

Canada

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1. **Directors' duties**

The Constitution Act, 1867 (Canada) governs the manner in which powers are divided among the governing authorities of each of Canada's 10 provinces and three territories. Section 92 of the Constitution Act, 1867 confers on provincial governments jurisdiction over the incorporation of companies with provincial objects. Canadian courts have held that the federal government's residuary power to legislate with respect to peace, order and good government includes the power to enact laws governing the incorporation of companies with objects other than those that are provincial in nature. As a consequence of this dichotomy, both federal and provincial legislation governing corporate law, and the duties of corporate directors thereunder, exist. The issue of directors' liability and indemnification is examined primarily from the perspective of federal corporate law (ie, the Canada Business Corporations Act) and other applicable federal legislation, with noteworthy provincial differentiations mentioned throughout the text.

1.1 **Nature of the duties**

(a) ***Duty of care and fiduciary duty of directors***

The statutory duty of directors is to manage and supervise the business and affairs of the corporation. Specifically, directors must:

- act honestly, in good faith and in the best interests of the corporation (the fiduciary duty); and
- exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (the duty of care).

The fiduciary duty requires that a director subordinate his personal interests to those of the corporation. For example, a director may not use confidential information received in his capacity as a director to his own advantage. A director is also forbidden from misappropriating a business opportunity that could be of interest to the corporation that he serves.

The fiduciary duty includes an obligation to inform the corporation of a conflict of interest arising from an actual or potential divergence of a director's personal interests from those of the corporation. Consequently, directors must disclose in writing or cause to be entered into the minutes of a board of directors' meeting the nature and extent of any interest they may have in a current or projected material contract or transaction with the corporation. This requirement applies if a director:

- is a party to the contract or transaction in question;
- is a director or officer, or an individual acting in a similar capacity, of a party to such contract or transaction; or
- has a material interest in a party to such contract or transaction.

A director required to make this disclosure is entitled to vote on a resolution to approve the contract or transaction only if the contract or transaction:

- is entered into with an affiliate of the corporation;

- relates primarily to the remuneration of the director; or
- is entered into for the purpose of providing the indemnity or insurance under Section 124 of the Canada Business Corporations Act (D&O liability).

A director who fails to disclose any such interest in an accurate, complete and timely manner, or who fails to abstain from voting, may be compelled to reimburse the corporation or its shareholders for any gain derived from the contract or transaction. In addition, such contract or transaction may also be declared null and void by a court of law. In such case a defence based solely on the fact that a true conflict never materialised is insufficient; entering into a *potential* conflict of interest suffices to trigger a director's personal liability. This principle is consistent with the common law principle that a fiduciary who acts with the object of deriving a personal benefit cannot subsequently seek to validate an otherwise invalid act by showing that the act was advantageous to the corporate beneficiary.

The duty of care requires that a director exercise reasonable care, prudence and skill in managing the affairs of a corporation. Attendance at meetings, compliance with reasonable policies and reliance upon professional counsel are generally perceived as characterising a sound and reasonable stewardship of a corporation's affairs. Directors may fulfil their responsibilities, where reasonable in the circumstances, by conferring certain responsibilities on third parties and by relying on management and financial statements. However, directors must inquire as to whether reasonable grounds exist to question the content of financial statements or other information provided to them.

(b) *Duties in the event of insolvency or bankruptcy*

A corporation's insolvency or bankruptcy broadens a director's exposure to personal liability in the form of claims which may include:

- claims by employees for debts arising from their employment;
- claims under the Excise Tax Act (Canada) for the payment of unremitted goods and services tax (essentially, a value added tax on the supply of products and services);
- claims by governmental authorities for the deduction, remittance and payment of income tax, employment insurance premiums, the Canada Pension Plan (or its provincial equivalent) contributions and certain other payroll and source deductions;
- claims by the corporation against directors who vote in favour of or consent to certain corporate finance actions; and
- claims under the Bankruptcy and Insolvency Act (Canada). If a corporation commits an offence under the Bankruptcy and Insolvency Act, any officer, director or agent of the corporation who directed or authorised the commission of the offence is a party to, and guilty of, the offence and is liable on conviction to the punishment associated with the offence, whether or not the corporation has been prosecuted or convicted.

Insolvency and restructuring legislation also provides that where a court finds that a bankrupt corporation has paid a dividend other than a stock dividend, or redeemed or purchased for cancellation any shares of the share capital of the corporation, at a time when the corporation was insolvent or in circumstances where such act rendered the corporation insolvent, and where the directors had reasonable grounds to believe that this would be the case, the directors may be jointly and severally liable for the amount of the dividend, the proceeds of the redemption or the purchase price, respectively, which has not been otherwise recovered by the corporation.

In the event of a corporation's insolvency, directors will continue to owe their fiduciary duty solely to the corporation and not to any particular shareholder, creditor or other stakeholder. However, directors may take into consideration the interests of the corporation's various stakeholders provided that they do not disregard entirely the interests of a particular group.

(c) ***Offences under corporate statutes***

The federal, provincial and territorial corporate statutes generally create director and officer-related offences that are punishable by fine and/or a period of imprisonment. While the offence provisions of each corporate statute differ, this section provides a general overview of certain commonly invoked offence provisions of the Canada Business Corporations Act.

Circumstances in which directors and officers of a corporation governed by the Canada Business Corporations Act will be guilty of an offence for failing to comply with their statutory duties include those set out next.the following.

(i) ***Capital impairment***

Directors have a duty to maintain the capital of the corporation, failing which they are personally liable to the corporation for impairing its capital in violation of applicable provisions of the Canada Business Corporations Act. For example, a director who consents to resolutions authorising the following commits an offence:

- the issuance of shares before consideration therefor is paid in full; or
- the payment of dividends or the purchase or redemption of shares in situations where the corporation is insolvent or otherwise fails to satisfy the solvency tests enumerated in the Canada Business Corporations Act.

(ii) ***Insider trading***

Directors and officers of a corporation who are guilty of insider trading (the purchase or sale of a security of a corporation by an insider of that corporation who has certain confidential information) will be liable to the person from or to whom the securities were sold or purchased, as the case may be, and will be required to compensate that person for any damages sustained as a result of the purchase or sale. Directors and officers who are guilty of insider trading will also be accountable to the corporation for any advantage received or receivable by them as a result of the purchase or sale.

(iii) ***Insider tipping***

Directors and officers of a corporation who are guilty of insider tipping (the communication of certain confidential information by an insider to another person who then purchases or sells a security of the corporation) must compensate any person who subsequently sells securities of the corporation to, or purchases securities of the corporation from, the person to whom the insider disclosed the confidential information.

(iv) ***Record maintenance***

Directors have a duty to maintain certain records for the corporation in accordance with the provisions set forth in the applicable corporate statute. Directors who, without reasonable cause, contravene the provisions dealing with the preparation, maintenance and safekeeping of corporate records are guilty of an offence.

1.2 Standards of care

The Supreme Court of Canada has affirmed that the standard of care to which directors are subject is an objective standard, albeit an objective standard that takes into consideration the factual circumstances surrounding a particular occurrence. Recall that the duty of care requires the care, diligence and skill that a reasonably prudent person would exercise *in comparable circumstances*. The decisions of directors and officers must be reasonable business decisions in light of all circumstances, including prevailing socio-economic conditions, of which they were or ought to have been aware. Directors who, in the absence of any reasonable suspicion as to their veracity, adopt a course of action in reliance on reports issued by professionals such as lawyers, accountants, engineers, appraisers or any other person whose profession lends

credibility to a statement made by that person may, if necessary, avail themselves of a defence of reasonable care.

Courts generally respect the business decisions of Canadian directors and officers as long as the decisions do not involve fraud or self-dealing, and are made on an informed basis in what the director or officer honestly believes to be the best interests of the corporation. It is generally accepted that directors and officers who have acted honestly and with care for the benefit of the corporation should not be personally liable for mere errors in judgement. The Supreme Court of Canada recently held that courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are often involved in corporate decision-making.

Consequently, if directors and officers have acted with due care in what they honestly consider to be the best interests of the corporation, Canadian courts will defer to their business judgement.

1.3 To whom the duties are owed

(a) *The corporation*

A director owes a fiduciary duty to the corporation. Consequently, decisions made by a director must always be in the best interests of the corporation and not those of the director himself or of a particular constituency of the corporation (eg, a controlling shareholder, a class of shareholders, creditors or others), irrespective of whether such constituency has nominated or appointed such director.

(b) *Holders of securities*

Though uncommon, directors may also owe a separate and distinct fiduciary duty directly to the holders of securities of a corporation (ie, shareholders and holders of debt obligations of the corporation). The Supreme Court of Canada has held that a fiduciary relationship may exist where a person, alone, has the ability to exercise some discretion or power to affect another's legal interests in circumstances where the other person is particularly vulnerable. Whether this principle of law can be relied upon by a holder of securities of a corporation will be a question of fact.

While a direct duty of directors to holders of securities of the corporation will rarely be found to exist, the consideration and furtherance of their interests may be necessary for a director to fulfil his duty to act in the best interests of the corporation properly. For example, the directors of a corporation that is the target of a takeover generally have the obligation to take steps to maximise shareholder value.

(c) *Creditors*

Directors and officers do not owe a duty directly to creditors (including contracting parties in favour of whom the corporation has undertaken obligations) of the corporation. However, directors of some corporations - particularly deposit-taking institutions or other companies that routinely receive sums of money in trust - may owe a duty directly to the beneficiaries of any trust monies.

(d) *Duty to employees*

Personal liability for amounts owing to employees and for payroll source deductions owing to government authorities are among the most significant areas of personal liability facing directors in Canada. Many provinces impose personal liability on directors for employee wages and related amounts under both their corporate statutes and their employment legislation. Employees seeking recourse often choose to avail themselves of the employment legislation, as governmental authorities charged with the application of such legislation may pursue a claim on their behalf by way of administrative proceedings. In those provinces where employment legislation imposes personal liability on directors for termination and severance pay, opting to initiate proceedings against the directors of a corporation under employment legislation may also be preferable.

The majority of the corporate statutes in Canada also impose liability on directors for salary arrears and other amounts owing to employees of a corporation; these statutes do not impose such liability on officers of the corporation. The corporate statutory provisions that make directors liable to ‘employees’ of the corporation generally apply to all employees of the corporation without regard to rank. Consequently, members of middle and senior management may initiate proceedings under corporate statutory regimes whereas they may be excluded from the ambit of employment legislation. The Canada Business Corporations Act provides that directors are personally liable for all service-related debts owing to employees up to a maximum amount equivalent to six months’ wages provided the director was, in fact, a director at the time the employee services were performed. However, an employee will succeed in his claim for such amounts only if he meets one of the following conditions:

- The corporation has been successfully sued for the debt within six months of it becoming due but complete execution of the judgment has been unsuccessful;
- The corporation has commenced liquidation and dissolution proceedings or has been dissolved and a claim for the debt has been proved within six months of the earlier of the date of commencement of the liquidation and dissolution proceedings and the date of dissolution; or
- The corporation has made an assignment, or a bankruptcy order has been made against it, under the Bankruptcy Act and a claim for the debt has been proved in the six months following the date of the assignment or bankruptcy order.

The personal liability of directors for unpaid service-related debts is joint and several. Consequently, if both plaintiff and defendant are directors, the plaintiff is not barred from relief under the Canada Business Corporations Act. However, he will have to share the responsibility of paying any such relief.

(e) *Duty to the public*

Directors and officers of a corporation owe no special duty to the public at large, but may become personally liable in contract or tort if their actions are judged to be personal and outside the scope of their authority as agents for the corporation. In addition, directors’ obligations to ensure a corporation’s compliance with applicable environmental statutes and the triggering of their personal liability in cases where they fail to do so can be seen as a statutory reflection of the duty of directors to the public.

1.4 Common defences to and exemptions from liability

The defences available to a director or officer will be determined by the elements of the offence which he is purported to have committed. In addition to the failure of a plaintiff to establish the elements of its cause of action, the corporate statutes of Canada provide for a number of defences which may be set up by directors or officers in connection with allegations directed towards them under such statutes. This section provides a brief overview of the most commonly available defences for directors and officers of corporations governed by the Canada Business Corporations Act.

No provision in a contract, the articles, the bylaws or a resolution relieves a director or officer from his duty to act in accordance with the Canada Business Corporations Act or its regulations; nor can such a provision relieve a director or officer from liability for a breach thereof. In addition, it is not a defence to personal liability under the Canada Business Corporations Act for a director to allege that he did not attend a board meeting. Nor is it sufficient that a director have abstained or voted against a resolution. To avoid responsibility for any resolution or action taken at a board meeting, one’s dissent must be recorded. A director absent from a meeting is deemed to have consented to resolutions passed thereat unless, within seven days of becoming aware of the resolution, he causes his dissent to be recorded in the minutes of the meeting or sends a dissent to the registered office of the corporation. A director can set up his registered dissent to avoid liability for a number of offences and breaches which the board of directors may be accused of having committed and which are expressly listed in the Canada Business Corporations Act (ie, issuing shares for

inadequate non-cash consideration, declaring dividends or otherwise paying out monies to shareholders when the corporation is insolvent or which render the corporation insolvent, or failing to pay employee wages) where he exercises the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances, including reliance, in good faith, on the corporation's financial statements or a professional report.

There now exists a due diligence defence in the Canada Business Corporations Act in respect of liability for an undervalued issuance of shares, improper declaration of dividends, improper purchase or redemption of shares, unpaid employee wages, and non-compliance with the Canada Business Corporations Act, the constitutive documents or any unanimous shareholder agreement. The due diligence defence is broader than a reliance in good faith defence, as a director may invoke that he acted upon the report of a person whose profession lends credibility to his statement to demonstrate the director's due diligence, but need not prove such reliance to succeed in the above defence. Conversely, a reliance in good faith defence does exist with respect to any liability arising under an alleged breach of the fiduciary duty or duty of care by a director of a corporation governed by the Canada Business Corporations Act. For such a defence to succeed, a director must prove actual reliance on either:

- financial statements presented to the director by an officer of the corporation or in a written report of the auditor of the corporation; or
- a report of a person whose profession lends credibility to a statement made by such professional.

The absence of intent may be set up as a defence by a director or officer in relation to certain offences. This defence is commonly invoked by directors and officers who are accused of having authorised or acquiesced to fraudulent preferences (a constituent element of which is a dominant intent to prefer) given by a corporation to one of its creditors in a bankruptcy situation. The determination of intent is an objective determination.

The scope of liability and the defences available to directors under provincial legislation vary considerably across Canada, and defences available to directors and officers in one province may not be available in another. For example, there is absolute personal liability on directors for the costs of remediation of a contaminated site if they are found to be 'responsible persons' within the meaning of the Waste Management Act (British Columbia). Consequently, a due diligence defence is unavailable to directors in such cases. Conversely, the Environment Quality Act (Quebec) specifies that every director or officer who authorises or, through advice or encouragement, leads the corporation to refuse or neglect to comply with an order under such act, or to discharge a contaminant into the environment, commits an offence. A defence of due diligence and absence of intent may be set up by a director or officer accused of breaching the latter provision, although the onus is on such director or officer to establish that the offence was committed without his knowledge or consent and despite measures taken to prevent its commission.

2. Who can bring claims

2.1 The company

A corporation may bring a claim against a director or officer where such person has acted in breach of his fiduciary duty, his duty to act diligently or his statutory or regulatory duties. The decision to bring such claim is subject to the same formalities required to bring suit in general.

Where a corporation is insolvent, the decision to bring suit against a director or officer is that of the trustee in bankruptcy. Pursuant to the Bankruptcy Act, the trustee may, with the permission of the inspectors named by the various creditors, bring, institute or defend any action or other legal proceeding relating to the property of the bankrupt. The Bankruptcy Act further provides that a creditor of the bankrupt is entitled to request that the trustee take any proceeding that, in the creditor's opinion, would be for the benefit of the

corporation. In the event that the trustee fails to acquiesce to such request, the creditor may seek an order from the court authorising him to bring suit in his own name and at his own expense.

2.2 Holders of securities on behalf of the company

A derivative action is a lawsuit in which one or more complainants sue in the corporation's name to remedy or prevent an injury to the corporation. The corporate statutes of Canada typically permit a holder of securities of a corporation to apply to a court to bring an action in the name of the corporation or any of its subsidiaries, or to intervene in an action to which the corporation is a party in order to prosecute, defend or discontinue an action on behalf of the corporation. The foregoing are all variations of derivative actions.

The court must approve each proposed derivative action and complainants must typically satisfy a number of conditions before a court will grant derivative relief. For example, the Canada Business Corporations Act provides that a complainant cannot bring a derivative action if it has not first shown that:

- it has given reasonable notice to the directors that an application is intended to be made if the directors do not bring, defend, prosecute or discontinue an action;
- it is acting in good faith; and
- it appears to be in the interests of the corporation that the action be brought, prosecuted, defended or discontinued.

A complainant need not be a minority shareholder to exercise a derivative action under the Canada Business Corporations Act. By way of example, each of the following persons can be a 'complainant':

- a current or former registered holder or beneficial owner of a security of a corporation or its subsidiary;
- a current or former director or officer of a corporation or its subsidiary; or
- any other person who, in the discretion of a court, is a proper person to make such an application.

A derivative action under the Canada Business Corporations Act relates only to the enforcement of the rights of a corporation and not those of individual shareholders. The following are examples of cases where a derivative action may be invoked:

- actions against directors or officers for a breach of the fiduciary duty or duty of care owed to the corporation; and
- actions for an injunction to prevent a threatened injury to the corporation.

2.3 Shareholders on their own account

The corporate statutes of Canada allow a shareholder and certain other persons with legitimate standing (eg, creditors) to apply to the court for a broad range of remedies when directors unfairly disregard the complainant's interests. Shareholders of a corporation, whether they be minority or majority shareholders, may seek a remedy against the corporation and its directors by bringing proceedings for:

- oppression, where the shareholder complains that the board of directors has acted in an oppressive or prejudicial manner and asks the court to address his complaint. In the latter case, it may be possible to obtain judgment against a corporation's directors personally. A recent decision by the Ontario Court of Appeal upheld an order requiring a director to pay C\$97,000 to the corporation so as to enable the creditor of such corporation to recover its judgment. The creditor in this case successfully sued for relief under the oppression provisions of the Business Corporations Act (Ontario), which reflect those set out in the Canada Business Corporations Act; or
- compliance, where the shareholder seeks a court order compelling the directors to comply with the articles, bylaws, shareholder agreement or governing corporate statute.

2.4 Third parties

Pursuant to the Canada Business Corporations Act and a number of other provincial corporate statutes, creditors and other stakeholders, including contracting parties, of a corporation who are not current or former holders or beneficial owners of a security of said corporation are not entitled, as of right, to remedies for oppression. They may do so only if they are qualified, at the discretion of the court, to be a proper person to make an application. Although the determination of who is a 'proper person to make an application' is fact specific, secured and unsecured creditors (including the Crown) of pecuniary and non-pecuniary obligations (ie, contracting parties) and shareholders of parent corporations have both been held to be such persons. The Supreme Court of Canada has recently recognised that creditors' interests become increasingly relevant as a corporation's finances deteriorate. This factor will be significant when courts consider whether a creditor is a 'proper person' with the requisite standing to bring an oppression remedy claim.

3. Claims culture

3.1 Litigation

Canadian litigation culture is not as favourable to plaintiffs as that of the United States. Judicially imposed caps on punitive damages, limited damage awards for non-pecuniary losses and the absence, in most Canadian jurisdictions, of jury trials for civil matters are several factors that serve to discourage large awards. Conservative views with respect to the judicial award of moral and punitive damages have been adopted to avoid clogged court dockets and the swelling of insurance premiums, and are consistent with the Canadian legal principle that damage awards should be commensurate with the actual and proven value of damages sustained.

3.2 Ability to bring class actions

Class actions, as a procedural vehicle by which legal proceedings are instituted against corporate directors and officers, have recently gained in popularity, particularly in the context of corporate insolvency. This is especially true in Quebec, where the increase in class actions against directors has arisen primarily as a result of recent legislative changes permitting class actions in securities matters. Moreover, this surge in class action litigation is also attributable to the relatively low threshold for certification in Quebec and the recent enactment of procedural amendments which substantially curtail a defendant's ability to challenge certification.

Ontario has also enacted legislation which facilitates the institution of class action proceedings, albeit by investors who purchase securities in Ontario. Secondary market investors may now institute proceedings against issuers and their directors where a document or a public declaration made by the issuer contains false representations or the issuer fails to disclose material information in a timely manner. Unlike similar legislation in the United States, a plaintiff need not prove that the defendant intended to deceive, manipulate or defraud the plaintiff, or that the defendant was reckless or wilfully blind. By eliminating the need for an investor to prove specific reliance, this legislation may have the effect of expanding the number of securities-related class actions in Ontario brought against directors. However, the projected increase in such litigation may be tempered by the recent enactment of amendments which provide that the prevailing party is entitled to costs, notwithstanding anything in the Courts of Justice Act (Ontario) and the Class Proceedings Act (Ontario).

In sum, the wider scope of liability resulting from the above-described amendments increases the number of potential civil claimants in Canada, making it reasonably foreseeable that securities-related class actions against issuers and their directors will become more popular. However, at present, the fact remains that the overwhelming majority of director liability cases proceed as individual actions.

3.3 Funding of claims and whether loser pays

(a) *Cost awards*

The question of whether a losing party may be required to pay a successful party's costs is provincially regulated and therefore contingent on the Canadian province in which the action is being instituted. Typically, costs are awarded by civil courts to a successful party and cover judicial costs (eg, filing costs) and fees (ie, nominal tariff in respect of legal fees). Only exceptionally would amounts in excess of the tariff be awarded to compensate for legal fees incurred by the successful party.

The percentage of a successful party's expenses that will be recoverable is discretionary; Canadian provinces and territories have each developed a set of factors to be considered when awarding costs in litigious proceedings. For instance, the Courts of Justice Act (Ontario) provides that, subject to the provisions of another act or rules of court, the award of costs of and incidental to a proceeding or a step in a proceeding are at the entire discretion of the court, and the court may determine by whom and to what extent the costs shall be paid. However, where the proceedings instituted in Ontario against a defendant are class action proceedings, the Class Proceedings Act (Ontario) provides for a different cost award mechanism; a successful defendant has a *prima facie* entitlement to costs except where the court, in its discretion, chooses not to award such costs because the action is a test case, raises a novel point of law or is in the public interest. As previously mentioned, this may serve as a disincentive to plaintiffs wishing to sue the directors or officers of a corporation by way of a class action lawsuit.

(b) *Funding and fee agreements*

Rules governing fee agreements between the parties to a judicial proceeding and their respective legal counsel are provincially regulated. For example, contingency fee arrangements, including conditional fee arrangements, were not permitted in Ontario prior to 2002. However, as a means of promoting access to justice, Ontario contingency fee arrangements were legalised in 2002 subject to the provisions of the Solicitors Act (Ontario).

The Supreme Court of Canada recently stipulated that the risk premium to which a solicitor may be entitled by virtue of a contingency agreement entered into with a successful plaintiff will not be considered when an award of indemnity costs is ordered. A defendant has no knowledge of the private arrangements between the plaintiff and his counsel, and thus has no means of measuring the risk of engaging in litigation if such arrangements are considered in the award.

3.4 Plaintiffs' bar

As damage awards in Canada have traditionally been compensatory in nature and thus limited to indemnifying plaintiffs for proven losses, class action tort litigation has not yet reached a level of popularity or profitability to warrant the development of a network of trial lawyers with the sophistication and influence of the plaintiffs' bar in the United States. However, given the recent trend in Canadian legislation and courtrooms towards awarding punitive damages of increasing importance, directors and officers may soon face a Canadian version of the plaintiffs' bar.

3.5 Procedural barriers

Except for the formalities which must first be satisfied in certain types of proceeding (eg, class actions and derivative actions), procedural barriers precluding the advancement of a claim against a director or officer are few. The expiration of the applicable limitation period is the procedural barrier common to all forms of action instituted against directors and officers of a corporation. The limitation periods vary depending on the provincial or territorial legislation applicable to the judicial proceedings and on the provision allegedly breached by a director or officer.

4. Indemnification rights

4.1 When the company can indemnify

A corporation may, in certain circumstances, indemnify its directors and officers in respect of liabilities incurred in such capacity, including defence costs.

As the costs, charges and expenses incurred in defending an action can be substantial, it is not uncommon for a director or officer to request that a corporation advance such amounts. Certain provincial corporate statutes do not permit such advances and expressly state that the amounts to be indemnified must have actually been incurred to be reimbursed. However, the Canada Business Corporations Act expressly permits the advance of costs to directors, although it requires a director to repay the amounts so advanced if he does not meet the statutory standard necessary for indemnification (see section 4.2). However, such an advance is permitted only where the director has acted honestly, in good faith and in the best interests of the corporation. In the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, the director must also have had reasonable grounds to believe that his conduct was lawful.

An indemnity agreement may also be drafted so as to require expressly the corporation to advance funds to a director for the purpose of covering ongoing costs and expenses prior to the final resolution of a claim, action or proceeding (subject to the director undertaking to repay the advances received if defence or appeal of such director is found to be without merit).

4.2 Formalities for indemnification

Canadian corporate statutes allow a corporation to indemnify its directors and officers provided that they acted honestly, in good faith and in the best interests of the corporation. With respect to liability for criminal or administrative actions, the individual must also have had reasonable grounds to believe that the conduct was lawful in order to be indemnified. To this end, both permissive and mandatory indemnification provisions have been set forth in the Canada Business Corporations Act.

First, the Canada Business Corporations Act permits a corporation to indemnify a current or former director or officer of the corporation against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred in respect of any individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation or other entity, provided that the director or officer in question:

- acted honestly, in good faith and in the best interests of the corporation or, as the case may be, in the best interests of another entity for which the individual acted as director or officer or in a similar capacity at the corporation's request; and
- in the case of a criminal or administrative action or proceeding punished by a monetary penalty, had reasonable grounds to believe that his conduct was lawful.

Second, the Canada Business Corporations Act renders mandatory the payment by the corporation of all amounts reasonably incurred by a director to defend an action to which he is a party by reason of his previous or current role as a director if such director is found not to be at fault and has complied with the conditions above. Under the corporate statutes of certain provinces (eg, Alberta and New Brunswick), the entitlement of a director or officer to the mandatory indemnity is contingent on the satisfaction by such director or officer of a third requirement that he be "fairly and reasonably entitled to indemnity". However, under the corporate statutes of other provinces (eg, Prince Edward Island and Quebec), there exist no mandatory indemnification provisions.

There is little case law relating to the mandatory indemnity provisions set out in Canada's various corporate statutes and the scope of such provisions remains largely ambiguous where, for example, an action against a director is terminated or charges are withdrawn. It is also unclear whether a director or officer who succeeds on a procedural technicality is entitled to receive the mandatory indemnity.

Directors and officers may further reduce their exposure to personal liability through the inclusion of indemnity provisions in the bylaws of the corporation or an indemnity agreement with the corporation.

Corporate bylaws in Canada often include indemnification provisions to ensure that the corporation is bound to indemnify its directors in situations where the legislation merely provides for permissive indemnification by the corporation. However, since the indemnification provisions stipulated in a corporation's bylaws do not constitute a binding agreement between the corporation and its directors, a director cannot prevent the provisions of the bylaws from being amended.

An indemnity agreement is an agreement whereby the corporation, a third party (eg, a majority shareholder) or both agree to indemnify the directors or officers of the corporation against claims that may be made against them as a result of the performance of their duties. Indemnity agreements offer stability of coverage insofar as the scope of indemnification provided for in such agreements may not be modified without the consent of the director benefiting therefrom. Often, directors and officers who are party to such agreements will strive to ensure that a number of criteria are met or items provided for. For example, a director or officer will often seek to extend indemnification to circumstances where he is simply a witness or participant in, rather than a party to, any proceedings.

The value of indemnity agreements is questionable in the event of a corporation's insolvency. A director or officer will often require that a corporation undertake to purchase and maintain an insurance policy which offers meaningful and sufficient liability coverage to such director or officer.

Finally, other protection mechanisms can be structured by the corporation to ensure the indemnification of its directors, although such mechanisms are rarely used. For instance, it is possible to create a trust specifically designed to segregate funds that will indemnify the directors and, in certain cases, third parties to whom the directors would normally be personally liable.

4.3 How indemnification works

Generally, the procedure to be followed in respect of statutory indemnification in Canada is largely determined by the corporation with no need for either the corporation or the indemnified party to resort to the court system of the relevant jurisdiction. However, provincial statutes may provide for certain exceptions. For instance, the Companies Act (Prince Edward Island) requires that "the consent of the company [be] given at any general meeting" before an indemnity may be paid to a director or officer by the corporation.

Further, the Canada Business Corporations Act and the majority of the provincial corporate statutes provide that if a director or officer seeks an indemnity with respect to a derivative action or an action brought by the corporation, he must obtain the approval of the court. However, this requirement will not apply to corporations created under certain provincial statutes (eg, Quebec, Nova Scotia and Prince Edward Island).

4.4 What cannot be indemnified

There are two important limitations to the statutory ability or obligation of a corporation to indemnify a director or officer for the liabilities incurred in the discharge of his duties.

First, the mandatory indemnity provision set out in the corporate statutes of Canada does not compel a corporation to indemnify its directors or officers for amounts paid to settle an action or satisfy a judgment. This limitation results from the condition that a mandatory indemnity is payable only where the director or officer susceptible to such indemnification is substantially successful on the merits of his defence.

Second, in the case of a derivative action commenced by the corporation, the indemnity does not extend to the amounts paid to settle an action or satisfy a judgment. This exception is premised on the improbability that a director called upon to defend a derivative action which is subsequently lost or settled has been acting in the corporation's best interest.

Directors who vote for, or consent to, a resolution authorising an indemnity payment which is contrary to an applicable corporate statute are generally liable on a joint and several basis to restore to the corporation

any unrecovered sums, unless they succeed in showing that their decision was based on their reliance, in good faith, on certain financial statements or professional reports.

5. D&O insurance

5.1 Availability of D&O insurance

A corporation may purchase and maintain insurance for the benefit of a director or officer against any liability incurred by the latter in the discharge of his duties. A corporation, on the same basis, may also purchase and maintain insurance policies for its directors and officers who acted as directors or officers of another corporation at the request of the corporation. The majority of the corporate statutes currently in force in Canada, with few exceptions (eg, Quebec, Prince Edward Island and Nova Scotia), have provisions which govern or apply to D&O insurance.

D&O policies traditionally include liability and indemnification coverage. Liability coverage insures directors and officers for loss for wrongful acts for which they are not indemnified by the corporation and generally includes damages, judgments, settlements, costs, and defence costs. In contrast, indemnification coverage does not provide direct contractual protection to the individual directors and officers of a corporation, but insures the corporation for amounts it is legally required to pay to indemnify its directors and officers. D&O insurance contracts are typically written on a 'claims-made and reported' basis. Claims-made policies differ from regular occurrence-based contracts in that coverage is triggered by claims made against the directors and officers during the policy period for wrongful acts committed before or during the policy period. A claims-made policy will cover only claims made against the directors or officers during the policy period, irrespective of when the act giving rise to the claim may have occurred.

The corporate statutes of Canada which contain provisions applicable to D&O insurance generally prohibit a corporation from purchasing and maintaining insurance for the benefit of its directors and officers against any liability arising from their failure to act honestly, in good faith and in the best interests of the corporation. If the policy provides for such coverage, the corporation is prohibited from paying the related insurance premium. However, the Canada Business Corporations Act and the Business Corporations Act (British Columbia) contain no restrictions on the actions of directors and officers that may be insured.

5.2 Local rules on cover provided under a non-domestic D&O policy

Generally speaking, but subject to prescribed exceptions, insurance companies that act as insurers within a given province need be authorised and licensed to do so by applicable provincial regulatory bodies. The definition of 'acting as an insurer' and the criteria that need be met to obtain a licence vary from province to province. The absence of a licence generally precludes a non-domestic insurer from providing a policy to a resident policyholder. Subject to the applicable provincial definition of 'acting as an insurer' or an equivalent expression, a foreign parent corporation is usually not precluded from subscribing to an umbrella D&O policy covering directors and officers of its domestic subsidiaries from an insurance company in the foreign parent corporation's home jurisdiction. However, doing so may raise questions of private international law with regard to the validity of any choice of law provisions, and such a policy may be subject to any provincial civil laws of public order governing relationships between insurers and insureds.