

D&O: An Overview for Not for Profit Companies

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Directors and Officers Liability: An Overview

The media is full of headlines which have made corporations, and particularly their directors and officers, take notice. Sarbanes Oxley in the United States, Bill 198 in Ontario, and similar legislation in other provinces, as well as investigations into stock option backdating, have brought heightened focus to directors and officers liabilities. These issues are shaping the way directors and officers (D&O) liability is being handled by corporations and executives. Increasingly, executives are making D&O insurance one of their top priorities.

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

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

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

Evolution of the Liability

Directors and officers liability first began to manifest itself in the early 1930s, primarily in the United States. The 1929 stock market crash prompted a wave of lawsuits against directors and officers, as shareholders looked to the management of companies for restitution for their losses. It was then that Lloyd's of London created the first insurance product designed to protect against this type of financial loss and the directors and officers liability insurance policy was born. However, this product did not receive immediate acceptance due to its price, limited coverage, and complexity.

While the 1950s era of consumerism caused an increase in the concern about liabilities of directors and officers, it was not until the 1970s and 1980s that these liabilities impacted corporate governance. In the United States, changing legislation, class action lawsuits and an overall climate of heightened litigiousness all served to threaten directors and officers personal assets. The 1990s created a different climate, as the liabilities became more severe, while difficult economic conditions affected corporate performance.

Evolution of the Liability (continued)

The start of the 21st Century is a risky time to sit on a company's board of directors. "Mega-settlements" (settlements over US\$100 million) are increasing in frequency. Seven of the ten largest class action settlements occurred in 2005 and 2006. The recent wave of high profile corporate scandals has prompted greater scrutiny of the activities of directors and officers, and triggered significant legislative response.

The Sarbanes-Oxley Act of 2002, often referred to as SOX or Sarbox, is the American federal legislation that strengthened requirements for corporate accounting and reporting and directly impacts Canadian inter-listed companies and companies with U.S. public debt. On December 31, 2005, the Ontario Government enacted Bill 198, Keeping the Promise for a Strong Economy Act (Budget Measures) ("Bill 198"). This act provides for significant amendments to the Securities Act (Ontario) ("OSA"), creates statutory civil liability for secondary market disclosure, expands enforcement powers of the Ontario Securities Commission (OSC), and establishes new offences and increased penalties for violations of Ontario's securities law. The impact of the amendments affects all companies listed on Canada's largest stock exchange. Other Canadian provinces have followed Ontario's lead and enacted commensurate legislation, or are considering such action. All of these recent corporate governance initiatives have created further liability exposures for directors and officers and made the D&O policy more important than ever.

While the Canadian experience has, on the whole, been more favourable to directors and officers, the past few years have seen an increase in the liabilities imposed upon directors and officers and claims made against them. Class action legislation in Ontario, British Columbia, Quebec, and elsewhere in Canada, makes it easier for class action lawsuits to be launched, and contain provisions for "contingency" legal fees. The difficult legal and business environment once associated only with the United States has spread northward.

During the latter part of 2006, a new threat began to emerge: stock option backdating. The SEC along with the Internal Revenue Service and the United States Department of Justice began to investigate and prosecute publicly traded companies on the issue of how they have used stock options to form part of their executive compensation plans. Generally, backdating is a process which sets the grant date back in time to a date when the stock price was at a lower value than current day. Thus, if the grantee exercises the option, he or she will receive an enlarged benefit based on the exercise price in relation to the stock price. This practice is barred under "SOX" and could result in liability under "Bill 198". The past decade has led to a drastic change in the landscape in which corporate directors and officers operate.

International Issues

Given the trend towards globalization, no discussion of directors and officers liability would be complete without considering the recent legal changes and other key developments in jurisdictions outside of North America. Until very recently, directors and officers liability insurance was primarily purchased to cover the exposures emanating out of the United States, Canada, the United Kingdom, and, to a lesser extent, European countries. As a result, D&O policies were purchased from insurers domiciled in the United States and the United Kingdom. Although coverage for other non-North American or non-U.K. directors and officers in an insured's organization was often granted, the coverage was often provided on a non-admitted basis (i.e, the insurer was not licensed outside of North America or the United Kingdom). Increasing liability and as a result, litigation outside the United States, heightened regulatory scrutiny of insureds and insurers, and increased awareness of tax implications have propelled multinational companies to review the efficacy of their D&O policies from an international perspective.

Legal Framework

Directors and Officers Liability: Legal Framework

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

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

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

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

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

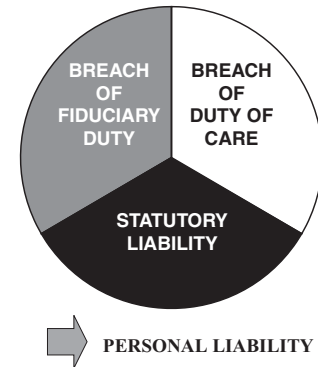


Figure No. 1 © Marsh Canada Limited 2008

Fiduciary Duty

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

"Every director and officer of a corporation in exercising his powers and discharging his duties shall,

- (a) *act honestly and in good faith with a view to the best interests of the Corporation" (i.e. Business Corporations Act (Ontario) ("OBCA"), section 134(1), Canada Business Corporations Act ("CBCA"), section 122(1)).*

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

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

The general rule in common law has been that directors only have a fiduciary duty to the company, and not to shareholders. However, recent Canadian case law recognizes the existence of a fiduciary duty to shareholders in a number of circumstances, particularly in the context of a closely held corporation. Liability from breach of this duty is in addition to the more traditional exposure to shareholder derivative actions, where an action is brought against the directors and officers by shareholders on behalf of the corporation. Oppression remedies by minority shareholders may also result in director liability.

Duty of Care

Directors and officers are also under a duty of care:

"Every director and officer of a corporation in exercising his powers and discharging his duties shall,

- (b) *exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances." (i.e. OBCA, section 134(1), CBCA, section 122 (1)).*

This duty requires not only reasonable behaviour with respect to matters submitted for approval but also reasonable inquiry and monitoring of corporate affairs. Directors and officers may rely on outside expertise but they must monitor the outside professional to ensure that the task is being completed properly. Recent trends also indicate that courts favour interpreting the standard of "prudent person" as "prudent professional" if the director or officer has special training or expertise, thereby increasing potential liability.

Legal Framework (continued)

Statutory Liabilities

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

Corporate and Securities Legislation:

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

Obligations to Employees:

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

* and similar statutes in other provinces

Obligations to Government for Taxes and Source Deductions:

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

Environmental Legislation:

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

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

Indemnification

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

- in all actions, if he acted honestly and in good faith with a view to the best interests of the corporation; and
- in the case of a criminal action or proceeding that is enforced by a monetary penalty, if he had reasonable grounds for believing his conduct was lawful.

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

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

- The corporation becomes insolvent or does not have sufficient available cash flow to pay the losses and expenses incurred by the directors and officers.
- Indemnification is often discretionary: The composition and attitude of the board of directors may change, so that it is no longer sympathetic to an officer or director. In such circumstances, the board of directors may refuse to indemnify such officer or director.
- Public policy considerations and statutory limitations may cause some claims to be insurable but not indemnifiable, such as derivative actions. In Ontario, for example, any indemnification for derivative actions must be approved by the courts. In derivative actions, even if court approval is granted, typically only defence costs are indemnified. This final point is important and often overlooked when evaluating the extent to which individuals are protected by corporate indemnification agreements.

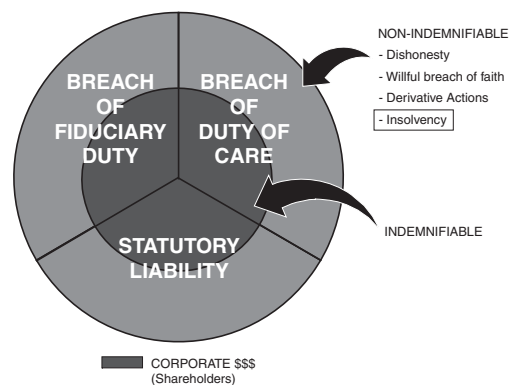


Figure No. 2 © Marsh Canada Limited 2008

There is often a gap between liabilities which are imposed on directors and officers and that which their company is permitted or able to indemnify. A directors and officers liability insurance policy fills many of these gaps and, therefore, mitigates the risk of directors and officers facing substantial, unfunded personal liability.

Claims Experience

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

Claims by Source and Allegation

Claimant	Sample Allegations
Shareholders and other investors	<ul style="list-style-type: none"> ■ Inadequate disclosures ■ Challenge to takeover ■ Merger/acquisition ■ Financial performance ■ Executive compensation ■ General gross negligence of fiduciary duty
Past, current, or prospective employees	<ul style="list-style-type: none"> ■ Wrongful employee dismissal or termination ■ Salary, wage, or compensation dispute
Competitors, suppliers, and other contractors	<ul style="list-style-type: none"> ■ Anti-trust ■ Copyright/patent infringement ■ Contract disputes
Government and regulatory agencies	<ul style="list-style-type: none"> ■ Dishonesty/fraud ■ Loss or bankruptcy ■ Environmental safety
Other third party claimants	<ul style="list-style-type: none"> ■ Merger/acquisition/divestiture ■ General breach of Fiduciary duty

Not for Profit Directors and Officers Insurance Policy

D&O liability insurance policies were designed to protect directors and officers for the legal liability they may sustain when acting in their executive capacity. A policy will also reimburse or pay on behalf of the organization to the extent to which it indemnifies its directors and officers. The following is the typical structure of a Not-for-Profit D&O policy:

I. INSURING AGREEMENTS

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

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

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

Clause 3: Corporate Coverage - Provides direct coverage for the organization's liability either through the policy wording or by endorsement. A deductible is applied.

Not for Profit Directors and Officers Insurance Policy (continued)

II. LIMIT OF LIABILITY

The policy's limit of liability applies to all loss, including defence costs, such that costs paid to defend a claim erode the limit available for settlements or judgments.

III. CLAIMS-MADE COVERAGE AND SEVERABILITY

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

"Severability" in D&O liability policies refers to the issue of whether facts or information pertaining to one insured under the policy can adversely affect coverage for another insured under the same policy. Generally, severability is meant to protect innocent directors and officers from losing coverage based on wrongdoing by other culpable directors and officers. Severability may exist in regard to the D&O liability insurance application (such that any false representations made in the application are imputed only to the person(s) having knowledge of their falsity) and with respect to the exclusions (such that only those persons to whom the exclusion directly applies will be denied coverage) concerning personal profit and dishonesty.

IV. KEY DEFINITIONS

The policy generally includes all "Loss" associated with a claim, including defence costs, but usually excludes fines and penalties. "Claim" is generally defined to include a demand from monetary or non-monetary damages, civil or criminal proceedings and administrative or regulatory proceedings. Many policies will also allow insureds to report circumstances which may evolve into a claim.

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

V. ALLOCATION

In most circumstances, claims will have both covered and uncovered allegations and will name both covered and uncovered individuals or entities. To establish how the claim will be treated, many insurers will pre-determine a method to establish the allocation in the event of such a claim (i.e. best efforts or relative legal basis).

VI. EXCLUSIONS

Matters which are typically excluded under a D&O policy can be split into three categories:

1. **Insured elsewhere:**
 - Bodily injury/property damage
 - ERISA/pension liability
2. **Uninsurable by law:**
 - Insider trading
 - Personal profit
 - Fines and penalties
3. **Outside the intent of the D&O policy:**
 - Pollution (clean-up costs)
 - One insured person suing another insured person

VII. EXTENSIONS

A number of extensions of coverage are currently available in the marketplace and are provided by insurers on a selective basis:

NOT FOR-PROFIT OUTSIDE DIRECTORSHIP LIABILITY:

- Coverage can be extended to directors and officers sitting on boards of outside not-for-profit organizations such as charities, associations, and sports clubs.
- Coverage is usually restricted to positions where the individual is sitting with the knowledge and consent of the organization.
- Coverage is typically provided on a blanket basis (not requiring a specific schedule).

SPOUSAL LIABILITY:

- Coverage is extended to the spouse or domestic partner of the director and officer if named as a co-defendant in an action, but typically only to the extent that the claim against the spouse or domestic partner arises out of a wrongful act of the director or officer; there is no coverage if the allegations against the spouse or domestic partners involved their own wrongful act.

EMPLOYMENT PRACTICES LIABILITY:

- Coverage is provided to an expanded group of insureds (including employees) for claims arising out of employment-related issues such as wrongful dismissal, discrimination, humiliation, and sexual harassment. In certain circumstances, the policy is expanded to include the organization as well as the employees.

POLLUTION D&O LIABILITY COVERAGE:

Pollution-related coverage is typically very narrow under a Not-for-Profit D&O policy, and is generally limited to the cost of defending a pollution-related action.

RECISSION

Insurers have the right to rescind any insurance policy in the event of a material misrepresentation, contained either in the application or the attachments thereto. This can be problematic in the circumstances of D&O coverage where the individual directors and officers may not have been privy to the procurement of insurance and the representations therein; or due to the fact that the financial statements are generally an attachment to the application, and in the circumstances of a material restatement, may lead to an insurer rescinding the policy. To protect innocent directors and officers, insurers may provide non-rescindable coverage for non-indemnifiable claims (Clause 1) or for the entire contract (Clauses 1, 2 and 3).

PRIORITY OF PAYMENTS

In the event a loss may exceed the available limit of liability, this provision will prioritize coverage first to non-indemnifiable claims (Clause 1) and then, subject to the insured's direction, to coverage for the organization (Clauses 2 and 3).

Conclusion

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

If you are interested in obtaining additional information on the subject of directors and officers liability, a list of all Canadian Marsh offices appears on the last page. Please feel free to contact a representative in the closest office.

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	Telephone	Fax
■ CALGARY	403 290 7900.....	403 261 9882
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■ HALIFAX	902 429 6710.....	902 422 6843
■ KITCHENER	519 743 5248.....	519 743 5979
■ LONDON	519 663 5061.....	519 673 6691
■ MONTREAL	514 285 4700.....	514 285 2040
■ OTTAWA.....	613 725 5050.....	613 725 1108
■ REGINA	306 791 4555.....	306 781 7374
■ SASKATOON.....	306 683 6950.....	306 653 5090
■ ST. JOHN'S.....	709 737 1625.....	709 737 1550
■ TORONTO	416 868 2600.....	416 868 2692
■ VANCOUVER.....	604 685 3765.....	604 685 3112
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