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PUBLICATION

Courts Clarify Important Limitations on Canadian Corporations' Capacity to Protect Directors Who Are Sued

Date: June 03, 2014

Original Newsletter(s) this article was published in: Blaneys on Business: June 2014

People who agree to become directors on the boards of Canadian corporations take on significant risks – for instance, the risk of being sued.

These liability risks can have a "chilling effect" on a person's willingness to become a corporate director and, by virtue of his or her knowledge and experience, can affect the potential success of a corporation.

Over the years, in order to encourage people to participate as members of boards, protections against directors' and officers' liability have been developed. One form of protection is through the purchase of liability insurance. As well, financial protection can be made available through corporate indemnity, in which the corporation itself undertakes to pay for any defence costs associated with legal proceedings brought against the director.

There are, however, limits on such corporate indemnification. A recent decision heard at the Ontario Court of Appeal has helped provide greater clarity on what the law allows.

These newly-clarified limits relate to the questions of when the corporation may provide financial assistance to a director who is being sued and whether the director's behavior qualifies him or her for such protection in the first place.

All board members of Canadian corporations will want to be aware of this recent case and what it means to them as directors.

Indemnities for Corporate Directors

Corporate legislation in Canada generally allows corporations to indemnify present as well as former directors for legal proceedings that arise out of actions taken by a corporation.

For instance, under section 124 of the *Canada Business Corporations Act* (CBCA), corporations are allowed (but are not required) to indemnify directors and officers for expenses related to any legal costs resulting from their association with the corporation.

A corporation is also permitted, but not required, to provide funds to directors or officers for the costs of proceedings under section 124(2). However, this is only permitted if conditions under section 124(3) are met; namely, that the director or officer acted honestly and in good faith or, in a criminal proceeding, that the director or officer reasonably believed his or her conduct was lawful. Under section 124(4), court approval is required *before* the corporation may advance funds to a director or officer involved in a lawsuit.

The statutory provisions under section 124 are often included as part of a corporation's by-laws. However, in order to afford greater protection for corporate decision-making, the permissive provisions are often made mandatory in those by-laws. As well, corporations may try to expand the scope of indemnification in the by-laws -- by allowing funds for indemnification to be advanced, even if there are allegations of bad faith against the directors, for example.

At issue for the Ontario Court of Appeal in the recent case *Cytrynbaum et al v Look Communications, Inc.* was whether corporate by-laws that mandate the advancement of indemnification funds can be constrained by corporate law statutes.

Cytrynbaum et al v Look Communications, Inc.

The appeal in *Look* concerned claims by former corporate directors and officers for advance funding of their legal costs to defend an action brought against them.

Look Communications, Inc. was a company engaged in wireless, internet and cable services that had been incorporated under the CBCA. The appellants were the former directors and officers of Look. The business had been in serious decline from 2005 to 2008. The board had not been able to sell the company or obtain the capital required to compete successfully in the market. Under a CBCA plan of arrangement, the board sold Look's assets (with shareholder approval) in 2009 for $80 million. The board then authorized the payment of 32 per cent of the net proceeds of the sale (approximately $20 million) to officers, directors, employees and consultants through bonus payments and equity cancellation payments. The $20 million figure was based on share appreciation rights pursuant to a share value that was twice the price on the open market at the time (40 cents per share vs. 20 cents).

The payments were not disclosed to shareholders until 2010 and attracted strong shareholder criticism. In anticipation of being sued, the appellants authorized Look to pay $1.5 million to retain three law firms acting for them personally. Look's by-laws provided for indemnity and advance funding under broad terms, allowing for advance funding without any limitation requiring judicial screening on the issue of good faith. Immediately after the retainer payments were made, the appellants resigned.

Look's new management and board commenced an action against the appellants in 2011 alleging breach of fiduciary duty, breach of statutory duty, negligence and unjust enrichment.

Look refused indemnity and advance funding for the appellants' legal costs. The appellants commenced applications seeking declaratory relief to require Look to indemnify them for their legal costs and directing Look to advance all expenses incurred in defending the claim.

The application judge, Mr. Justice Laurence A. Patillo of the Ontario Superior Court of Justice, refused to restrict the application of section 124(4) of the CBCA strictly to derivative actions (actions taken on behalf of corporations vs. actions taken by the corporations themselves). The holding in the Ontario Superior Court case *Jolian Investments Ltd. v Unique Broadband Systems Inc.* stated that judicial approval of advanced funds is required only in the context of derivative actions. However, Mr. Justice Patillo found that despite the action being brought by the corporation itself, approval of the advancement of funds was nonetheless required by the court. Additionally, he found a strong *prima facie* ("at first sight") case of bad faith by the directors, based on the evidence.

The Ontario Court of Appeal upheld Mr. Justice Patillo's decision, stating that the requirement of court approval for advance funding under section 124(4) is applicable for both derivative actions and actions brought by the corporation itself. Mr. Justice Robert A. Sharpe of the Court of Appeal noted at paragraph 42:

"The purpose of achieving an appropriate balance between encouraging responsible behaviour and attracting strong entrepreneurial candidates applies whether the directors and officers are faced with a derivative action or an action by the corporation itself. Both kinds of action flow from dissatisfaction with the conduct of the officers or directors; both expose the directors or officers to scrutiny for their conduct; and both reflect situations in which the officers and directors have lost control over litigation affecting or relating to the affairs of the corporation."

The court also held that the application judge's refusal of advance funding on the basis of the strong *prima facie* case of bad faith standard had to be examined in light of section 124(4). Under that provision, court approval for advancement of funds can only be given if the claimant can satisfy that he or she "acted honestly and in good faith with a view to the best interests of the corporation." In the words of Mr. Justice Sharpe:

"In my view, the strong *prima facie* case test strikes an appropriate balance between those competing considerations. It is a stringent test that gives significant weight to the protection of officers and directors. It ensures that they will ordinarily receive advance funding but leaves open the possibility that advancement will be denied when there is strong evidence of bad faith."

The manner in which the Board valued the shares led the Court to the conclusion that the appellants had acted in bad faith. While the appellants claimed reliance on legal opinion, the Court noted that the appellants' solicitor had not expressed any view as to the value of shares. Instead, the solicitor had explained the "business judgment rule" (denoting the court's general deference to the decisions of corporate directors and officers) and had indicated that the directors should act honestly and in good faith when making a business judgment decision. Thus, the appellants could not claim reliance on legal opinion to negate the finding of bad faith.

The Supreme Court of Canada has recently refused the appellants' application for leave to appeal.

Implications for Directors' Indemnities

The *Look* case is important for clarifying issues surrounding the advancement of indemnification funds as well as the standard of review for *prima facie* bad faith actions by a corporate director. Whether a director is sued directly by the corporation or in a derivative action, court approval is required for the advancement of funds to indemnify the director. Before such approval is granted, there must be a preliminary inquiry into the merits of the case, and if there is *prima facie* evidence of bad faith on the part of the directors that are the subject of any action, then advancement of funds will not be granted.

This limitation on advancement of funds to directors cannot be circumvented through generously-drafted corporate by-laws. If a director is the subject of a civil, criminal or regulatory proceeding, he or she will not be entitled to advanced funds to support litigation proceedings and will be responsible for the cost of funding hearings before receiving any indemnities from the corporation. This holds true even if a corporate by-law or indemnity agreement provides for advancement of funds despite bad faith conduct.

It follows from the holdings in *Look* that directors may lose some of the assurances provided under both the indemnity provisions in the by-laws or indemnity agreements, as well as directors' and officers' (D&O) policies. Corporate by-laws may be scrutinized more thoroughly by D&O policy underwriters which could affect policy coverage. As well, directors may not be able to rely on generalized legal opinions encouraging good faith dealings in order to be indemnified.