's obligation to defend arises when notice of the claim is received and continues as long as it is outstanding even though the insurer may consider the allegation to be groundless.[15]

The *Bacon* v. *McBride*[16] approach was consistently followed until the question was considered by the Supreme Court of Canada in *Nichols* v. *American Home Insurance Co.*[17] Nichols was a lawyer sued by the Bank of Montreal for fraud in

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[13]Where a policy is silent with respect to the duty to defend it is interpreted as being an indemnity policy, Hilliker, *supra* n. 50, at 59, citing Couch, *Cyclopedia on Insurance*, § 15:35, n.14.

[14](1984), 6 D.L.R. (4th) 96, 5 C.C.L.I. 146 (B.C.S.C.).

[15]References omitted. *Ibid.*, at 99.

[16]*Supra* n. 55.

[17][1990] 1 S.C.R. 801, 68 D.L.R. (4th) 321.

connection with certain real estate transactions. His liability insurer refused to take up his defence, invoking instead the fraud exclusion in the policy. Although the principal action against Nichols was ultimately dismissed, he was never fully indemnified for the cost of defending his suit. He therefore instituted an action against the insurer to recover these losses.

The Court's *per curiam* judgment was rendered by McLachlin, J. She accepted the insurer's contention based on a literal interpretation of the policy which she found to be "unambiguously restricted to claims for damages which fall within the scope of the policy".[18] She then proceeded to discuss the interplay between the two intertwining duties.

> I do not think it amiss, however, to set out my view of the relationship of the exclusion clause to the defence clause, for it is only in reading the policy as a whole that its true intention can be ascertained. As I read the policy, the exclusion clause is primarily concerned with the duty to indemnify. For this reason, it refers to actual acts or omission, which are the precondition of the duty to indemnify. The scope of the duty to indemnify, in turn, triggers the application of the defence clause, through use of the phrase in the defence clause limiting the duty to claims for "damages which are or may be payable under the terms of this Policy". The duty to defend, unlike the duty to indemnify, is triggered not by actual acts or omission, but by allegations, applying "even if an of the allegations of the suit are groundless, false or fraudulent." Thus the scope of the duty to defend is not conditioned directly by the exclusion clause, but only indirectly through that clause's definition of the scope of coverage.[19]

It is undeniable that the effect of *Nichols* is to place an insurer in a potentially vulnerable position for its ability to avail itself of an exclusion may ultimately depend on the whim of the

[18] *Ibid.*, at 809.
[19] *Ibid.*

plaintiff in framing its action. This has led some insurers to plead an "underlying facts exception",[20] the purpose of which is to allow the insurer to invoke an exclusion where the **known** facts of a situation involve dishonesty, even where this is not alleged in the claim. The jurisprudence maintaining that it is the pleadings which govern the determination of the duty to defend[21] has successfully been availed of by trial courts to defeat this contention.[22]

Although the duty to defend is said to be broader than the duty to indemnify, there are cases where a court may find that there will be no duty to indemnify, regardless of the form the pleadings take. No duty to defend will arise in such circumstances. It is only in the simplest of cases where a court will be able to determine at such a preliminary stage that there is no possibility of coverage. An example of this is *Heck* v. *Prudential Assurance Co.*[23] In that case a certain Mr. Block decided to test the level of tolerance of his neighbour by discharging three rounds from his .357 magnum revolver in the latter's general direction. After one of these shots struck Mr. Heck in the back he instituted a civil action against Block's homeowner insurer. By the time the duty to defend application was heard, Heck had already been found guilty of *Criminal Code* offences in connection with the unlawful discharge of his firearm. Before the Queen's Bench the insurer argued that there was no duty to defend because the claim fell under the intentional conduct exclusion. The Court agreed, noting that the certificate of conviction for a *mens rea* offence was sufficient to establish that the act was intentional and could not, under any circumstances, be covered under the policy. As has already been

[20]The origin of the exception is the pre-*Nichols* case of *Cansulex* v. *Reed Stenhouse Ltd.* (1986), 70 B.C.L.R. 189, 18 C.C.L.I. 24 (S.C.).

[21]Pleadings must be interpreted broadly so as to include not only the statement of claim but the defence and third party defence. *Shragie* v. *Tanemura* (1987), 22 B.C.L.R. 64, 32 C.C.L.I. 126 (S.C.), followed in *Daher* v. *Economical Mutual Insurance Co.* (1993) 19 C.C.L.I. (2d) 106, [1994] I.L.R. 1-3007 (Ont. Gen. Div.).

[22]*Léger* v. *Canadian Lawyers Insurance Association* (1993), 132 N.B.R. (2d) 179, (1994) 17 C.C.L.I. (2d) 61 (Q.B. (T.D.), followed in *Jon Picken Ltd.* v. *Guardian Insurance Co. of Canada* (1993), 66 O.A.C. 39, (1994) 17 C.C.L.I. (2d) 167 (C.A.).

[23](1991), 77 Man. R. (2d) 200, 5 C.C.L.I. (2d) 134 (Q.B.).

observed, however, cases where the determination is so easy must be comparatively rare.

In Quebec, as noted above, there is a public order duty to defend enshrined in the *Civil Code.*[24] *Nichols*, it must be remembered, was a case which arose in Ontario, decided on the specific policy language involved and general principles of insurance law. Some have, therefore, questioned the extent to which the *Nichols* case reflects the law in Quebec.

This confusion has been exacerbated by the seemingly contradictory decision of the Court of Appeal in the *Filion* case[25] which was decided in the months just prior to the release of *Nichols*. *Filion* involved a claim under a D&O policy arising out of an action based on fraud taken by the Attorney-General of Canada in Ontario against the board of Industrie Marine Ltée. The insurer, invoking dishonesty, refused to defend. Mr. Filion then instituted an action for declaratory judgment to compel the insurers to defend. The trial judge found in favour of the insured,[26] noting that, as a rule of law, good faith is presumed.[27] The insurer was therefore bound to assume the defence until such time as the facts were proved to be otherwise.

Professor Bergeron has taken the view that the approach formulated in *Filion* is to be preferred over *Nichols*. He bases this view on the textual approach he takes to art. 2503 *C.C.Q.* which he argues embodies a duty to defend wider than that expressed by McLachlin, J. in *Nichols*. The insurer has an obligation to defend any person in any action.[28] Referring to the statement of claim is, in his view, an unnecessary exercise, for what is significant is the legal outcome of these claims.[29] Although the solution proposed by Bergeron may accord with

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[24] Art. 2503 *C.C.Q.*

[25] *Filion*, *supra* n. 52.

[26] [1986] R.J.Q. 1449 (C.S.).

[27] Art. 2805, *C.C.Q.*

[28] J.-G. Bergeron, *Les contrats d'assurance*, Vol. 2, (Sherbrooke, Que.: Les Éditions SEM Inc., 1992), at 402.

[29] *Ibid.*, at 407.

the literal text of the *Civil Code*, it does not necessarily reflect the legislative intent as expressed in the commentaries issued by the Minister of Justice. The comment on art. 2503 is to the effect that the duty arises where "the claim calls into play the subscribed liability insurance coverage".[30] The *reductio ad absurdum* of the contrary argument is that a director sued in any connection, even where the case clearly falls outside of the coverage, would be entitled to have his defence assumed by the insurer. What then is the advantage gained by an insurer in stipulating exclusions or limiting coverage? Quite simply put, such an interpretation would produce pernicious results for insurers, the only result of which, were it to become the prevailing view, would be upwards pressure on premiums.

The Quebec courts, however, have allowed themselves to be guided by *Nichols* and general principles of insurance law.[31] In some instances the apparent contradiction is ignored altogether while, in one case, a judge of the Quebec Court went so far as to attempt a reconciliation between *Nichols* and *Filion*.[32] *Bionaire* is another example, perhaps the most recent one, of a Quebec court following the methodology outlined in *Nichols*.

To conclude, although there is still some slight debate on the question, *Nichols* represents the state of the law on the duty to defend in Canada. It is perhaps unfortunate that at the time the Quebec Court of Appeal decided *Filion* it did not have the benefit of that judgment. Nevertheless, considering that the appeal in *Bionaire* is still pending before that Court, the uncertainty may soon be remedied.

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[30]Our translation. *Commentaires du Ministre de la Justice*, Tome II, (Québec: Éditeur officiel, 1993), p. 1569.

[31]See *Bionaire*, *supra* n. 53.

[32]*Fortin* v. *Société mutuelle d'assurances générales du Lac St-Pierre*, [1993] R.R.A. 149 (C.Q.).

5. Principal Liabilities Covered

Despite our review above of the wide gamut of statutory and common law liabilities which might conceivably attach to the directors of a corporation, the standard D&O policy limits coverage through two precise terms of art: "wrongful act" and "loss". A typical insuring clause reads as follows:

> [...] that if during the policy period any claim or claims are made against any of the Directors and Officers' individually or collectively, for a Wrongful Act, the insurer shall pay on behalf of such Directors and Officers all loss which such Directors and Officers shall become legally obligated to pay [...]

In short, what the D&O insurer undertakes is to make good losses suffered by the corporation in indemnifying directors against claims made on the basis that liability arose as a result of a wrongful act. Any "loss", to fall within the coverage, must have been occasioned by an act falling within the definition of "wrongful act" and not be subject to any of the exclusions.[33] It obviously goes without saying that the insured must, at the time of the act or omission giving rise to the claim, have been acting in the capacity of a director or officer.

a) Wrongful Act

A typical D&O policy defines wrongful act as

> "Wrongful Act" shall mean any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the Directors or Officers in the discharge of their duties, individually or collectively, or any other matter not excluded by the terms and conditions of this policy, claimed against them solely by reason of their being Directors or Officers of the Company.

At first glance, it appears that an element of fault is a *sine qua non*, although intentional fault would obviously be excluded

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[33] On exclusions see Part III, *infra*.

as a matter of public policy.[34] Notice, however, that the clause ends with a blanket phrase including any claim made against an officer or director based solely on the fact of that person's capacity as a director of the corporation. This sub-clause is independent of fault and is crucial to coverage for such statutory obligations as that making directors accountable for six months arrears in wages. Such a liability arises not because of any direct fault on the part of the director, but because of the fact that the corporation has become insolvent and the claim of the former employees has not been satisfied.

b) Loss

"Loss" is usually defined as

> Any amount which the Insureds are legally obligated to pay for which they are not indemnified by the Company, or for which the Company may be required or permitted by law to pay as indemnity to the Directors and Officers, for a claim or claims made against them for Wrongful Acts, and shall include, but not be limited to, damages, judgments, settlements and costs, cost of investigation (excluding from such cost of investigation and defence, salaries of officers or employees of the Company), and amounts incurred in the defence of legal actions, claims or proceedings and appeals therefrom, cost of attachment or similar bonds; provided always, however, such subject of loss shall not include fines or penalties imposed by law, or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed.

A few elements of this definition are of interest. Firstly, recovery is limited to amounts for which there is a **legal obligation** to pay, flowing from "Wrongful Acts". In addition, the range of expenses which are addressed is of considerable breadth, but an important limitation is built into the concluding

[34] As would be any act, regardless of fault, which was intentional and not merely the result of a bad business decision as opposed to negligence: *Crum & Forster Managers Corp.* v. *Basin Electric Power Coop.*, 911 F. 2d 155 (8th. Cir. 1990) at 160.

words of the definition. Thus, fines imposed as a result of convictions for regulatory offences are effectively excluded without the additional necessity of providing an express exclusion elsewhere in the policy.

6. *Claims-made Policy*

D&O liability policies are usually underwritten on a claims made basis. Thus, regardless of the time at which the underlying events of a claim arose, coverage will be available provided that the claim is made during the life of the policy and within the stipulated notice period, if any.[35] Some policies do require that claims be reported within the policy period. This can prove problematic where, for instance, a director only becomes aware of a potential claim within days of the policy's term. All the more reason why, therefore, a director should ensure that the policy contains an adequate discovery clause which allows for an additional period of time, beyond the policy's term, to report claims arising from misconduct during the policy period. It is thus a question of some importance as to when a "claim" is deemed to be made. Reference must, as always, first be had to the policy which may mandate some degree of formality for a claim to be considered to have been made. Where the policy is silent on the matter the general rule in the doctrine and jurisprudence is that a claim arises at the time that a demand is made, either verbal or written, to the insured expressing the claimant's intention to hold the latter liable. As McLachlin, J. observed in *Reid Crowther*[36]

> There is no magic formula. One must look to the reality of what the third party was communicating to the insured by words and conduct. If the message was clear, the fact that the third party through politeness refrained from stating its

[35] Art. 2470 *C.C.Q.* requires that notice be given as soon as the insured becomes aware of the loss. At common law, in the absence of a stipulated reporting period, the insured must give the insurer reasonable notice: *American Institute of Architects* v. *Interstate Fire & Casualty Co.*, 986 F.2d 1455 (D.C. Cir. 1993).

[36] *Reid Crowther & Partners Ltd.* v. *Simcoe & Erie General Insurance Co.*, [1993] 1 S.C.R. 252 at 275, 13 C.C.L.I. (2d) 161 [hereinafter *Reid Crowther*, cited to S.C.R.].

> demand or intention to hold the insured liable in categorical legal terms should not preclude a finding that a claim has been made.

The advantages to the insurer of proceeding on a claims-made basis are obvious in that it allows the insurer to impose some control over and forecast its own potential liabilities. The transition from occurrence to claims-made liability policies was a probable result of the trepidation felt by insurers in the wake of asbestos and environmental claims.[37] The fact that these sorts of claims can arise years after the initial event and the necessity of insurers to keep files open and pending indefinitely contributed to the introduction of the claims-made policy. It presents a number of advantages to the insurer:

> In summary, the characteristics of certain liability insurance (such as professional and product liability) when written on occurrence forms inherently causes roller coaster market cycles, and perpetuate the likelihood of future liability crises. Claims-Made coverage is a rational solution for long-tail liability problems. It offers stable pricing, coverage availability, and better promise of solvency over the long run.[38]

The concomitant disadvantage faced by the insured is that the policy must perpetually be maintained, for the fact that a policy was in place at the time of the occurrence is irrelevant where the claim is ultimately made after the expiry of the policy. From the perspective of the director, then, it is essential that there be coverage available as long as risk exposure persists. Risk exposure may be assessed by reference to relevant statutory limitation periods[39] or general rules of prescription in the *Civil Code*[40]. This is particularly the situation of directors who retire

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[37]Hilliker, *supra* n. 50, at 135.

[38]Thomas A. Konopka, "The Advantage of Claims-Made Forms for Insurance Buyers" (1992) 59 *Assurances* 479 at 489-90.

[39]Most of the corporate law recourses against directors are prescribed after two years: s. 118(7) *C.B.C.A.*; s. 123.168 *Q.C.A.*

[40]Rights in *personnam* are prescribed after three years, art. 2925 *C.C.Q.*

or otherwise leave the corporation, who should ensure that coverage for them is maintained after they leave the board. Since a director will incur no new liabilities once he has left the board, the policy's discovery clause represents one useful way of ensuring at least 12 months additional coverage for subsequent claims. Once again, statutory limitation periods and the law of prescription serve to indicate the appropriate exposure period for which a former director should continue to be covered.

Directors and officers are especially vulnerable where gaps in insurance coverage arise, a risk which is greatly enhanced by the claims-made nature of the policy. Coverage gaps can have disastrous consequences, particularly in the context of corporate insolvency or bankruptcy, a risk best illustrated by the example of the directors' liability to employees for arrears in wages. This is a statutory liability found in both the *C.B.C.A.* and *O.B.C.A.* as well as most other provincial corporate statutes. For the sake of simplicity, we reproduce here the federal provision.

> 119.(1) Directors of a corporation are jointly and severally liable to employees of the corporation for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively.
>
> (2) A director is not liable under subsection (1) unless
>
> (a) the corporation has been sued for the debt within six months after it has become due and execution has been returned unsatisfied in whole or in part;
>
> (b) the corporation has commenced liquidation and dissolution proceeding or has been dissolved and a claim for the debt has been proved within six months after the earlier of the date of commencement of the liquidation and dissolution proceeding and the date of dissolution; or

(c) the corporation has made an assignment or a receiving order has been made against it under the Bankruptcy and Insolvency Act and a claim for the debt has been proved within six months after the date of the assignment or receiving order.

(3) A director is not liable under this section unless he is sued for a debt referred to in subsection (1) while he is a director or within two years after he has ceased to be a director.

(4) Where execution referred to in paragraph (2)(a) has issued, the amount recoverable from a director is the amount remaining unsatisfied after execution.

(5) Where a director pays a debt referred to in subsection (1) that is proved in liquidation and dissolution or bankruptcy proceedings, he is entitled to any preference that the employee would have been entitled to, and where a judgment has been obtained he is entitled to an assignment of the judgment.

(6) A director who has satisfied a claim under this section is entitled to contribution from the other directors who were liable for the claim.

The constituent elements of a successful claim under this section may be summarized as follows:[41]

1) the defendant is or was a director of the corporation;
2) the claim was brought within 6 months of the director ceasing to act;
3) the claim is proved;
4) the plaintiff was an employee;

[41] *Kornblum* v. *Dye* (1986), 59 C.B.R. (N.S.) 219 (Ont. Dist. Ct.) at 221.

5) the claim is for services rendered;[42] and

6) the amount of the claim.

If a director's liability is likely to arise at all under this section, it will almost certainly be in the context of a bankruptcy or insolvency. In such a case the directors may well have "jumped ship" fearing a pending disaster and left the running of the corporation to the receiver or trustee as the case may be.[43] Assuming that the policy is cancelled by the insurer or simply not renewed, the former directors will, nevertheless, have some additional protection, for the policy's discovery clause, provided an additional premium is paid, will extend the coverage for an additional 12 months or more for any claim which arises during the discovery period but only in respect of Wrongful Acts committed prior to the discovery period.[44] However, gaps may still arise.

The gap problem derives its source from the nature of the statutory liability. Section 119(2) imposes a number of conditions precedent before an action can be taken against the directors under s. 119(1). These require that the corporation first be successfully sued for the arrears and that this judgment not be satisfied. Thus, although a director may foresee an impending action, a considerable amount of time may pass before all of the

[42]This condition has given rise to a considerable amount of conflicting jurisprudence. It is now settled, however, that unsatisfied judgments for wrongful dismissal and termination pay are not covered within the scope of s. 119: *Barrette* v. *Crabtree Estate*, [1993] 1 S.C.R. 1027, 101 D.L.R. (4th) 66.

[43]There have been a number of such public stampedes to the lifeboats in recent years. One such example was that of Westar Mining in 1992 where all the outside directors resigned their posts when faced with the possibility of a $20 million claim on behalf of former employees for arrears in wages: Bryan Haynes, "Directors' Liability for Termination Pay: Barrette v. Crabtree Estate", (1994) 23 *Can Bus. L.J.* 283 at 284. Several witnesses appearing before the Dey Committee referred to the Westar episode as an illustration of how the policy objectives underlying the section are thwarted by encouraging directors to quit under these conditions rather than to stay and employ their skill to the advantage of the corporation in such times of crisis. The report concluded that imposing strict liability under such circumstances was "unfair and counter-productive to good corporate governance.", *Dey Report*, *supra* n. 3, at para. 5.63.

[44]It is quite common for D&O policies to grant the insurer a discretionary cancellation right. In an insolvency situation, it may well have availed itself of its right to cancel the policy, or declined renewal, when the corporation reached insolvency. This is all the more likely where the corporation is unable to continue paying its premium.

conditions are satisfied and the directors personally suffer a loss. Remember that only a "loss" triggers payment under the policy, and a "loss" is "an amount which the Insureds are legally obligated to pay". Some time may possibly pass before this legal obligation to pay arises. It may well be possible, in such a situation, that when the claim does eventually arise, it may be outside the 12 month discovery period. A director caught in such a situation may find himself personally at risk to satisfy the judgment. Although a natural instinct when faced with this possibility might be to subscribe to another policy, this may be to no avail for when a director, in order to protect himself, approaches another insurer, any actual or potential claim existing at the new policy's inception date will be excluded. Consequently, the director will have fallen in between two coverage periods and effectively be uninsured.

PART III: SOME COMMON EXCLUSIONS

Exclusion clauses are an obvious means by which insurers control their potential exposure. Over recent years, insurers in both the United States and Canada increased the number of exclusions contained in their D&O policies.[45] Standard exclusions include liability for bodily injury & property damage, libel & slander, and pollution or environmental accidents. These are all liabilities which are best covered under other forms of policies currently available on the market such as the Comprehensive General Liability policy (CGL). The D&O policy is, thus, in many respects a policy of last resorts and, barring excess coverage, liabilities covered under "other insurance" are always excluded. Coverage, moreover, can be denied even in the absence of an exclusion clause because of the controlling nature of the definitions given to "wrongful act" and "loss".[46] The coverage question, therefore, must be considered not only in light of the insuring clause and the exclusions, but the

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[45]Daniels & Hutton, *supra* n. 7, at 192.

[46]W.E. Knepper & D. Bailey, *Liability of Corporate Officers and Directors*, 5th ed., Vol. 2, (Charlottesville, V.A.: Michie Co., 1993) at §25-1, p.433.

contract as a whole including any inherent limitations built into the various definitions in the policy.

There are, in addition, a number of exclusions directed to the conduct of the insured. These can raise interesting questions about the extent of coverage and the insurer's obligations to defend and indemnify.

1. Dishonesty

Public policy usually precludes procuring liability insurance against one's own intentional fault.[47] Dishonesty is a very obvious manifestation of intention and it is hardly surprising that D&O policies contain an exclusion for such acts. Dishonesty is defined as

> [...]any dishonest, fraudulent, criminal or malicious act or omission of an Insured, however, the exclusion does not apply to any Insured who is neither the author of the said act or omission, nor an accomplice.

As straight forward as this exclusion may initially appear, it raises important and controversial questions, particularly concerning the scope of the insurer's duty to defend. The primary issue can be formulated quite simply as follows. At the time that a claim is made against a director or officer alleging dishonesty, the claim is, until it is adjudicated upon, merely a series of allegations. In the meantime, an insured may wish to defend to the action and in so doing run up considerable expenses. Until such time as there is a judgment on the merits which concludes, as a finding of fact, that there was indeed dishonesty, the insured may feel perfectly justified in calling upon its insurer to take up the defence until such time as it can, on a factual basis, establish that an exclusion applies.[48]

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[47] Art. 2464 *C.C.Q.* Most provincial Insurance Acts contain a similar provision.

[48] The usual burden of proof in insurance matters is on the insured to show that the claim falls within the coverage provided for in the policy. Once this initial burden is met it then shifts to the insurer to make out that the circumstances of the claim fall within one of the expressed policy exclusions. Bates & Clements, *supra* n. 49, at 174.

Some sympathy can also be found for the insurer which may be loathe to commit itself to a defence where allegations of fraud and dishonesty form part of the claim. Even where the plaintiff's statement of claim is not explicit in its allegations, the insurer's own investigation may nevertheless have convinced them that the underlying facts of the case involve conduct on the part of their insured which should be excluded from coverage. In the D&O context, where the stakes involved are high,[49] it can be readily understood why the insurer may be reluctant to assume defence costs.

The determinative factor appears to be the wording of the policy and the allegations contained in the claim against the director. The solutions offered by the jurisprudence fall around two extremes. The first is that where all the allegations in the claim, if proven, would be a basis for denying coverage, the insurer is not bound to take up the defence and the insured is left on the hook. This was the situation which presented itself in *Nichols*.

The second position taken is that where the policy requires an adjudication as to the existence of dishonesty, the insurer must defend any claim which might otherwise be covered until such time as a court determines that the claim of dishonesty or intentional fault has been proven. This was the outcome proposed by the Quebec Superior Court in *Bionaire*.

In between the two positions are those cases which involve allegations, some of which fall under the policy coverage, others of which do not. Cases of this sort are relatively frequent and arise wherever a statement of claim contains, for example, allegations of intentional fault and negligence. This was the situation in *Bacon* v. *McBride* where the court held that the duty to defend extends only to that portion of the defence costs which

[49]The average cost of a D&O lawsuit in the U.S. 1990 was estimated at around $3.5 million, with legal costs amounting to $1,3 million: Carol A. Noer, "Negotiating the Hazards of D&O Lawsuits (1991) *John Liner Review* no. 5. Although legal costs are generally higher in the U.S. than in Canada, the costs of defending a D&O lawsuit can still be substantial. Between 1980 and 1990 the average cost of defending a D&O lawsuit in Canada was estimated at $257,500: Tontini, *supra* n. 5.

very clearly relate to the defence against allegations which are covered under the policy.

While the first body of cases, and the in-between position, derive from general principles of insurance law, the second body of cases, of which *Bionaire* is an example, usually results from express wording in the policy rather than general principles of insurance law.

> ...the Directors or Officers shall be protected under the terms of this policy as to any claims upon which suit may be brought against them by reason of any alleged dishonesty on the part of the Directors or officers, **unless a judgment or other final adjudication thereof adverse to the Directors or Officers** shall establish that acts or active and deliberate dishonesty committed by the Directors or Officers with actual dishonest purpose and intent were material to the cause of action so adjudicated.
>
> (emphasis added)

What is to be made from a comparison of *Nichols* and *Bionaire*? The two cases agree on how the relevant principles of the general law of insurance are to be formulated. In *Bionaire*, however, the Superior Court gave a greater importance to the policy wording, despite the general principles of insurance law. While the policy wording should always be a factor to be considered, it is not clear that it should override the principles developed in *Nichols*. It must be remembered that *Bionaire* is a trial court decision which is currently under appeal; it may be some time, therefore, before we have any authoritative comment as to the validity of the approach followed in the *Bionaire* trial decision.

2. Securities Acts Exclusions

Some D&O policies incorporate an exclusion for claims under the insider trading provisions of the *O.S.A.*[50] and the

[50] s. 76.

American *Securities Exchange Act, 1934*.[51] The American *1934 Act*, in addition to traditional insider trading, creates what is commonly called "short-swing" liability. This provision permits the corporation to disgorge any profits realized by an officer or director on transactions in the corporation's equity securities for any period less than six months from the date of their acquisition. The provision is what Loss has referred to as "a nice piece of native American radicalism".[52] Securities Acts exclusions usually embrace both forms of liability.

It is submitted that an express insider is superfluous in the sense that such conduct would almost certainly be outside of D&O coverage, and this for two reasons. In the first instance, such infractions are usually enforced by way of regulatory offence, the usual penalty being a fine. A fine under such circumstances would not fall within the scope of the definition of "loss" as has already been noted above. Secondly, self-dealing and intentional acts are virtually always outside of the coverage of liability insurance and could not, therefore, be considered a "wrongful act" for which coverage could be claimed.[53] The inclusion of insider trading exclusions, however, serves a useful purpose in that it puts the director who reads the fine print of every document before signing it on express notice that coverage will not be available in this context. In addition, an express exclusion may also be useful as an interpretative aid as to the scope of the indemnity available under the policy on a duty to defend application.

3. Prior Knowledge

As our discussion of the rationale for claims-made liability policies above makes clear, the insurer seeks to encourage

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[51] 15 U.S.C. § 78a et seq., § 16(a) - (b) [hereinafter *1934 Act*].

[52] Louis Loss, *Fundamentals of Securities Regulation*, 2ed., (Boston: Little, Brown & Co., 1988), at 542.

[53] Although many policies contain an express exclusion for personal profit and advantage, where the benefits accrue by usurping corporate advantages or otherwise in violation of the director's fiduciary duty, *quaere* whether public policy would exclude recovery under an insurance policy, even in the absence of an express exclusion. See arts. 1310, 1312 and 2147 *C.C.Q.*

prompt reporting of claims so that it has control over its own potential liabilities after the expiry of the policy period. The same rationale explains why all such policies exclude claims, or potential claims, of which the insured had knowledge at the time of entering into the policy. The intent clearly is to prevent an applicant for insurance from concealing the existence of a potential claim so that coverage under the policy being contracted will be available immediately at its inception date. An insurer, after all, has little interest in insuring a burning building.

358 An interesting problem which should be of interest to those who agree to take on the responsibilities of a corporate director is the extent to which the corporation's knowledge may be imputed to its directors. Let us take for example civil responsibility to a third party in tort. There is nothing which initially suggests that the directors and officers will be named as defendants in the action. Suppose that the action is commenced against the corporation on June 1, 1995 and the very next day the corporation files an application for Directors' and Officers' liability insurance, the inception date of which is July 1, 1995. At the time of the application, the directors had no knowledge of any claim actual, or potential which concerned them, so none need have been disclosed. On September 1, 1995 the plaintiffs in the tort action realize that the corporation is experiencing financial difficulties and that their ability to execute any judgment in their favour is in jeopardy. They nevertheless learn that a policy has recently been taken out in favour of the directors and officers and the same day make application to join as defendants the directors jointly and severally with the corporation. It is only at that point that a claim is born. The directors will, of course, promptly report this fact to the insurer in accordance with the reporting and notice requirements of the policy, but there will be no grounds for the insurer to invoke the prior knowledge exclusion.

The above is not to suggest that the knowledge of the corporation can never be attributed to the directors and *vice versa*. There is ample jurisprudence in the domain of the law of corporate criminal and civil responsibility which makes it clear

that where a director is a controlling or directing mind of the corporation, his actions and mental state can be attributed to the corporation.[54] As one judge has observed,

> To invest a corporation with a mind and personality of its own, distinct from those who are charged with the responsibility of directing its policy, carries a useful legal fiction to absurdity and creates an aura of unreality with respect to everyday business affairs.

All that this body of law establishes, however, is at what point the actions of a corporation's agents may trigger the former's liability. It is still the corporation, which is not an insured, which is being sued. There is a very important distinction to be made between potential claims against the corporation and potential claims against its directors and officers. For D&O liability purposes, a claim against the corporation only becomes relevant at the point where the directors and/or officers are either made a party to the action, or have just cause for believing that they will become involved. This is a consideration quite separate and apart from traditional questions of corporate control and liability.

PART IV: DEFENCE CONSIDERATIONS

We have already observed that the insurer has a duty to defend the insured. This can nevertheless prove to be a double-edged sword for the insured. Obviously it is financially beneficial to the insured to have the defence and its associated costs borne by the insurer. On the other hand, the duty of the insurer to defend implies a correlative right to control the conduct of the defence, including all decisions relating to

[54] *Lennard's Carrying Co. Ltd.* v. *Asiatic Petroleum Co. Ltd.*, [1915] A.C. 705 (H.L.) at 713-714, *Clarkson Co.* v. *Canadian Indemnity Co.* (1979), 25 O.R. (2d) 281, 7 B.L.R. 152 (Ont. H.C.) at 176-180, *Mohawk Horning Ltd.* v. *M.N.R.* (1986), 66 N.R. 376 (F.C.A.). See also generally, Bruce Welling, *Corporate Law in Canada, the Governing Principles*, 2 ed. (Toronto: Butterworths, 1991), Ch. 4.

settlements.[55] The rationale for the insurer's control over the defence is explained by Brown and Menezes,

> Insurance reduces the insured's incentive to be careful in acknowledging responsibility for the third party's loss or in agreeing to the amount of settlement. Since this would be prejudicial to the insurer it is appropriate that control of the defence should rest with it.[56]

This can prove to be a very significant right when issues of settlement arise, and it is particularly in this connection that their interests may diverge and even conflict.

Exceptionally, the insurer can be deprived of its right to exercise its control over the process. This occurs where it has unjustifiably refused to provide a defence. It is now accepted in both common law[57] and civil law[58] that the refusal on the part of the insurer to honour its duty to defend constitutes a breach of the contract of insurance. In the common law provinces there is jurisprudence to show that refusing to defend can represent a repudiation of the contract by the insurer.[59] The consequences of a repudiation are serious for the insurer, for it can mean that the insurer can no longer rely on the policy to assume control of the defence of the underlying action, nor be able to participate in settlement negotiations.[60] Moreover, all of the usual damages which would lie in a breach of contract case may be claimed.

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[55] Although an insured is always free to stipulate that it shall retain control in exchange for an additional premium. This alternative would not, however, be available in Quebec given the public order duty to defend in art. 2503 *C.C.Q.* Moreover, an insured cannot set up against an insurer a settlement to which the latter has not consented, art. 2504 and 2631 *C.C.Q.*

[56] Brown & Menezes, *Insurance Law in Canada*, 2 ed., (Toronto: Carswell, 1991) at para. 12:5:11.

[57] *Ibid.*, at para. 12:5:9.

[58] *Bionaire, supra* n. 53, where the additional indemnity provided for in art. 1619 C.C.Q. was awarded. The indemnity is available in cases of breach of obligations, be they delictual or contractual.

[59] *Heads* v. *Brownlee*, [1943] 59 B.C.L.R. 246, [1943] 4 D.L.R. 513 (B.C.C.A.). The conduct of the insurer, on the whole, must be looked to in order to find a repudiation. Only if there is a *de facto* repudiation does the insurer lose the right to control the defence: *Ontario* v. *Kansa General Insurance Co.*, [1991] I.L.R. 1-2727 (Ont. Gen. Div.).

[60] Brown & Menezes, *supra* n. 97, at para. 12:5:13, Hilliker, *supra* n. 50, at 83.

1. Separate Representation

A lawsuit involving directors and officers can be a very complicated and costly undertaking for all concerned. One might have named as defendants the corporation, each member of the board, the officers and where the suit arises out of the issue of securities, the underwriters and auditors might also find themselves joined as defendants. Some parties may be insured while others are not, as will, for instance, be the case were the directors and the corporation are sued together.

Under ordinary circumstances, as we have already seen in relation to the duty to defend, the policy will give the insurer control over the conduct of the defence. In practice this permits the insurer to call upon its own counsel to represent the sued directors and officers. In many such cases, the interest of the insurer and each of the defendants will converge. There is no certainty, however, that this will always be the case.

Counsel acting for several parties to a litigated D&O claim must remain ever vigilant against potential conflicts of interest, for although interests will often coincide, there is a potential both for divergence and eventual conflict.[61] These conflicts can arise not only between the insurer and the insureds, but even among the insured directors *inter se*. Such a conflict in the context of a D&O claim might arise where one of the directors has a defence which can be asserted against the others, or which depends on a finding of wrongdoing against the others. One might envisage a situation where the directors may plead a defence of due diligence reliance on financial reports and point instead to the negligence of the corporation's financial officers, defendants in the same action.

A distinction must, nevertheless, be made between situations which pose a veritable conflict of interest and those which amount merely to a divergence of interest. Where their interests are merely divergent, rather than conflicting, the same

[61] See generally R.E. Mallen & J.M. Smith, *Legal Malpractice*, 3d ed., vol. 2, (St. Paul, Minn.: West Publishing Co., 1989), ch. 23.

counsel could continue to act as long as the parties are made aware of the situation and give their consent.[62] Directors have only diverging interests where, for example, their exposure may differ, but the underlying facts of the case and defences asserted are the same. Admittedly, the dividing line can be a very fine one. Consider, for instance, the situation, not of a director asserting a defence against another co-defendant, but where he nevertheless has a defence open to him which is unavailable to the others. At first blush this does not seem to lock them into a conflict of interest. One author, however, has argued that this can still amount to a conflict of interest, for the remaining directors will have an interest in seeing their co-defendant fail in his defence so that one more pocket will be available in the event of an adverse judgment.[63] As the matter is far from clear, the ambiguities which may arise provide all the more justification for acting with prudence.

It is cases of conflict, rather than divergence which can create serious problems and challenges in the conduct of D&O insurance litigation. Various provincial codes of ethics prohibit a lawyer from acting in a conflict of interest situation.[64] The Canadian Bar Association *Code of Professional Conduct,*[65] though of no legal force, is nonetheless representative of provincial codes of ethics and has persuasive value in guiding the conduct of lawyers who find themselves in similar situations. The *Code of Professional Conduct* provides that a lawyer should not represent more than one client unless each is informed of this

[62]Mallen & Smith, *supra* n. 102, §23.17.

[63]See generally, Allan D. Windt, *Insurance Claims and Disputes*, 2d ed., (Colorado Springs: Shepard's McGraw-Hill, 1988), at §4-21.

[64]Conflict of interest has been the source of a good deal of jurisprudence. Two tests emerge from these cases as to whether or not a conflict situation is present where more than one party is defended: i) a probability of real mischief: *Rakusen* v. *Ellis, Munday & Clarke*, [1912] 1 Ch. 831, [1911-13] All E.R. 813 (C.A.); and ii) a probability of mischief or appearance of impropriety: *Steed & Evans Ltd.* v. *McTavish* (1976), 12 O.R. (2d) 236, 68 D.L.R. (3d) 420 (H.C.). The second test is a more modern and more demanding test on counsel which has been evolving in Ontario. For a review of the cases see *Szebelledy* v. *Constitution Insurance Co.* (1985) 11 C.C.L.I. 140 (Ont. D.C.).

[65]Adopted in August 1987. See generally Ch. 5: Impartiality and Conflicts of Interest Between Clients. See also the Quebec *Règlement sur le Code de déontologie des avocats*, art. 3.05.04.

fact, warned that relevant information received from one cannot be kept confidential from the others, and consents to the lawyer continuing to act.[66] Where a veritable conflict emerges between parties represented by the same counsel, the latter must immediately inform them that he can no longer continue to act on the particular question on which they are opposed. Moreover, even where consents are obtained as suggested above, the lawyer must still withdraw if it is likely that, as the case progresses, either divergence of view will emerge or their rights and obligations will coincide less and less. It is in situations such as this where difficult questions of professional privilege and client confidentiality become more and more problematic[67] and a judicial determination that confidential information received from one defendant was used to the advantage of another, against the first, may have serious consequences on the outcome of the underlying action.[68]

An obvious potential for conflict arises where the insurer assumes a direct role in the preparation of a defence while at the same time raising issues about the insured's coverage. Counsel acting in defence of a D&O claim have a responsibility both to the insurer and the insured and the authorities are unanimous to the effect that the same lawyer may not both prepare a defence while simultaneously advising the insurer on coverage questions.[69] It would not, however, appear to be objectionable, for counsel to proceed to defend an insured after having fully exhausted any coverage questions.

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[66]The *C.B.A. Code of Professional Conduct*, *supra*, recommends that this consent be obtained in writing, at commentary 5, p. 18. See also B.G. Smith, *Professional Conduct for Canadian Lawyers*, (Toronto: Butterworths, 1989) at 27-31.

[67]A client's right to have the confidentiality of its communications to counsel protected is guaranteed by s. 9 of the *Charter of Human Rights and Freedoms*, R.S.Q. 1977, c. C-12.

[68]*Citadel General Assurance Co.* v. *Wolofsky*, [1984] C.A. 377, R.D.J. 440, leave to appeal to S.C.C. denied: where insurer's counsel of record were found to be in a conflict of interest between the insurer and defendant. The court ordered that they remove themselves from the file. Moreover, various statements made by the defendant, which the insurer sought to introduce into evidence, were ruled inadmissible because of client privilege.

2. Settlement Issues

There can be little doubt that where a claim falls under the coverage of the policy the insurer has an obligation to pay on behalf of the insured the amount of a settlement paid up to the policy limit, just as it would were a court to have rendered a final judgment in the case. This is a result of the broad range of costs identified in the definition of "loss". Can any settlement be recovered? Although the standard is generally one of reasonableness, the insurer and the insured may not share the same conception of what is reasonable. This is particularly the case where the insured takes into account business considerations in agreeing to a settlement.

Any one of dozens of possible motivations can justify a corporation's approval of a settlement. These might range from a mere desire to make the problem disappear for the sake of convenience, to making the matter disappear quietly for the sake of the reputation of the corporation. The latter category is the bedrock of the "business consideration" issue.

Situations may arise where it will just make good business sense to settle a claim irrespective of the probability of its success on the merits. Such is the case where the claimant and the corporation ordinarily have a good working relationship and wish to maintain it. The corporation might also consider the potential effect that the publicity surrounding a trial might have on its reputation and goodwill. While the goodwill of a corporation may be somewhat of an intangible asset it is, nevertheless, of tremendous value to the corporation and well worth protecting. Assume, for example, that a suit is commenced against a corporation for $1 million and the opportunity arises for the corporation to settle for $100,000. The board, thinking as business people, will readily appreciate the bargain at only one tenth of the "asking price". What, on the other hand, is likely to be the attitude of the liability insurer whose adjusters estimate the settlement value of the claim to be only $10,000? In short,

[69]Mallen & Smith, *supra*. n. 102, at §23.18, *Couch on Insurance* 2d (Rev. ed) §51-165, *Rosenblood Estate* v. *L.S.U.C.* (1989), 37 C.C.L.I. 142 (Ont. H.C.),

settlement is but one of the practical situations in which the interests of the insurer and the insured are likely to come into conflict in defending a claim.

The insurer's argument would undoubtedly be that its role is to reimburse losses rather than to finance business transactions. That the settlement may make perfect business sense is quite simply not a consideration which is relevant to the insurer in the conduct of the defence. Such business considerations, moreover, are not a function of the loss which arises from the wrongful act, but are merely adverse consequences of a disputed claim. For its part, the corporation could be expected to argue that the claim impugns the reputation and goodwill of the corporation, damages which are quantifiable and should be considered as losses under the policy. Such an interpretation, however, is fallacious. All that the insurer undertakes to pay or reimburse under the policy are losses incurred in defending or settling a claim occasioned by the wrongful act of a director. Losses of reputation or goodwill, while they may well be quantifiable damages, do not flow directly from the wrongful act which founded the initial claim.

This interpretation is buttressed by article 2463 *C.C.Q.* which describes the principle of indemnity in damage insurance policies.[70]

> **2463.** In damage insurance, the insurer is obliged to compensate for any injury **suffered at the time of the loss** but only up to the amount of the insurance.
>
> (emphasis added)

Loss of reputation and profits which flow therefrom are not suffered at the time of the initial loss. They arise quite independently of the initial loss. If a corporation wishes to insure itself against possible losses arising from the fallout after being named in an action, then it ought to expressly stipulate it and pay an additional premium.

[70] Of which liability insurance policies are considered to be a category.

Although this question has not been considered extensively in Canada, the approach that has emerged in the United States is to rely on the policy in determining who will have the last say. The decided cases there seem to indicate that the ability to force the insurer to settle for business considerations will depend on the level of control which the policy grants to the insured over the defence of the action. Where the policy wording allows the insurer to "make such investigation and such settlement of any claim or suit as it deems expedient" the courts have tended to find that there is no obligation to take into consideration non-economic business considerations.[71] Where the policy leaves the defence of the action to the insurer, which is the norm, then the insured may not force the insurer to accept a settlement which is unreasonable in comparison to the settlement value of the action, even where motivated by valid business considerations.

It is submitted that the same result should be obtained in Quebec civil law. Although Professor Bergeron takes the view that an insurer has an obligation to consider such factors as the insured's reputation in approving a settlement, he does not cite any authority for this proposition.[72] In fact, what scant jurisprudence there is in the Province of Quebec suggests the contrary view. In *Guay* v. *Garage D.L. Inc.*[73] the insured garage, anxious to protect its reputation, entered into a settlement when the insurer refused to assume the duty to defend. The Court held that although the insurer would ultimately be liable to answer for the damages awarded on the underlying action as a consequence of its breach of the duty to defend, the *Civil Code* did not require

[71] *Feliberty* v. *Damon*, 527 N.E. 2d (N.Y. 1988) at 262. *Contra* see *Lieberman* v. *Employers Insurance of Wausau*, 419 A. 2d 417 (N.J., 1980) at 422-423, although the *ratio* of the court here stems from the finding of a fiduciary duty between the insurer and the insured and the silence in the policy about the right of the insured to revoke his consent to a settlement, and *Rogers* v. *Robson. Masters, Ryan, Brumund and Belom*, 392, N.E. 2d 1365 (Ill., 1979). The scope of the "deemed expedient" clause was considered in *Gardner* v. *Aetna Casualty & Surety Co.*, 841 F.2d 82 (4th. Cir. 1988) where the Court noted that the insurer's discretion is not absolute, although greater deference will be shown to the insurer's decision where a settlement is reached within the policy limits (at 85). The test, applied in this case, was one of "reasoned good faith" on the part of the insurer on reaching a settlement over the objections of the insured surgeon, at 86.

[72] Bergeron, *supra* n. 69, at 414.

[73] [1991] R.R.A. 396 (C.Q.).

the insurer to accept the settlement reached by the garage. Similarly, in *Roberge* v. *Travelers of Canada*[74] the Provincial Court refused to accept the proposition advanced on behalf of the insured that the insurer was under an obligation to consider the insured's reputation as a driver in settling an automobile claim, dismissing it as an altogether secondary consideration.[75] On the whole then, the authorities seem to support the view that such considerations do not form part of the obligation borne by the insurer in considering a settlement.

3. Apportionment of Defence Costs

The apportionment issue arises where there are either some covered and uncovered parties to the action or where there are both covered and excluded claims involved in the action. The problem of the covered and uncovered defendant occurs, for example, whenever the corporation and the directors are sued together. It will be recalled that the corporation is not, itself, an insured under the policy, but is only entitled to reimbursement for an indemnification it pays to the insureds. The difficulties involved in apportioning defence costs between insured and uninsured parties is illustrated in *Bionaire*. In that case, after having disposed of the duty to defend question, the Court then had to address how to apportion defence costs. The Court there admitted that it was proceeding in an arbitrary manner and imposed a 30%-70% split in the legal fees incurred in respect of defending the action between uninsured and insured defendants respectively.[76]

As the above makes clear, it is not always evident as to how defence costs are to be apportioned. This, in itself, suggests an interest on the part of all parties concerned in the defence to reach an agreement as to how costs will be apportioned. The arbitrary nature in which courts appear to approach such questions may add some additional incentive to a negotiated

74[1978] C.P. 29.

75*Ibid.*, at 30-31.

76*Bionaire*, *supra* n. 53, at 1301-1302.

apportionment. It is interesting to note, in closing, that the Chubb Insurance Co. of Canada now offers a separate endorsement to its D&O policy to pre-determine how these matters are to be handled.[77]

Conclusions

The potential liabilities faced by corporate directors and officers are tremendous. While D&O insurance goes some way towards affording protection, the discussion above highlights how it must be viewed as a policy with inherent limitations. A number of elements may leave the insured exposed: the breadth of policy exclusions, possible *lacunae* in coverage due to the claims-made nature of the policy, insufficient policy limits, the failure to define regulatory offences as being losses, or uncertainty as to whether or not the insurer will assume the defence or not. All of these factors combine to suggest that serious risk assessment be undertaken by persons considering fulfilling these functions.

With the diversity of insurance products currently available on the market, it should not be a question of looking to one specific form of insurance policy to provide blanket protection against all risks. Certainly the corporation's Comprehensive General Liability (CGL) policy will go a long way in this direction covering areas traditionally excluded from D&O policies such as bodily injury, or damage to property. Today, however, new policies for employment practices, environmental liability and so on are available. Corporations and their directors more an more will have to consider the appropriate composition of the corporate insurance portfolio.

Rare, however, is the insurance policy, or combination of policies, which can provide 100% coverage for every conceivable risk. Apart from the possibility of exclusions and coverage limitations, there are just some risks which simply are

[77] "Predetermined Allocation for Securities Claims Endorsement". It should be noted that the availability of the endorsement is available only for claims relating to securities as Chubb estimates that these are the easiest claims to resolve in this manner.

not known at the time that the policy is subscribed. A director should, therefore, notwithstanding the fact that the corporation may have undertaken a serious risk assessment and subscribed to various policies of insurance, continue to ensure that sufficient indemnification from the corporation will be available should the need arise.