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WHITE PAPER

THE PROTECTIVE SHIELD IN A HIGH STAKES GAME

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A reading of certain recent cases may strike terror in the hearts of directors and officers. In Onex Corp. v. American Home Assurance Co. [2013] 114 O.R. (3d) 161, the personal defendants incurred defence costs of $35 million en route to a $9.25 million settlement of a Georgia bankruptcy-related action. In Coventree Inc. v. Lloyds Syndicate 1221 (Millenium Syndicate) [2012] O.J. No. 2287, $12 million in defence costs were incurred in responding to an OSC administrative hearing. In R. v. Dunn [2013] O.J. No. 99, former senior officers of Nortel faced a 62-day criminal trial alleging accounting fraud. One can only speculate how much was spent on three separate sets of defence counsel before they were exonerated.

It is not surprising that with such catastrophic legal costs, directors and officers insurance has become a key part of risk management strategy. A robust D&O policy has become vital for attracting top talent to management or the board. If a corporate insolvency occurs, the D&O policy may be all that stands between an officer or director and personal ruin.

At the same time, the natural desire of D&O insurers to limit defence costs (and fulfil their obligations to protect their insureds) has created an incentive for plaintiff 's counsel to add personal claims in the hope that D&O insurers will contribute to settlement, if only on a cost avoidance basis. A strategy employed by astute counsel is to “pick off” D&O’s by a settlement within their insurance limits and then use the funds generated as a war chest against other, deeper pocketed defendants.

As the chances of being personally sued have increased — and as defence costs have skyrocketed — the impact associated with unexpected problems with D&O coverage has increased. We — and our clients — need to know where the potential minefields are.

The first minefield is the most obvious one — inadequate limits. Coverage amounts vary from, say, $10 million or less for private companies, to $50 million or more for larger public entities. Although the face sum of policies often seems adequate, defence costs eat into the limits. On complex matters, litigation costs may be an order of magnitude greater then they were a generation ago. In a complex action, defence costs may threaten to seriously erode all but the most generous of limits. This risk is heightened with the increasing number of policies that name the corporation itself as an insured, thereby diluting the available insurance for the directors and officers.

An insurer claiming invalidity of the policy is the next, although rarer risk. For business reasons, D&O insurers are usually quite reluctant to assert a policy is rescindable. However, if a material misrepresentation has occurred an insurer may be within their legal rights to do so. For example, as financial statements generally accompany a policy’s application, materially inaccurate financials may be a basis for the insurer to seek rescission. To partially avoid this risk, a rider may be added to protect “innocent insureds” so that the policy protects them if they did not know of the misrepresentation in the application.

Exclusions are the major battleground. Although D&O insurance is wide, it is also normally subject to numerous exclusions. There will be an exclusion for potential claims known but not disclosed to the insurer at the time of application — a particular risk if the corporation is changing insurers, and one which highlights the need for proper reporting to the present insurer.

Fraud is always excluded. An insurer will typically have a duty to defend the litigation and advance defence costs unless and until a court finds that fraud is proven as a fact. (If this occurs, then depending on the policy wording, an insurer may be entitled to seek reimbursement from the insured of the defence costs paid in respect of the fraud claim.)

Another common exception is the “insured versus insured” exclusion. This provision excludes from coverage claims brought by a person or company who is also insured under the same D&O policy. The purpose of this clause is to avoid collusion between insureds. However, it can apply in circumstances far removed from any collusion. Depending on its wording, it could bar derivative actions brought in the name of the company by shareholders or creditors, or claims brought by a receiver or bankruptcy trustee in the name of the company against its past D&Os.

Typically, it is possible to narrow the scope of this exception but there is still a residual risk that in certain circumstances (e.g. a change in control of the corporation) the exception may apply. Combined with the possible limits to advancement for indemnification costs in such claims (currently being litigated in our courts) this can create a real hole in protection.

To date, the possible exceptions in D&O coverage have been relatively lightly litigated in our courts. There may be business reasons why this trend will continue. However, as litigation increases and defence costs multiply, the stakes involved for all concerned will correspondingly increase.

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John has appeared before all levels of trial and appellate courts and before domestic and international arbitral tribunals. A significant percentage of his practice is in the Ontario Commercial Court. He has also represented members of the National Hockey League in salary arbitrations with their players.

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