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| The expanding scope of director and officer liability: recent developments and insights  |
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Directors and officers of companies doing business in Canada have long concerned themselves with liabilities that attach to them, personally. Personal statutory liability for a number of director or officer professional responsibilities – including compliance with employment, income tax, and environmental requirements – has given potential executives reason to pause before accepting an engagement. Moreover, unlimited personal liability, including responsibility for actions undertaken by a corporation prior to a director or officer assuming the position, raises the risk of rational actors refusing to take on these positions.

The director and officer liability insurance (“D&O Insurance”) market is a partial response to this exposure, offering comfort to directors and officers who undertake their duties in good faith, and shifting certain liability for losses to insurers from directors and officers and corporations that may indemnify them. The growth of this market speaks to increasing sensitivity to these issues. However, until very recently D&O Insurance policies were not often considered by the courts, and many market participants had questions and doubts about areas of coverage. Recent Canadian cases relating to D&O Insurance offer instructive lessons to companies, directors and officers, and insurers.

This article offers a primer on recent developments in the area of director and officer liability and D&O Insurance, as well as some best practices to consider with respect to pursuing liability coverage both as an insurer or an executive.

## Beware statutory liability

Ontario’s *Environmental Protection Act* (“EPA”) is an example of a statute that exposes directors and officers to considerable personal liability. A recent case involving an order made under the EPA highlights the expanding scope of personal liability that directors and officers face. It also suggests that the decisions of executives may be subject to more regulatory scrutiny when environmental contamination is a factor.

The former directors and officers of Northstar Aerospace (Canada) Inc., a bankrupt subsidiary of Northstar Aerospace Inc. (together, “Northstar”) were ordered under section 18 of the EPA to personally fund the clean-up of a contaminated manufacturing site. The parties reached a confidential settlement before trial (the “Settlement”). The Settlement, reached between Ontario’s Ministry of the Environment (“MoE”) and the former directors and officers of Northstar, saw the former executives personally pay $4.75 million in clean-up costs. The Settlement highlights a number of concerns for directors and officers with respect to personal liability.

The Settlement is significant on account of the unprecedented pursuit of the former executives in their personal capacity for an environmental matter. Following this outcome, executives may even be liable for the environmental hazards caused by their corporations outside the window of their tenure. The MoE successfully recovered against the former directors and officers directly, even though some of the executives in question had no input into the decisions that resulted in the contamination of the site prior to their appointment.

Post-Northstar, it appears that regulators such as the MoE are more willing to push the burden of environmental clean-up costs on to the corporations that own contaminated sites. If those corporations are insolvent, or have filed for bankruptcy proceedings, the Northstar situation shows that the MoE is willing to pursue damages further by targeting a corporation’s former directors and officers so as to minimize the burden on taxpayers with respect to clean-up costs.

*Best Practice*: While it remains to be seen precisely how expansive D&O Insurance is with respect to insuring over environmental hazards, as the concern over environmental contamination continues to be a pressing concern for executives, current and former directors and officers ought to verify whether they have appropriate environmental coverage included as part of their D&O Insurance policies. In particular, as environmental issues are a frequent carve-out of liability policies, directors and officers ought to verify the level of risk they are incurring and, as applicable, seek comfort that this risk is covered. Without this coverage, as was the case for Northstar, current and former directors and officers alike could be left having to pay significant sums out-of-pocket.

## Words Matter

Establishing a clear timeframe with respect to the coverage offered in an insurance policy is crucial, both for insurance companies looking to insure directors and officers, and for the executives who require insurance to properly function in their roles. In the case of *Dunn v. Chubb Insurance Company of Canada* (“Dunn”), ambiguity surrounding the scope of coverage was the basis for a finding that saw the insurance company obliged to pay up to 90% of the insured executive’s defence costs. This, in spite of the fact that the actions in question transpired more than a year after the prescribed expiry date of the policy’s coverage.

In *Dunn*, the former President and CEO and other former executives of Nortel Networks Corporation (“Nortel”) were covered under a D&O Insurance policy that covered claims arising from a specified period of time between 2000 and 2001. These Nortel executives were insured under a “claims made” policy, which provides coverage for claims made inside the policy period. Following the expiration of the coverage period, further claims were brought against the Nortel executives for actions alleged to have occurred both during the coverage period and shortly after the conclusion of the coverage period.

The insurance policy required the Nortel executives to provide notice of anticipated actions to the insurer if, during the period the executives were insured under the policy, a civil proceeding was reasonably contemplated to occur at some point in the future. Chubb Insurance Company of Canada (“Chubb”) argued that the proceedings stemming from the allegations fell outside the coverage period, leaving the executives uninsured. However, the Court of Appeal decided that Chubb was liable, relying on the broader intentions behind the insured’s allocation provisions: a supplemental special endorsement had been issued by Chubb that ultimately undid the success of its argument.

Specifically, this special endorsement included a provision that required Chubb to pay up to 90% of the defence costs when the alleged claim included both covered and uncovered losses. The decision came down to the interpretation of the endorsement’s use of the word “loss.” The Court of Appeal held that in context, the use of the defined term “Loss” was a typographical error and that the everyday word “loss” was intended, resulting in coverage on those claims occurring outside of the policy period.

*Best Practice*: Insurers are advised to ensure that their policies are clearly-written to match the intended coverage, as this case is another example of the insurance law principle that ambiguity in policies is often resolved against the insurer.

## Review exclusions carefully

As in *Dunn*, the case of *Lloyds Syndicate 1221 (Millennium Syndicate) v. Coventree Inc*. serves as a warning to insurers that ambiguity – this time resulting from silence – could lead to increased exposure. The *Coventree* decision is significant, as it saw the Ontario Court of Appeal enforce to the benefit of the insured a D&O Insurance policy with a muddled definition of the term “prior acts”.

The defendant, Coventree Inc. (“Coventree”), had purchased a D&O Insurance policy from a Lloyd’s syndicate for a one-year term, commencing in October 2007. The policy expressly excluded coverage for “prior acts” that occurred before the commencement of the policy. Following the beginning of this insurance policy, Coventree purchased another, similar, policy from Lloyd’s, to commence at the conclusion of the initial policy. This second policy removed the express prohibition on “prior acts,” and put a cap on the coverage provided for such prior acts.

The facts of the case were unique, as Coventree’s claim for coverage arose from events that occurred prior to the initial coverage period, but which were insured during the second coverage period, during which the “prior acts” exclusion was absent. The court interpreted this discrepancy between policies in Coventree’s favor; while the insurer and insured had initially contracted out of coverage for “prior acts” for the term of the initial policy, the subsequent policy’s omission of this provision inclined the court to hold in favor of Coventree, leaving Lloyd’s with $5 million exposure for the excluded period they once had explicitly contracted out of.

*Best Practice*: In drafting and developing an effective D&O Insurance policy, insurers and insureds need to ensure that their intentions are reduced to writing. As important as dates, coverage amounts, and classes of coverage are, entire coverage cases may turn on exclusions, as well as exclusions from exclusions. These details, whether explicitly stated or intentionally withheld, may make the difference between insulation from liability and ending up liable for unanticipated expenses. In particular, applying the starting principle that coverage provisions are interpreted broadly and exclusions narrowly meant that Coventree benefitted from coverage which the insurer had not intended to provide.

## The devil is in the details

Finally, the case of *Onex Corporation v. American Home Assurance Company* highlights how D&O Insurance policies ought to be contemplated in the drafting stage. Onex Corporation (“Onex”) purchased D&O Insurance from American Home Assurance Company for a one-year period, commencing in 2002. The policy provided for coverage up to US$15 million. In early 2003, Onex was considering selling Magnatrax Corporation (“Magnatrax”), one of its subsidiaries in the United States. Onex’s policy covered the directors and officers of Magnatrax, but only for as long as Magnatrax remained under the control of Onex.

In an effort to mitigate the risk of facing civil proceedings, as it shopped Magnatrax for a possible sale, Onex purchased a run-off policy covering the directors and officers of Magnatrax. The run-off policy was to cover the executives with respect to claims brought in the lead-up and direct aftermath of the potential sale.

In May of 2003, Magnatrax filed a voluntary petition for reorganization under the United States Bankruptcy Code. As part of the plan, Magnatrax assigned to a litigation trust its right to pursue actions against Onex, its affiliates and their directors and officers. As the high-stress conditions of a bankruptcy proceeding tend to go, the litigation trustee eventually brought a claim against Onex on behalf of Magnatrax.

The insurer agreed to pay out the sum total of Onex’s run-off policy, but refused to contribute anything from the original 2002-2003 policy, relying on an endorsement of this policy that stated that any actions “brought by” Magnatrax would be excluded from coverage.

The circumstances surrounding the adoption of the exclusion were the difference-maker in the Court of Appeal’s reasoning: that, had the parties intended to exclude coverage of claims brought by Magnatrax’s litigation trustee, as well as excluding coverage of claims brought by Magnatrax itself, that exclusion would have been explicitly drafted into the written wording of the policy. The failure to contemplate the trajectory of Magnatrax with sufficient contingency planning ended up as a costly misstep for the insurance company, which was liable to provide coverage.

Best Practice: When preparing insurance policies, the insurer, insured and broker (as applicable) should discuss the applicable and important risks and business contingencies, to ensure that the policy applies to those intended and that so-called “insured vs. insured” issues do not arise, except where expressly intended.

In a regulatory environment with potentially serious and significant exposure of directors and officers to liability, D&O Insurance and policy interpretation is a growth industry. However, as with many policies, insureds and insurers have divergent interests, as insureds want to expand coverage and insurers wish to limit coverage. This collection of cases brings together a number of key lessons for insurers and executives regarding D&O Insurance:

* Ensure that issued policies, including any exclusions and exclusions to exclusions reflect the intended scope of coverage and the negotiated deal between the parties, including consideration of and coverage over statutory and regulatory exposure;
* Recall that in the case of ambiguity, coverages are interpreted broadly and exclusions interpreted narrowly;
* Understand that courts typically will defer to the intention of sophisticated parties as expressed in the policy and will not adjust the wording of policies to accommodate the subjective intention of one of the parties; and
* Review the timing and characteristics of coverages, to ensure that there are no unintended gaps or overlaps in coverage, and that coverages in various policies fit together as intended.

*This piece was co-authored by Mark Cavdar, (Student-at-Law)*

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