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THE CANADIAN BAR INSURANCE ASSOCIATION
L'ASSOCIATION D'ASSURANCES DU BARREAU CANADIEN

OUTSIDE DIRECTORSHIP LIABILITY INSURANCE

A LAWYER'S ROADMAP

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A LAWYER'S ROADMAP –
OUTSIDE DIRECTORSHIP LIABILITY INSURANCE

I. INTRODUCTION

This Handbook is intended to inform you, the practising lawyer, about some of the risks associated with sitting as a director on a Board, to explain the rationale and the content of the Canadian Bar Insurance Association (CBIA) sponsored Outside Directorship Liability (ODL) Insurance Program, and how to report a claim should one arise. Finally, and perhaps most significantly, this handbook will hopefully provide you with some valuable insights into certain practices that will hopefully help you be a better director and as a result reduce your exposure to claims.

A. History of the CBIA Sponsored ODL Program

The Canadian Bar Association (CBA) was formed in 1896 and incorporated by a Special Act of Parliament on April 15, 1921. The CBA represents approximately 36,000 lawyers, judges, notaries, law teachers, and law students from across Canada. Approximately two-thirds of all practising lawyers in Canada belong to the CBA.

The Canadian Bar Insurance Association (CBIA) is the insurance arm of the CBA. It is a not-for-profit corporation controlled and directed by lawyers which arranges for the provision of insurance products to members of the legal community, their families and employees. The CBIA offers a full line of insurance products planned and designed to meet the personal and business needs of Canadian lawyers and notaries at a cost that provides value and stability.

The ODL Insurance Program is sponsored by the CBIA. It was designed to provide coverage (both defence and indemnity) to lawyers who sit as directors on boards outside of their partnership or employment association. The program currently insures over 7,000 lawyers who sit on over 10,000 directorships across Canada.

The CBIA's ODL Insurance Program has been in existence since September 1989. Dion, Durrell + Associates Inc., a firm of actuaries and consultants, has managed the CBIA's ODL Insurance Program in Canada since April 1, 1998 when certain syndicates at Lloyd's became the program underwriters.

B. Why ODL Insurance?

The ODL Insurance Policy provides insurance coverage to a lawyer who sits as a director on the board of a corporation as opposed to a lawyer who acts as counsel and provides legal services to a corporation. **This insurance policy provides coverage for lawyers who sit as outside directors of corporations.** Given that the role of a director is vastly different than the role of a lawyer giving legal advice is different, the risk of exposure is also different. Accordingly, it is important for a lawyer who is contemplating a

directorship to be aware of what the role of a director involves and the potential exposures that may exist.

In general terms, the role of the director is one of stewardship or guidance. The Toronto Stock Exchange Report *"Where Were the Directors"* [1] analyzed the role of the director by examining the responsibilities of the board. The report concluded that key responsibilities included the adoption of a strategic planning process, managing risk, appointing, training, and monitoring senior management, ensuring that effective communication policies exist within the organization and that internal control and management information systems are in place and are effective.

A board of directors typically includes "inside" and "outside" directors. Inside directors are typically employees of the company. Examples of an inside director would be an individual from the ranks of management – such as the president or treasurer of a corporation. Outside directors are non-employees of the corporation. By virtue of their independence, they are expected to act as "watchdogs" for the shareholders. A more recent study by the Toronto Stock Exchange found that over 77% of all directors on today's boards are independent outside directors and this number is on the increase.[2]

While the line distinguishing the responsibilities of managers and directors is often blurred, it is the directors who have ultimate responsibility for the corporation. Managers are employees. If they are remiss or negligent in their duties, outside of criminal activity, arguably the worst consequence that a manager faces is dismissal from his or her employment. In sharp contrast, negligent stewardship of a company may have far more severe consequences for the company's directors. Directors are exposed to facing regulatory proceedings, quasi-criminal prosecution and/or civil lawsuits by Trustees in Bankruptcy, Receivers and/or shareholder and investors. Moreover, in the face of a company without assets and/or lack of directors and officers (D&O) insurance, a director's personal assets are potentially at risk. For the latter reason alone, it is extremely important that directors understand the processes through which decisions are made and implemented and that they monitor these processes.

As this Handbook is being published, its contents must be viewed in the context of two significant events. First, the tragic events of September 11, 2001 accelerated the pace of change in the worldwide insurance market and a fundamental reanalysis of all types of insurance coverage being underwritten. Directors and Officers insurance was not spared by insurers as they reviewed the risks that they were prepared to insure particularly in light of the second "event" that was virtually contemporaneous with the first. The second "event" was actually a series of events. Accounting irregularities coupled with the bursting of the "tech stock" bubble led to numerous lawsuits against corporations and their directors and officers. In combination, these two events have resulted in new calls by regulators, stock investors, government agencies and the public for more stringent

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[1] Toronto Stock Exchange: Committee on Corporate Governance in Canada, "Where were the Directors?" (Dey Report), Toronto, December 1994

[2] Toronto Stock Exchange: The Institute of Corporate Directors Report on Corporate Governance, "Five Years to the DEY", Toronto, June 1999

corporate governance and higher standards of care imposed on directors, in particular, of corporations. These two events have also resulted in an extremely "hard" market for directors and officers insurance resulting in lower limits being offered to companies at significantly higher prices.

While this handbook is not the venue to explore recent changes to securities laws and regulations in the U.S. and Canada, mention must be made of two very significant and far reaching pieces of legislation.

In the United States, the Sarbanes Oxley Act of 2002 (Sarbanes) was enacted, in part, as a response to the wave of corporate frauds that either coincided with or overlapped the meltdown of technology sector stocks. Sarbanes cuts a wide swath through what used to be complacency of inside management and boards of directors. The legislation places greater corporate responsibility on directors and officers, including certifications of audited financial statements by CEOs and CFOs, greater internal controls, real-time updates of filings and other guidelines, restricts the role of outside auditors and lawyers, requires enhanced disclosures to shareholders, and may have federal criminal consequences for some actions. It is obvious that Sarbanes changes the way the boards are expected to act, and this, in turn will increase directors and officers obligations and liabilities.

Here, in Canada, legislators and regulators have not ignored what has happened south of the border since Canada has not been spared of its own versions of Enron, WorldCom etc. For example, Ontario's Bill 198 contains a number of securities reforms which impose liability on, among others, directors and officers for misleading statements. Shareholders can now sue directors who were responsible at the time a misleading document or public statement is made that contains a misrepresentation. While there are some limits placed on the liability of directors there are also very tough penalties separate and apart from the potential civil liability. As with Sarbanes, Bill 198 should change the playing field for corporations who will have to commit or recommit themselves to adopting principles of good corporate governance to avoid coming under scrutiny or worse yet run afoul of its provisions.

II. DUTIES OF DIRECTORS

A. Basic Duties

Directors owe a number of basic duties to the corporation:

1. Duty of Knowledge

   The director must have knowledge of the corporation and its activities. A prudent director should review the corporation's charter documents and by-laws to understand the parameters of his/her powers and responsibilities as a director.

2. Duty of Care/Duty of Diligence

Directors must perform their duties in good faith and in the best interests of the corporation. They must monitor the business activities of the corporation on an ongoing basis and exercise due diligence in making business decisions for the corporation.

3. Duty of Loyalty

Directors must not use their position of trust and confidence to further their own personal interests, i.e. they must avoid placing themselves in positions where they would be in a conflict of interest. For example, directors are prohibited from appropriating corporate opportunities or taking secret profits (which would include insider trading). Directors owe a fiduciary duty to the corporation.

4. Duty of Obedience

Directors should be guided in carrying out their duties in accordance with the charter/by-laws of the corporation, in accordance with the legislation in the jurisdiction(s) in which the corporation carries on business and in accordance with the common law. Directors must not exceed the powers granted to them by the terms of incorporation.

5. Duty of Skill and Prudence

A director brings a certain skill set to the corporation. That skill set must be utilized practically and with caution.

6. Duty to Manage

Directors are responsible for the overall direction that the company takes. As a result, they have a duty to act reasonably and with prudence, as they may be held responsible for the consequences flowing from the direction taken.

Legislation dealing with business corporations across Canada (federal and provincial) has, to a large degree, codified these duties and responsibilities. The Acts impose a duty on directors to act in good faith and in the best interests of the corporation, and to exercise the skill, care and diligence that a reasonably prudent person would exercise in similar circumstances. In addition, many federal and provincial statutes ranging from the *Income Tax Act* to environmental protection legislation impose specific responsibilities on, and attach potential liabilities to, directors of corporations.

One leading international organization summarizes the responsibility of the board of directors as follows: [3]

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[3] Organization for Economic Cooperation and Development, Ad Hoc Committee for Corporate Governance, OECD Principles of Corporate Governance, April 16, 1999

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

A. *Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.*

B. *Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.*

C. *The board should ensure compliance with applicable law and take into account the interests of stakeholders.*

D. *The board should fulfil certain key functions, including:*

   1. *Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.*

   2. *Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.*

   3. *Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.*

   4. *Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.*

   5. *Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.*

   6. *Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.*

   7. *Overseeing the process of disclosure and communications.*

E. *The board should be able to exercise objective judgement on corporate affairs independent, in particular, from management.*

   1. *Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.*

   2. *Board members should devote sufficient time to their responsibilities.*

F. *In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.*

B. Protection for Directors

Business corporation statutes also provide for the indemnification of directors by the corporation under certain circumstances. The corporation is *permitted* to indemnify where the director acted honestly and in good faith with a view to the best interests of the corporation. In the case of criminal or administrative proceedings, it is also necessary to show that the director had reasonable grounds to believe that his or her conduct was lawful. However, the better and more prudent practice is for the corporation to enter into a contract of indemnity with the director. This makes the indemnity mandatory as

opposed to permissive or discretionary. The director can look to the corporation for indemnity immediately upon notice of a claim.

Business corporation statutes also contain provisions permitting the corporation to purchase insurance for the benefit of directors against liability except where the liability relates to the failure to act in good faith with a view to the best interests of the corporation. Prudent lawyers who are considering whether to accept an appointment to a board should inquire whether the corporation has or is prepared to put such protection in place before accepting an appointment.

Often a corporation's by-laws will provide for a corporate indemnity and/or the purchase of insurance for the benefit of directors against liability.

For directors on boards of privately owned corporations directors can obtain protection through indemnification provisions provided in unanimous shareholders agreements. However, it should be noted that similar to a corporate indemnity, the value of the indemnity is tied to the financial status of the entity. Furthermore, such an indemnity affords no direct defence to a third party making a claim and may therefore have limited value.

III. THE LAWYER AS DIRECTOR

A. Motivations

Lawyers are the second most frequently desired occupational group (behind independent business people) chosen by corporations for outside directors holding up to 32% of all outside directorships in Canada.[4] It has been estimated that more than three-quarters of all boards have lawyers as outside directors. In the United States, approximately 30% of the 250 largest industrial companies in the United States include lawyers on their boards.[5] There are numerous reasons for this trend both from the perspective of the company and from the perspective of the lawyer.

From the corporation's viewpoint, lawyers are excellent candidates because they have many positive attributes that qualify them to sit on the board of directors. Lawyers are highly educated. Lawyers are perceived to exercise good judgment. Lawyers possess a certain level of specialized expertise even perhaps in the industry or business environment within which the corporation competes. Lawyers frequently have knowledge of the corporation's business and regulatory affairs if they or their law firms do the corporation's legal work. Furthermore, lawyers are viewed as leaders in the community. Having one sit on a board of directors may give a corporation heightened profile or lend legitimacy to its operation.

For lawyers, there are numerous personal motivations to sit as a director. These reasons may be any number of the following:

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[4] ibid, Footnote 2
[5] Directors & Officers – The ACE Report, Issue No. 17 – January 1995

- Financial or business reasons
- Firmly held belief that they can add value
- Public service, e.g. non-profit societies
- Professional recognition or stature

Whatever those reasons may be, the interests dovetail to result in a growing trend for lawyers to take on corporate directorships.

B. What type of corporations seeks lawyers for directorships?

An examination of the applications for ODL insurance completed by lawyers across Canada reveals a broad spectrum of corporate directorships - private, public, non-profit corporations. No one industry or type of corporation seems predisposed to select lawyers as opposed to other individuals or professionals as directors.

IV. SOURCES OF CLAIM

Directors are increasingly exposed to all kinds of exposures regardless of whether they have carried out their duties in accordance with the law. At one time, directorships might have been collected for reasons of prestige or client convenience with very little work or responsibility involved. However, those days are long gone. A recent survey by Tillinghast-Towers Perrin shows that there are many and varied sources of claims against directors. [6]

The statistics from this survey for Canadian respondants reported the following breakdown of where and from whom directors faced claims:

Employees	- 20%
Shareholders	- 16%
Customers and Clients	- 8%
Competitors/Suppliers	- 16%
Government	- 24%
Other	- 16%

[6] Tillinghast-Towers Perrin, 2002 Directors and Officers Liability Survey

U.S. respondents to this survey reported the following breakdown of where and from whom directors faced claims:

Employees	-	63.3%
Shareholders	-	21.4%
Customers and Clients	-	5.8%
Competitors/Suppliers	-	4.0%
Government	-	0.8%
Other	-	4.7%

In a comparison of the statistics between Canada and United States employee claims are much more prevalent in the US than in Canada (three times higher) while claims by the government are far more prevalent in Canada than in the US (the US having roughly 3% of the number of claims that Canada experiences). This may reflect the tendency in Canada for greater government intervention in the corporate sector or fewer protections for the work force in the US, but no hard and fast conclusions or inferences can really be drawn here.

Common sources of claims experienced by the ODL Insurance Program include, but are not limited, to the following:

- Employment related claims – Employment Standards Act etc.
- Statute created claims – Canadian Customs and Revenue Agency, Securities Commission claim etc.
- Tax
- Environmental
- Privacy Concerns
- Breach of fiduciary duty, bad faith and oppression claims by shareholders and investors

The experience of the ODL Insurance Program largely mirrors that of the industry in Canada when compared to the Tillinghast survey.

The following is a list of some of the allegations that are often made against directors and officers in lawsuits and regulatory proceedings many of which have shown up in claims in the ODL Insurance Program:

- Acting beyond the scope of authority
- Defamation – libel and slander
- Inefficient or lack of supervision and monitoring of management
- Misleading reports and/or misrepresentation of status
- Inadequate or misleading disclosure
- Wasting of assets

- Conflicts of interest
- Fraud and mismanagement
- Improper accounting practices
- Improper stock transactions
- Misconduct at shareholders meetings

Based on the experience of the ODL Insurance Program by far the most problematic area that an Insured faces are claims that arise when corporations become insolvent. This can and does result in claims by government authorities (e.g. for unpaid source deductions), class actions by shareholders and/or claims are made by Receivers/Trustees in Bankruptcy.

Generally, directors have not been held liable for breach of contract or torts committed by corporations on whose boards they serve. However, a recent decision of the Ontario Court of Appeal appears to put into question that longstanding assumption. In *ADGA Systems International Ltd. v. Valcom Ltd.*, ADGA and Valcom were competitors on a federal building contract. The tender required the tendering parties to disclose the names and technical qualifications of at least 25 of its senior technicians. Valcom had no employees so through its sole director and two senior employees convinced ADGA's technical staff to use their names on their tender. In return, if successful, Valcom would hire them. Valcom succeeded. ADGA sued for damages for inducing breach of contract and inducing breach of fiduciary duty. Valcom succeeded on a motion for summary judgement, was reversed on appeal to Divisional Court but ultimately succeeded in the Court of Appeal (leave to the Supreme Court of Canada denied). The court stated "*there is no principled basis for protecting the director and employees of Valcom from liability for their alleged conduct on the basis that such conduct was in pursuance of the interests of the corporation*". [7]

Directors clearly owe a fiduciary duty to the corporation. To a large degree this duty has been codified into statute. However, it was widely assumed that this duty did not, in the past, extend to the corporation's creditors. However, at least one recent decision has put this assumption into doubt. In *People's Department Stores v. Wise et al*, [8] Peoples was a wholly owned subsidiary of Wiseco. The directors of Peoples also sat as directors of Wiseco. Peoples made a profit, Wiseco did not. A new purchasing practice was entered into – Peoples would buy for both itself and Wiseco. Peoples would deliver product to Wiseco and a trade account was created between the two entities. Peoples ended up being owed considerable money by Wiseco. Both went bankrupt. The Trustee in Bankruptcy sued the directors of Wiseco (and Wiseco's D&O insurer) for the value of Peoples' uncollectible account receivable from Wise Stores. The trustee claimed that the Wise brothers had acted negligently toward Peoples and were "privy" to a "reviewable transaction" in Peoples' bankruptcy. At trial, the court held that the directors could not avail themselves of the "business judgement" defence, i.e. a defence ordinarily available

[7] ADGA Systems International Ltd. v Valcom Ltd. (1999) 43 O.R. (3d) 101 (CA)
[8] People Department Stores Inc. v. Wise, [1998] Q.J. No. 3571; Peoples Department Stores ([2003] Q.J. 505)(appeal)

to corporate directors who have exercised their business judgment in a reasonably informed manner. In this case, the court held this defence was negated by the directors' failure to have obtained material information about, or to have made reasonable inquiry into matters surrounding their decision to make Peoples the domestic purchaser for Wiseco. The court stated: *"... directors of a wholly-owned subsidiary may consider the best interests of the parent and, where those and the best interests of the subsidiary overlap or coincide, they may act accordingly. Where those respective interests are not concurrent, they must attempt to conciliate the two. Hence, where there is a mutuality of interests, there is no problem. However, where the best interests of the subsidiary are in direct conflict with those of the parent, the former must prevail in regard to the actions of the directors of the subsidiary."* Of equal, if not greater, significance was the court's recognition of Peoples' creditors as stakeholders of that corporation. The court said that corporate directors should not sacrifice the interests of the corporate creditors and that creditors interest, not just the interests of the corporation's shareholders, must be considered. The Court of Appeal reversed the trial decision and the matter is now under appeal to the Supreme Court of Canada.

Taken together, ADGA and People's serve as examples of the changing world of corporate governance and the resulting challenges facing directors in Canada today.

V. LOSS PREVENTION/BEST PRACTICES

No one likes to be the target of a Claim. However, the realities of today's business and regulatory environment suggest that professionals are being held to very high standards. While lawyers' are being held to increasingly high standards by the courts in their capacity as lawyers, it is suggested that they are also increasingly being held to as high or perhaps even higher standards as directors by virtue of their professional status as lawyers. One recent case out of the Alberta Securities Commission is an example of this very situation.[9] In this case, the Commission had the following comment about the lawyer, who fortunately was held not to be in breach:

> *In order to determine what an individual director's obligations are under any particular circumstances, it is necessary to consider a number of factors that will vary with each director, including: the director's role with the company; the director's individual experience, skills and expertise; and the information available to the director...*
>
> *Even though D was not involved in the management of Cartaway, his dual role as director and lawyer gave him access to more information regarding Cartaway's affairs than an outside director (a director who was not an officer or employee) would normally have. That was especially true in relation to Cartaway's material change because D dealt with almost every detail of the transactions involved. Because of this dual role, D was an inside director, and assumed a higher degree of responsibility, in relation to these transactions.*

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[9] In the Matter of Cartaway Resources Corporation, Alberta Securities Commission, decision released August 11, 2000

Another, and perhaps more publicized case, is one involving *YBM Magnex* in Ontario. The case dragged on for 124 days of hearing in front of the Ontario Securities Commission (OSC) over the period commencing in November 1999 and finally concluding in November 2002. [10] There were also a number of civil lawsuits (class actions and an action by the Receiver) in the US and in Canada against the directors and underwriters. These actions were ultimately settled reportedly for $85 million making the largest class action settlement in Canadian history. Exact details of the settlement amount and who paid what amount have never been made public but one can speculate with reasonable certainty that directors and officers (and perhaps other) insurance was involved.

YBM was an industrial magnet manufacturer. The company's value soared until collapsing in May 1998 amidst speculation that it had ties to Russian organized crime and was involved in profit laundering. The OSC investigated and then commenced a prosecution against brokerages involved in placements, the officers and directors and the corporation's lawyer. Notably, one of the outside directors was a lawyer.

The OSC handed down a lengthy decision. It fined the brokerages. It banned some directors from sitting for three years or longer. The lawyer who sat as an outside director, while escaping either fines or punishment was unfortunately not entirely exonerated by the findings despite not having known about the fraud perpetrated on the public. The OSC had this to say about lawyers who sit as outside directors:

> *185] When dealing with legal matters, more may be expected of a director who is a lawyer. A lawyer-director may be in a better position to assess the materiality of certain facts. Due to improved access to information, more may sometimes be expected of directors depending on the function they are performing, for example those who sit on board committees, such as a special committee or audit committee. An outside director who takes on committee duties may be treated like an inside director with respect to matters that are covered by the committee's work; Victor P. Alboini, Securities Law and Practice, loose-leaf (Toronto: Carswell, 1984) at s. 23.4.1.*

The OSC went on and made specific reference to this lawyer director:

> *321] While we believe P could have done more, we have concluded that P acted reasonably based on his involvement in the matter, his skill and his access to information in the circumstances. Accordingly, his due diligence defence is available to him, but just barely. We are of the view that P brought a unique perspective to the board. His professional reputation as testified to by Mr. MW, Mr. DB and Mr. JT, and his experience in many other public company boards, was not in any way equaled by any other Director. He had unique access to counsel to the Special Committee, whom he supported as counsel both to YBM and the Special Committee. He was appointed to add to the prestige and status of YBM. While P meets the legal test of due diligence, the panel remains disappointed that he did not offer more insight and leadership to the board in these circumstances.*

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[10] In the Matter of the Securities Act, RXO 1990, C. S.5, as amended and YBM Magnex & Others, decision released June 27, 2003

These cases may be anomalies or they may be the spectre of things to come. Given Sarbanes and Bill 198 and the renewal of calls for better corporate governance across Canada the latter is probably the better call to make.

Regardless of what the future may hold, these two cases are instructive and there are clearly lessons to be learned by directors for loss prevention practices. First, directors are being held to higher standards of care than ever before – perhaps lawyer directors even more so. Second, it is incumbent on directors, both lawyer and non-lawyer, to understand their duties and responsibilities and to take steps to engage in loss prevention or face the possibility and the unpleasant consequences of lawsuits, regulatory proceedings or other professional discipline.

In a recent publication, KPMG published a list of what it considered to be "*Best Practices"* for Boards of Directors.[11] Set out below is an excerpt for the Attributes and Activities from that report that can be used to measure the performance of the directors.

Best Practice Attributes:

- Clear understanding of board roles and responsibilities
- Experience/expertise relevant to company
- Sufficient availability and contribution of time
- Clear understanding of business and industry
- Ability to always act on behalf of shareholders
- Ability/confidence to challenge management
- Demonstrate high integrity, diligence, ethics
- Appreciation for quality financial reporting
- Positive influence over controls, ethics

Best Practice Activities:

- Annual meeting with external auditors prior to issuing financial statements
- Assure audit committee has appropriate resources
- Assure audit committee has appropriate capabilities
- Consider committee terms - continuity vs. freshness
- Encourage new member orientation/education
- Annual self-evaluation of board and members

In a recent article, one writer set out the following Seven Principles of Corporate Governance: [12]

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[11] KPMG Audit Committee Institute, Audit Committee Best Practices
[12] Source: Strategy + Business Spring 2003

1. Select the right people – principle based
2. Director Education
3. Inform and Communicate – directors, auditors, employees
4. Balance the CEO's power
5. Encourage "constructive scepticism" – directors and auditors
6. Time – directors should limit their board service to a few Companies
7. Evaluate and Improve

VI. WARNING SIGNS

In the Toronto Stock Exchange's Report on Corporate Governance, a number of respondents were asked to identify the signs that directors should watch for as early warning signs about impending crises.[13] The three most common answers are listed below:

- 49% of the respondents identified situations where the directors were too passive and where management acted too independently
- 26% of the respondents identified situations where the corporation continually missed targets and that the company received a negative market outlook
- 21% of the respondents identified situations where management was unresponsive, missed deadlines and/or misled the board

The inference that can be drawn from the above is obvious - directors need to sit up and take notice of these and other clear indicia which are signs of future problems for the corporation and potential claims against officers and directors. Sarbanes Oxley in the United States, Bill 198 in Ontario, and the comments of the securities commissions from the two cases reviewed above support that proposition.

To protect oneself , three common sense steps will assist a director in fulfilling his or her fiduciary duty to the corporation:

✓ Stay informed – Do you look at the financial statements? Do you understand them? If not, ask questions and don't relent until you get an answer that is satisfactory.

✓ Monitor Duties Delegated to Others – As a director you are not management. You are an overseer. You may reasonably rely in good faith on the honesty and integrity of advisers, officers, and subordinates. However, as a precaution, you should always follow up with the party to whom a duty has been delegated.

✓ Be alert to and respond to Red Flags – If something looks suspicious or if you become aware of facts that would arouse suspicion in others ask management the "tough" questions – to ignore doing so may be perilous down the road.

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[13] ibid, Footnote 2

How to put this into practice? For example, claims are often made against directors for unpaid tax remittances after a corporation becomes insolvent. Using the above as a guide, the diligent director might consider taking the following steps:

- Review the financial statements and look for unusual liabilities.
- Ask for an explanation what these liabilities represent. For example, ask the chief financial officer whether all taxes have been paid.
- If not, ask "why not?". Get assurances, incorporated into the minutes of meetings, that these liabilities, particularly if they are taxes, will be paid.
- Follow up at the next or subsequent meetings "has this been done?".
- As a last resort, consider your long term options if your entreaties as a director are being ignored by management. It may be necessary to consider tendering your resignation over the issue. Unpaid liabilities, particularly taxes that are not being remitted, may be indicia of much bigger problems that are being hidden from you.

VII. THE POLICY

Note: This Summary is intended to serve as a brief guide to policy coverage. In all cases, coverage will be provided in accordance with the actual terms, conditions and exclusions of the policy. Actual policy wording, and not this Summary, will determine the binding terms and conditions of coverage.

A. A General Primer

1. ODL Insurance versus the Corporate Indemnity

Many companies realize that their directors are potentially exposed to many different kinds of risk. As a result, they often agree to indemnify their directors for any defence costs and/or damages that may be awarded against them. This is accomplished by incorporating the indemnity into the company's by-laws and/or by entering into separate indemnification agreements with their directors.

An indemnity agreement is a contract between the corporation and the individual director. Hence, it is possible that the corporation may breach the contract either intentionally (as for example in a situation where a director is dismissed from the board and a dispute exists) or unintentionally (as for example where the corporation is insolvent and it does not have the financial resources to honour the indemnity, which based on the experience of the ODL Insurance Program is a frequent occurrence). In either event, the director is potentially at risk of exposing his or her own personal assets in the face of a claim where there is a finding of liability. In other words, the value of an indemnity is only as good as the financial strength of the company that provided it. When a corporation fails, there is rarely, if ever, sufficient resources to finance the defence of officers and directors whose activities are being scrutinized by potential claimants to see whether there is any fault to be found.

It is for that very reason that a lawyer (or for that matter any individual) who is considering whether or not to accept a directorship should seriously consider that as a precondition to accepting an appointment that the corporation purchase D&O liability insurance. For even greater protection, a lawyer also has the option of purchasing affordable ODL insurance.

2. ODL Insurance versus Lawyers' Professional Indemnity Insurance

In every jurisdiction in Canada, the provincial/territorial law societies require compulsory professional liability insurance for its lawyers. The policy limits provided by these compulsory insurance programs are generally $1 million per claim and $2 million in the aggregate.

There are similarities between the coverages that most of these insurance policies provide. However, virtually every one of those policies contain specific policy wording excluding coverage for activities by lawyers as officers or directors[14] or may potentially exclude coverage by not including these activities under the definition of Professional Services. [15]

Many if not most lawyers may believe that the skills and experience that they bring to the director's table cannot be separated from the role as a director. However, from the insurance perspective, a lawyer's errors and omissions/professional liability insurance

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[14] In British Columbia, for example, the B.C. Lawyers' Compulsory Professional Liability Insurance Policy (2001) contains the following exclusion:

This Policy does not apply to…

5. *a **claim** arising out of your activities as an officer or director except your activities as an officer or director of a **law corporation** or law office management corporation*

In Alberta, another example of lawyer's professional liability policy wording contains the following exclusion:

The insurance coverage given by this Part A does not apply to a Claim arising out of or from:…

3.9 *an Insured's acting in the capacity of director or officer of any Enterprise other than ALIA or the Law Society;*

[15] In Ontario, the Lawyers' Professional Liability Insurance Policy (2003) contains the following definition of "Professional Services":

"PROFESSIONAL SERVICES" *means the practice of the Law of Canada, its provinces and territories and further means those services performed, or which ought to have been performed by or on behalf of an INSURED in such INSURED'S capacity as a lawyer and as a member of The Law Society of Upper Canada, subject to Part II Special Provision A; and shall include, without restricting the generality of the foregoing, those services for which the INSURED is responsible as a lawyer arising out of such INSURED'S activity as a trustee, administrator, executor, arbitrator, mediator, patent or trademark agent.*

The LPIC policy does not contain a specific exclusion for activities as an officer and director but at the same time acting as a director is not included under the definition of "Professional Services". While LPIC's policy wording may be ambiguous enough to provide coverage in the event of a claim against a lawyer who sitting as a director is also performing services as a lawyer the Kerr vs. Lawyers' Professional Indemnity (1995), 25 O.R. (3d) 804 at 812, 128 D.L.R. (4th) 269 (C.A.) may be an indication of the position of LPIC on this point.

policy may not provide any protection for any claims in the event that the lawyer is sued in the capacity as director.

3. ODL Insurance versus Traditional Directors & Officers (D&O) Insurance

Traditional D&O insurance policies are generally not written with any specific profession, individual or group of individuals in mind. Many D&O policies are written with very restricted and narrow coverage, which may be reflective of the limited insurance market for this type of insurance.

The ODL Insurance Policy is intended to be separate excess insurance for lawyers over and above any corporate indemnity and/or D&O insurance that may exist.

The ODL Insurance Policy has the following features that distinguish it from a traditional D&O policy:

- ✓ You must be a lawyer or notary to apply and qualify for coverage
- ✓ The policy is written as an excess policy but in certain limited situations can "drop down" in the absence of underlying coverage
- ✓ Policy coverage can extend to multiple directorships
- ✓ For some coverage options there are no reporting requirements or premium charged for newly added lawyers or newly acquired directorships
- ✓ Individual directorship are risk rated according to a short questionnaire attached to the application
- ✓ Premiums are competitively priced versus traditional D&O insurance policies

B. The ODL Insurance Policy

The following is a brief summary of the most significant terms of the ODL Insurance Policy. It is a simplified analysis of the insurance policy's terms and conditions. For a more in-depth view, please refer to your actual insurance policy (a sample policy is attached as Appendix A) and review any endorsements attached to it which may provide slightly different coverage than that summarized hereunder.

1. What does the ODL Insurance Policy cover?

The ODL Insurance Program provides lawyers the choice of three different options depending on the lawyer's or law firm's circumstances:

a) An "Individual" policy covers a <u>Named</u> lawyer for <u>Named</u> directorships;

b) A "Group - Selected Lawyers" or Group Select policy covers only <u>selected lawyers</u> who are named by the Law Firm in the application for <u>selected directorships;</u>

c) A “Group - All Lawyers” or Group All policy covers all lawyers in the Law Firm for all directorships.

2. The Coverage

The ODL Insurance Policy is an excess insurance policy that is intended to provide defence and/or indemnity coverage for lawyers who sit as directors on boards of corporations outside of their partnership or employment association.

The ODL Insurance Policy insures against the legal liability of outside directors for claims arising out of “Wrongful Acts”, as defined in the policy, in the event that the director is not totally indemnified by the corporation, and/or other insurance is not available to indemnify the directors.

Coverage under the ODL Insurance Policy extends to claims made anywhere in the world. The Insurer will provide a defence for claims made or suits brought in any jurisdiction within Canada, the United States, its territories or possessions, or in a jurisdiction where the judgement rendered could be enforced in Canada.

The payment of defence costs reduces the available policy limits under the policy except in the province of Quebec where there is a statutory requirement for defence costs to be in addition to the limit.

3. The ODL Insurance Policy is a “Claims Made” Policy

The ODL Insurance Policy is a “**Claims-made”** policy. This means that for a claim to fall within policy coverage it must have been first made against the lawyer director during the policy period and reported to the Insurer prior to the expiry date of the policy.

4. What is a “Claim”?

A Claim is a written demand for monetary damages, a civil proceeding commenced by service of originating process or an administrative or regulatory proceeding commenced by the filing of notice of charges or formal investigative order.

5. What is a “Wrongful Act”?

This policy provides coverage for Wrongful Acts committed by lawyers who sit as directors of Corporations. A “Wrongful Act” means any actual or alleged error, misstatement, misleading statement, act, omission, neglect, negligent act or breach of duty, by the Named Insured, individually or otherwise, or any matter claimed against him or her by reason of his or her serving in an outside directorship.

6. What Policy Limits are available?

There are three policy limits options for individuals – per claim and annual aggregates of $1,000,000, $2,000,000 and $3,000,000 are available.

There are also three policy limits options available for law firms for the Group Select and the Group All policies as follows:

> $5,000,000 "Each Loss" and $5,000,000 "Each Policy Period"
> $5,000,000 "Each Loss" and $10,000,000 "Each Policy Period"
> $10,000,000 "Each Loss" and $10,000,000 "Each Policy Period"

The limit of liability for "Each Corporation in the Aggregate" is either $10,000,000. In other words, this is the maximum amount of insurance coverage available for all claims against any number of Insureds, insurance policies or directorships relating to any single Corporation.

The ODL Insurance Policy requires insureds who sit on the boards of publicly traded corporations to carry Minimum Underlying Insurance of up to CAN$10 million. In the absence of underlying insurance, there is a sub limit of coverage of CAN$1 million. For US publicly traded corporations, regardless of the existence of underlying insurance, there is a sub limit of coverage of CAN$2 million.

7. Who is the "Named Insured"?

The "Named Insured" is the lawyer, partner or employee who is insured under the ODL Insurance Policy.

For the "Individual" option, the Named Insured is the individual named in the application for insurance.

For the Group All and Group Select options, the Named Insured includes partners, employees or others who are deemed to be employees by the Law Firm named in the insurance application.

Coverage applies to such persons only while they remain members of the Law Firm. However, for an additional premium, coverage can be extended to lawyers who have left the Law Firm but only for Wrongful Acts that occurred while they were still in the employ of the Law Firm.

On a Group All policy, new lawyers automatically covered during the policy term and notification is only required at the next renewal date. On a Group Select policy, new lawyers holding directorship and wanting coverage must be applied for and accepted by the insurer.

8. What is an "Outside Directorship"?

An "Outside Directorship" means the position of director, officer or equivalent position held by any "Named Insured" in a Corporation or non-profit Corporation as stated in the application.

A Corporation for the purposes of the Policy is a legal entity other than:

- The Named Insured's employer or subsidiary
- Legal entities for which any "Named Insured" is a director or officer and is a partner or salaried employee/officer
- Legal entities in which a "Named Insured" owns, directly or indirectly, more than ten (10) percent of the voting shares
- Partnerships, limited partnerships and general partnerships

9. Is the ODL Insurance Policy primary or excess insurance?

The ODL Insurance Policy applies in excess of any corporate indemnity or other underlying D&O liability insurance.

Directorships for both Canadian and U.S. publicly traded corporations must have underlying insurance in place or a sub limit of insurance will apply.

10. What does the term "Retroactive Date" mean?

"Retroactive Date" means the date at which insurance is first effected for the "Named Insured" under this policy or its predecessor policies, provided that there is no break in the continuity of policy coverage.

11. What does the ODL Insurance Policy exclude?

The Insurance Policy does not cover claims arising from:

- known Wrongful Acts committed on or prior to the Retroactive Date or to the date on which coverage is first effected by any directorship
- any deliberately fraudulent act or omission or any wilful violation of any statute or regulation
- bodily injury, mental or emotional distress, sickness, disease or death of any person or any property damage (tangible property or loss of use)
- any remuneration paid to directors without the previous approval of the shareholders
- profits from insider trading in securities of the corporation

- fines, penalties or punitive damages with exception, in some circumstances, of certain statutory liabilities
- actual, alleged or threatened discharge, release or escape of pollutants, including clean-up and testing costs
- claims brought by the corporation on whose board the director serves except derivative actions

12. Is there Coverage for Prior Acts?

The ODL Insurance Policy is a claims made policy. This means that, under ordinary circumstances, insurance coverage is determined by the date that the director first becomes aware of a Claim and reports it to the Insurer.

However, in very limited circumstances, prior Wrongful Acts (as opposed to Claims) may be covered. For example, if a prior Wrongful Act was committed related to an insured directorship but the Insured had no prior knowledge of either the prior Wrongful Act or of any prior Claim being made and the Wrongful Act did not occur before the Retroactive Date of the Policy coverage may be extended.

13. What happens if I leave a law firm during the Policy Year – am I covered?

If a "Named Insured" leaves the law firm, coverage will continue until the expiry date of the policy, but only for Wrongful Acts committed prior to his or her departure.

If coverage is elected for that individual under the Extended Reporting Period at the next renewal, that Named Insured will then be covered under the Extended Reporting Period, but only for Wrongful Acts committed prior to the individual's departure.

Under the Group All and Group Select option, a blanket "Extended Reporting Period Endorsement" is also available. Rather than having to name specific individuals, coverage for all former "Named Insureds" is automatically included for an additional 5% of the total premium.

14. What happens if New Directorships are acquired during the Policy Year?

Under the Group All coverage option new lawyers and eligible outside directorships acquired by the "Named Insured" subsequent to the date of the application are automatically covered without notification to the Insurer. Notification is to be provided to the Insurer at the next renewal date.

Under the Group Select coverage option both newly added lawyers to the firm and newly acquired outside directorships must be applied for and accepted by the Insurer before coverage applies.

15. What happens if a Directorship ends during the Policy Year?

If any directorship covered by the policy is terminated during the policy period, the policy will continue to cover the "Named Insured" until the expiry date of the policy and renewals thereof, but only with respect to Wrongful Acts committed prior to the termination of such directorship.

16. Is there a Deductible?

A deductible of $5,000 shall apply to each loss. The deductible does not apply to defence costs.

VIII. HOW DO I APPLY FOR ODL INSURANCE?

To obtain details on how to apply for ODL insurance coverage, please contact your insurance broker or contact the Program Manager directly at the following address:

CBIA Outside Directorship Liability Insurance Program
c/o Dion, Durrell + Associates Inc.
Suite 306
20 Queen Street West
Toronto, ON
M5H 3R3

Phone: (416) 408-5296
Fax: (416) 408-3721
CBIA-ODL@dion-durrell.com

A sample copy of the Insurance Application and Schedule 1 is attached as Appendix B hereto.

IX. WHEN AND HOW TO REPORT A CLAIM?

If a claim is made against you for a Wrongful Act or if you become aware of circumstances that could give rise to a claim, you should immediately provide written notice of the claim or potential claim to the Insurer through your broker and/or to the Insurer (c/o the Program Manager) at the above-noted address. Your written notice should be sent to the attention of the "Claims Administrator" at that address.

Your written notice should contain the following details:

- Name of Insured Lawyer
- Name of Law Firm
- Policy Number
- Name of Corporation in which directorship held

- Date you were put on notice of claim or date that your first became aware of a potential claim
- Nature of Claim
- Brief description of the circumstances leading up to claim or potential claim
- Attach any relevant correspondance, notices or pleadings which give rise to the claim

If you are in doubt whether a claim should be reported to the Insurer, you should exercise caution and provide written notice of the claim to your broker and/or to the Insurer.

If you are unsure whether a claim falls under your lawyers' professional liability/errors and omissions insurance or the ODL Insurance Policy, you should exercise caution and provide written notice of the claim to both Insurers.

Remember, a delay in reporting any claim to your Insurers (ODL or otherwise) may jeopardize your insurance coverage under those policies.

If there is some urgency in obtaining a response from the Insurer (for example, if you have been served with a Statement of Claim in your capacity as director and the plaintiff is holding you to a strict timetable to file a Statement of Defence), you should make sure that you fax or courier your written notice to your broker and/or to the Insurer and clearly indicate on the fax cover sheet or letter that the matter is urgent and requires immediate attention.

All information provided to the Insurer will be treated confidentially.

X. WHAT HAPPENS WHEN I REPORT A CLAIM?

If you report a claim or potential claim to the Insurer, there are a number of possible steps that the Insurer might take. The following is an illustrative guide of the steps that the Insurer might take, depending on the nature and circumstances of the claim being reported.

- The Insurer will immediately review the claim to determine whether it is a claim that needs to be investigated or whether it is a potential claim or incident that can simply be monitored.

- The Insurer will send either you or your insurance broker written confirmation that it has received written notice of your claim generally within seven (7) days of its receipt by the Insurer unless it is an urgent matter which will generate a more immediate response.

- If the claim requires investigation, an adjuster will contact you either by telephone or in writing generally within fourteen (14) days of its receipt by the Insurer. The adjuster will identify himself/herself as the Insurer's representative and will ask you questions to provide sufficient details to assess the claim and may ask you for documentation relating to the claim. This information is required to enable the

adjuster to put together a report to the Insurer and to make any recommendations for future claim handling.

- If there is a coverage issue, the Insurer or the adjuster or the Insurer's coverage counsel will promptly advise you of the nature of the coverage issue. If there is a coverage issue, you may wish to retain your own counsel to protect your own interests.

- If an action is commenced against you for a Wrongful Act, subject to whether a valid corporate indemnity exists or whether there is underlying D&O insurance in force, the Insurer may appoint defence counsel on your behalf.

- You have a duty to cooperate with the Insurer which includes assisting the Insurer's investigation, attending hearings and trials, securing and giving evidence, obtaining the attendance of witnesses and assisting in settlement efforts (ADR etc.).

- The Insurer has the right to select defence counsel, to direct the defence and to settle claims, if necessary.

- If a payment is made by the Insurer, the Insurer is subrogated to any of your rights of recovery.

XI. SUMMARY

Heading into the 21st century, the legal profession faces many challenges - specialization, accounting firms and paralegals encroaching on traditional areas of legal practice, an increasingly rigid regulatory environment for the profession, the fallout from the corporate scandals such as Enron, WorldCom, an increase in terrorist acts around the world, a proliferation of class action litigation, Sarbanes-Oxley in the United States and Bill 198 in Ontario. The list is lengthy. Lawyers must become informed about what needs to be done to adapt to these changes. The situation facing a lawyer, who sits as a director, whether on a board of directors of a Fortune 500 company or a non-profit organization, is vastly different now than it was as recently as five years ago. The corporation's shareholders, the courts and regulatory agencies will hold directors to a high standard of care. It is arguable, as mentioned earlier in this Handbook, that an even higher standard of care is expected from a lawyer who sits as a director by virtue of his or her professional experience and qualifications – particularly where the lawyer has a separate business relationship with the corporation. The long-held notions that directors are not liable for the torts or breaches of contract of the corporations on which they serve or that directors do not owe any fiduciary duties to the corporations creditors are under assault.

In summary, this Handbook makes three broad suggestions to a lawyer who is considering joining a board or who is already on a board.

First, lawyers who are considering accepting an appointment to a directorship should be asking themselves, at a minimum, the following questions:

- ✓ How well do I know this corporation?
- ✓ What are my motivations for joining this board – business, personal, community service etc.?
- ✓ Will I be able to devote my time and energy to ensure that I act diligently in this role?
- ✓ Do I understand the risks and responsibilities that come with directorship?

Having considered these questions and making a choice, the following two suggestions are in order.

Second, lawyers who are sitting as directors or who are considering accepting an appointment to a directorship should consider doing the following:

- ✓ Negotiate for a contract of indemnity with the corporation
- ✓ Negotiate for company purchased D&O insurance
- ✓ If a privately held corporation, negotiate for an indemnity in a unanimous shareholders agreement
- ✓ Separately purchase CBIA-ODL insurance either on an individual or law firm basis

Third, lawyers should look beyond the external protection that can be put into place and consider what they can do from a personal standpoint to implement personal "best practices" with a view to loss prevention on a personal basis:

- ✓ Consider the business and regulatory environment that the corporation operates within
- ✓ Consider the common law and statutory duties imposed on directors
- ✓ Consider and, where appropriate, implement "Best Practices" (see page 10), if not at the board level, then at a personal level

Do not be mistaken, while the risks of acting as a director are great, the rewards (both personally and professionally) are well worth the effort. Lawyers have and will continue to serve valuable functions – either as counsel to and/or as outside directors of for profit and not for profit corporations. Lawyers can add value not only by sharing their professional experiences, wisdom and insight but also by educating corporations and their directors about Loss Prevention.

APPENDIX A

SAMPLE 2004 ODL INSURANCE POLICY

APPENDIX B

SAMPLE ODL INSURANCE APPLICATION (INCLUDING SCHEDULE 1 QUESTIONNAIRE)