New To The Board? What D&O Insurance Can Do For You

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- In the third in our series of posts for new corporate directors, we look at how directors' and officers' (D&O) insurance can help to insulate you against personal legal liability.
- While D&O insurance will generally be provided by your company, it is important that individual directors understand what they are and are not covered for.
- This post supplements our *Directors & Officers in Canada* guide, which goes into greater detail about the liabilities that D&O insurance is designed to deal with.

Indemnification: Your First Defence

D&O insurance, which we will discuss here in the context of directors only, is necessitated by the statutory liabilities to which board members are potentially subject (see our previous post). In many situations, the statutes that govern Canada's business corporations – such as the *Canada Business Corporations Act* or "CBCA" –expressly **permit** a corporation to indemnify its directors with respect not only to the costs of defending themselves but also with respect to amounts paid to satisfy an adverse judgment or to settle a claim. However, there are two other points to keep in mind:

- In some cases – generally where there was no finding of impropriety on the part of the director – indemnification is **mandatory**; and
- Indemnification is expressly **prohibited** by the CBCA and other statutes in certain less "innocent" situations, e.g. where a director has breached his or her fiduciary duty.

The situations in which indemnification is permitted, mandatory or prohibited depend on the statute that governs your corporation. For more information, see our *Directors & Officers in Canada* guide, pp. 66-68.

Even where the by-laws permit or require indemnification, it is prudent to obtain an indemnification agreement in favour of an individual director that will typically also provide for advancement of expenses, which can be significant in these claims.

How D&O Insurance Works

From your perspective as a director, the type of D&O insurance that matters most is the type that extends your protection **beyond** the situations in which you can expect to be indemnified by the company. In the jargon of D&O coverage, that type of insurance is known as **"Side A"** coverage. The following summary

will help you understand where Side A falls in the traditional scheme of D&O insurance, which is usually divided into three basic types:

- Side A Coverage **pays the directors directly** for losses that are **not indemnified** by the corporation.
- Side B Coverage **reimburses the corporation** for amounts paid as indemnification to directors and officers.
- Side C Coverage, also called "entity coverage", **covers the corporation** for its own losses when it is sued together with the directors and officers. The scope of Side C coverage depends on whether a company is public (generally securities claims only) or private (broader coverage).

D&O insurance is typically purchased in **"towers"** that are essentially separate policies that are drawn on in a predetermined order. The "primary policy" covers claims up to a certain cumulative amount, after which policies further up the tower (the "excess policies") are drawn on.

Your company's D&O policy will generally be customized to its circumstances rather than being standard form.

Key Coverage Issues

Because D&O policies are usually customized, their contents tend to vary. However, you should try to familiarize yourself with key coverage issues, including the following:

- Severability
- Dilution of claims
- Insured persons
- Exclusions from coverage
- Insolvency issues
- Topping up your D&O coverage

These are considered in order, below.

Severability

Because decisions about whether to cover a certain risk are often heavily reliant on the honesty of the person applying for the coverage, policies often provide that coverage may be rescinded if the application contains inaccurate statements. As a new board member, you probably won't be negotiating your coverage personally, unless it is a top-up policy (see below). It is far more likely that you will simply be added to an existing group policy that is based on information provided by other directors and officers. In order to ensure that you aren't deprived of coverage because of an inaccuracy in an application form for which you had no responsibility, many D&O policies contain a "severability" clause that limits the insurer's ability to rescind the policy to those directors and officers who had actual knowledge of any materially false statements that were made in the application process.

Dilution of claims

D&O insurance policies often cover multiple groups of injured persons – not only the directors and officers but also the corporation itself. Each policy is capped at a certain aggregate amount and it is common that a provision is included to prescribe priorities for payouts. As a director, you will want to see a provision confirming that the priority is Side A (you), then Side B (corporation re indemnities) and finally Side C (corporation re entity claims).

Insured Persons

How the policy defines “insured person” is also a critical issue. Both current and former directors and officers are typically included but you should confirm that this is the case.

In some situations, you could be asked to serve on the board of one or more subsidiary or affiliated corporations. You should ensure that you are covered in those roles as well. There will often be a clause in the main D&O policy that makes this clear.

Exclusions of coverage

Just as corporate indemnities are limited by the CBCA and other statutes to situations in which the director’s conduct meets certain standards, D&O policies will exclude losses that can be attributed to acts such as fraud, dishonesty or criminal conduct. The precise extent of these exclusions varies from policy to policy. For example, from your perspective as a director, it is important that the insurer not be permitted to exclude you from coverage merely on the basis of a third-party allegation.

Insolvency

You will want to understand how your D&O insurance policies protect you in the event that the corporation itself becomes insolvent. In such a context, Side B and Side C coverage may be viewed as an asset of the estate subject to court approval and related processes before it can be dispersed. In addition, you should be aware of any general carve-outs in the insurance policies that may permit the insurer to cancel the coverage in the context of an insolvency or bankruptcy.

Top-up policies

D&O insurance is purchased in towers. In other words, there is a primary policy that is supplemented by numerous levels of excess insurance coverage that can be used as back-up. At the end of the day, if you are looking to join a corporation as a director or officer and it doesn’t appear to have sufficient coverage, the corporation’s suite of insurance can almost always – for a price – be topped-up by seeking out additional coverage from another insurance carrier, much as can be done with life insurance, for example.

Conclusion

In a litigious environment, the possibility of a claim alleging personal liability is something that all directors and officers need to take seriously. The first line of defence is always, without exception, diligent attention to one’s duties. But issues can sometimes arise no matter how careful an individual director is, and in such situations board members of Canadian companies will generally enjoy additional lines of defence in the form of (i) indemnification (both mandated and permitted) and (ii) well-crafted insurance coverage provided by one of the many insurers that are active in this area.