



WHITE PAPER

COURT OF APPEAL AFFIRMS ABILITY TO “HANG A DIRECTOR OR OFFICER OUT TO DRY” AND DENY DEFENCE COST FUNDING

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There has been a generally held belief that if a company has provided a contractual indemnity to its Directors or Officers that it is not necessary to meet the test of “acting in good faith and in the best interest of the company” in order for the advancement of defence cost funding. However, in *Cytrynbaum et al v. Look et al*¹ (“*Look*”), the Ontario Superior Court considered whether or not a company can refuse to advance defence costs, even though there was a contractual indemnity agreement in place, in circumstances where a Director or Officer has not met the “good faith” test.

In *Look*, the Court ultimately concluded that if, on its face, there is strong evidence to suggest that a Director or Officer has acted in bad faith and contrary to the best interests of the company (which can include acts of fraud, recklessness, misappropriation against corporate interests, and opportunistic or self-seeking behavior that displays a type of dishonesty), then this type of conduct should not be rewarded with an advancement of defence costs. On July 4, 2013, this decision was upheld on appeal to the Ontario Court of Appeal.²

The decision in *Look* resulted from a series of transactions that were taken in response to a serious downturn in Look’s business. The Board of Directors had decided to sell substantially all of its assets pursuant to a Court supervised plan of arrangement. The arrangement was approved by shareholders in January 2009 and Look’s key assets were sold for \$80 million. The Board also authorized Look to vest all unvested options under an Option Plan to permit its Directors and Officers to exercise their options, and to compensate all Share Appreciation Rights (“SAR”) holders using the market price of Look’s shares on the date prior to the Court approval of the sale. In total, Look’s Board approved payments in the amount of \$20 million dollars, which consisted of \$11 million dollars in severance and bonus payments to the Directors and Officers, and payments to discharge the Directors and Officers entitlements under the Option and SAR Plan, which was valued at an inflated share price of \$0.40 per share. The Board later authorized Look to issue payments in the amount of \$1.5 million to defend the very same Directors and Officers, in relation to what was perceived as impending litigation due to these payouts, and of course which did manifest.

The former Directors and Officers promptly demanded that Look advance them defence costs pursuant to Look’s by-laws and the indemnity agreements in place. However, Look refused, relying on a provision contained in the Canada Business Corporations Act (“CBCA”) ³. Look argued that it was only required to advance defence costs when a Court approves the transfer of funds upon being satisfied that the “good faith” conditions prescribed by the CBCA have been met. Not surprisingly, the former Directors and Officers took the traditionally held position that advancement of these funds was mandatory pursuant to the contractual indemnity agreement.

The Court held that the CBCA provides a complete statutory code in circumstances where a company has sued its Directors or Officers or when they have been sued in a derivative action, and that the supervisory function of the Court cannot be contracted out of nor can an indemnity agreement exclude or infringe upon the Court’s discretion to approve the advancement of defence. Further, the Court noted that the statute plays an important role in operating to protect the interests of both The company and its Directors and Officers, stating that:

Actions which have no merit should not delay advancement. On the other hand, directors or officers who have engaged in misconduct towards the corporation ought not to be allowed to use corporate funds to defend themselves...

In my view, requiring the court to scrutinize indemnification and advances in circumstances where a corporation has sued its former directors and officers ensures corporations cannot arbitrarily avoid indemnity or advancement obligations to former directors and officers who have acted in good faith and in the best interests of the corporation, while at the same time ensuring

¹ 2012 ONSC 4578.

² *Cytrynbaum v. Look Communications Inc.*, 2013 ONCA 455.

³ RSC 1985, c C-44, section 124(4).

that directors and officers that have acted [in bad faith] to harm the corporation ought not to be able to draw upon the corporation to defend themselves.

The Court concluded that Look was not required to make an advance payment of defence costs because there was sufficient evidence of bad faith as: the share price of \$0.40 per share used by the Board to calculate payments was considerably higher than the market value of Look's shares during the relevant time period (\$0.13 - \$0.27 per share); and the decision to issue defence payments in the amount of \$1.5 million was self-serving, in light of the fact that Look had received legal advice that it was not in the best interests of the company to do so.

On appeal it was argued that the provision of the CBCA only applied to derivative actions, which are a type of proceeding brought on "behalf of the corporation," and that to allow a company to raise the issue of "bad faith" at a preliminary stage would effectively gut the contractual indemnity which should not be denied on the basis of a preliminary finding of "bad faith." However, the Court of Appeal did not accede to these arguments.

The Court of Appeal found that the language of the applicable legislation was framed broadly enough to encompass both derivative actions and actions that are brought directly by a corporation, thereby confirming that Section 124 of the CBCA applies to both derivative actions and actions by a corporation against its Directors and Officers. The statutory requirement provides a pre-trial good conduct filter that limits the circumstances when a company may advance defence funding to its Directors and Officers, which trumps the terms of any contractual indemnity or indemnity requirement contained in a company's bylaws.

The appellants argued that requiring them to litigate the issues at a preliminary stage, but without defence cost funding, circumvented and deprived them of their contractual right of indemnity. However, this argument was premised on U.S. case law and the theory that a corporation should not be able to withdraw an indemnity because of a finding or subsequent harsh judgment of a Director or Officer's conduct. Unfortunately for the appellants, the law in the United States does not require court approval for the advancement of legal expenses, whereas the Court of Appeal confirmed that Canadian legislation expressly requires the Court to examine whether or not a Director or Officer has acted in good faith and in the best interests of the corporation prior to advancement.

It was also argued that requiring a Director or Officer to fund their own defence costs, before being provided any sort of indemnification, would defeat the very purpose of the indemnity. While the Court acknowledged that corporations often offer these types of indemnities to recruit and attract strong entrepreneurial candidates to serve as Directors and Officers, the role of Court is to achieve a balance between the private interests of corporations and to give effect to the meaning of the applicable legislation. The Court suggested that this balance is reached by assessing the "good faith" of the Directors or Officers at the preliminary stage of the proceeding.

On the threshold issue of what constitutes bad faith for the purpose of the statute, the Court of Appeal confirmed that advance defence costs funding should be refused where the company has shown a strong prima facie case of bad faith. In this case, Look filed substantial records, conducted cross-examinations, and made out a strong prima facie case of bad faith on the basis of evidence presented during a two-day contested hearing.

The appellants had argued that advance defence cost funding could only be denied where the evidence is such that a Court would be able to go beyond making a preliminary finding, and actually conclude that a Director or Officer had acted in "bad faith." The Court of Appeal rejected this argument, recognizing that a preliminary assessment with respect to the conduct of a Director or Officer is distinctly different than a final determination of this issue at trial. Since the right to advance funding is subject to court approval before trial, it requires a preliminary assessment of the merits but does not bind the parties for the purposes of trial. It is still open to the parties at trial to challenge the issue of bad faith, and a Court may ultimately reach the opposite conclusion after trial.

The Court of Appeal also confirmed that an applicant seeking advance funding is entitled to a presumption of good faith. The company has the onus of leading evidence of bad faith to rebut that presumption. Where strong evidence of bad faith has been shown on a preliminary assessment, such that a strong prima facie case has been made out, advance funding will be refused.

So what is the significance of this decision?

The *Look* decision is important for a number of reasons. It is the first case in Canada to squarely confirm that a company may be prohibited by statute from indemnifying its Directors and Officers as may be required by contract or the company's bylaws, where the Director or Officer has not acted in good faith and in the best interests of the company. It represents a shift in the law which will lead to more companies refusing to indemnify its Directors or Officers, by codifying the circumstances when it may be appropriate to refuse to indemnify. However, the practical result of this decision will be to compel more companies to purchase D&O liability insurance.

D&O liability insurance typically provides two types of indemnity:

(1) it reimburses Directors and Officers for defence costs and indemnity payments made by them directly in circumstances where the company is unable or unwilling to defend or reimburse them (often referred to as "Side A" coverage); or (2) it reimburses the company for defence costs and indemnity payments that the company has incurred on behalf of its Directors and Officers (often referred to as "Side B" coverage).

Typically in Canada, insurance brokers and CFO's believed that if there is an indemnity agreement in place, then a company is required to advance defence cost funding even if the conduct requirement has not been met. This requirement, it was believed, is subject only to an undertaking to repay the defence costs in the event a Court determines that the Directors or Officers were not entitled to the advancement. This led to the conclusion that so long as a company has sufficient resources to meet the cost of these claims, D&O liability coverage was unnecessary. On the other hand, D&O liability insurers have historically taken the view that a contractual indemnity agreement does not override the need to satisfy the conduct requirements before granting an indemnity, which is why Side A coverage is necessary. Most claims currently arising under D&O policies in Canada are for Side B reimbursement coverage.

However, if the case of *Look* results in more companies refusing to advance defence cost funding to its Directors and Officers, brokers may start to look for stronger policy language that requires mandatory defence cost funding. Dedicated Side A policies may also become more in demand, particularly by independent Directors. Similarly, if there is an increased risk of a company refusing to advance defence costs, D&O liability insurers should expect an increase in the number of Side A claims under D&O liability policies, and a decrease in the number of Side B claims. Side A claims typically have lower or no self-insured retention, whereas Side B claims typically have a much larger self-insured retention. If there is a shift in the types of claims made under these policies, pricing and retentions may need to be changed.

Further, if a company refuses to advance defence costs, but it is ultimately determined that the Director or Officer did act in good faith and in the best interest of the company, then D&O liability insurers that have paid out Side A claims may subrogate against the company to recover the retention that would otherwise have been payable if the claim had been properly paid as a Side B claim.

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Jill Shore is an Associate at Dolden Wallace Folick LLP's Vancouver office. Jill's practice consists of advising insurers with respect to coverage obligations, litigating claims relating to insurance coverage, drafting policy wordings and defending insureds from a variety of liability claims. Prior to joining Dolden Wallace Folick LLP, Jill practiced civil and commercial litigation in Vancouver, in the areas of insurance coverage, construction litigation, class action litigation, commercial disputes, environmental and aboriginal litigation.

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