

**INTERNAL AND REGULATORY  
INVESTIGATIONS: INDEMNITY  
AND INSURANCE ISSUES**

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## **Introduction**

With increasing frequency, Canadian public companies are devoting substantial resources to the conduct of internal investigations and in responding to OSC and other regulatory investigations. Directors and officers of public companies are directly impacted by these investigations which may result in actions being commenced against them by the corporation or which may be the harbinger of significant derivative actions or class actions involving the directors and officers. Not surprisingly, there is now increased attention paid to statutory and contractual indemnities for directors and senior officers of Canadian public companies and related directors' and officers' liability insurance. However, in my experience, the focus of this attention is typically on litigation exposures and not the prelude to the litigation, hearing or prosecution, namely, the investigation.

One of the greatest areas of legal expenditures by individuals are investigations, informal and formal, yet the statutory protections available to individuals under the various corporations statutes in Canada – and the related liability insurance protections – are, in my view, not as robust as they could be to provide complete personal asset protection to individuals who are embroiled in an investigation – either as a witness or as a target – by reason of serving as a director or officer of a corporation. Frequently, individuals are surprised by the gaps in their indemnities and insurance when it comes to investigations.

This paper will outline some of the current issues in indemnification and insurance relating to investigations – internal and regulatory. Hopefully, it will provide a useful guide for practitioners in assessing and managing the issues that might arise when their clients are compelled as witnesses or identified as targets of an investigation.

## **Corporate Indemnification for Investigations**

When a civil or criminal action or regulatory proceeding is threatened or commenced against a corporation and its directors and officers, the individual defendants will look first to the corporation to pay their defence costs, on a current basis, pursuant to

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the applicable corporations statute, indemnification by-law and, where applicable, indemnity agreements. Indemnity should include the concurrent advancement of legal fees for defence counsel and any experts who must be retained (collectively “Defence Costs”) as well as the cost of satisfying any orders made or judgments ultimately rendered against the directors and officers.

During the past decade, many of the significant differences in the scope of permitted indemnification under the *Canada Business Corporations Act* (“CBCA”) and most other provincial and federal legislation<sup>1</sup> under which various types of publicly traded financial institutions are incorporated have been eliminated. The CBCA<sup>2</sup> confers broad permissive indemnity protection for directors and officers in terms of the advancement of Defence Costs and the inclusion of investigations among the types of proceedings for which indemnity is available.

The CBCA provides that Defence Costs may be advanced to a director or officer but they must be repaid if the individual does not fulfill the statutory prerequisites for

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<sup>1</sup> Such as, the federal *Bank Act*, S.C. 1991, c. 46, as amended, and the *Insurance Companies Act of Canada*, S.C. 1991, c. 47, as amended. The Ontario *Business Corporations Act* was amended in 2007 to expressly permit advancement of Defence Costs and to extend indemnification to “investigative proceedings”. Note that the Alberta *Business Corporations Act* makes no mention of “investigative” proceedings, but does permit the advancement of Defence Costs.

<sup>2</sup> Subsection 124(1) of the CBCA provides:

“A corporation may indemnify a director or officer of the corporation, a former director or officer of the corporation or another individual who acts or acted at the corporation’s request as a director or officer, or an individual acting in a similar capacity, of another entity, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the 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.”

Subsection 124(2) of the CBCA provides that:

“A corporation may advance monies to a director, officer or other individual for the costs, charges and expenses of the proceeding referred to in subsection (1). The individual shall repay the monies if the individual does not fulfill the conditions of subsection (3).”

indemnity. *The CBCA* permits indemnification for “investigative or other proceedings”, but is silent with respect to an investigation which cannot be characterized as a “proceeding” because it is not initiated by an administrative or court process that results in an adversarial proceeding. An investigation, in and of itself, is not “a civil, criminal or administrative action or proceeding.”<sup>3</sup> There is, therefore, a lacuna in the legislation. The broadest type of statutory indemnity would be provided if the *CBCA* and other acts permitted indemnification for civil, criminal, administrative or other investigations, actions or proceedings.

Recently, Canadian courts have shown a willingness to imply broader rights of indemnity in a corporation statute than a literal reading might suggest. In *Manitoba (Securities Commission) v. Crocus Investment Fund*<sup>4</sup>, the Manitoba Court of Appeal upheld a motions court decision to permit the receiver of the Crocus Investment Fund to advance defence costs to the fund’s former directors and officers who were involved in certain proceedings, including an investigation conducted by the Office of the Auditor General, an investigation by the Manitoba Securities Commission, and a proposed class action. There was no evidence before the Court to suggest that the directors and officers had acted other than in good faith. The Court of Appeal reviewed the relevant statutory provisions (which were silent about advancement of Defence Costs and referred only to a civil, criminal or administrative action or proceeding to which the director or officer is made a party). The corporate by-laws of the Crocus Investment Fund created a mandatory right of indemnity, for the matters referenced in the statute, subject to satisfaction of the statutory prerequisites for indemnification, but said nothing about advancing Defence Costs during the conduct of any action or proceeding.

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<sup>3</sup> *Denton v. Equus Petroleum Corp.* (1986), 33 B.L.R. 314 (B.C.S.C.). The *CBCA* was amended to include “investigative” or other proceedings as a result of the *Denton* case where the Court refused to approve indemnity for a director for his legal costs incurred in regard to his personal involvement as a director of a company under investigation by the Superintendent of Brokers, the Vancouver Stock Exchange and the Commercial Crime Division of the RCMP that concerned alleged improper expenditures by the company.

<sup>4</sup> [2007] 7 W.W.R. 32, 28 B.L.R. (4<sup>th</sup>) 246 (Man. C.A.)

The Court noted:

This plethora of provisions relating to the subject of indemnity for costs and amounts incurred while acting in good faith suggests both a legislative and a corporate recognition of a reality which, if not entitled to judicial notice in the traditional sense, is nevertheless obvious to observers of the Canadian business scene. That reality is simply that persons who serve as directors and senior officers of corporations whose securities are widely held expect, as incidental to that service, that, when they act honestly and in good faith, they will be indemnified for costs and amounts reasonably incurred in actions or proceedings, for which they might be personally responsible. The [Manitoba] Act, like its counterparts, is framed to be consistent with this reality. (at para. 13)

The Court of Appeal then referred to “the interplay between the policy underlying the statutory provisions and the legitimate exigencies of the corporate world” which was best expressed in the unanimous Supreme Court of Canada decision in *Blair v. Consolidated Enfield Corp.*<sup>5</sup> where Iacobucci J. stated:

...[T]he broad policy goals underlying indemnity provisions...allow for reimbursement for reasonable good faith behaviour, thereby discouraging the hindsight application of perfection. Indemnification is geared to encourage responsible behaviour yet still permit enough leeway to attract strong candidates to directorships and consequently foster entrepreneurship. It is for this reason that indemnification should only be denied in cases of *mala fides*. A balance must be maintained... (at para. 74)

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<sup>5</sup> [1995] 4 S.C.R. 5

The Manitoba Court of Appeal acknowledged that the issue before it related to the financing of ongoing legal costs, but concluded that the policy context relating to indemnification outlined in the passage above, which is inextricably linked to the reason why the costs are being incurred, is both relevant and instructive. It was distinguished in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*<sup>6</sup> where the Alberta Court of Appeal held that under the then federal *Bank Act*, the right to indemnity depended on the result of the action so that prior to its conclusion, ongoing defence costs could not be advanced. The Court of Appeal appears to have distinguished the Alberta appellate decision on the basis that it was restricted to derivative actions. However, a subsequent decision by the same Alberta appellate court<sup>7</sup> indicates that the reasoning in *Canadian Commercial Bank* applied to both third party and derivative claims against the directors, which makes the basis on which the Manitoba Court of Appeal sought to distinguish *Canadian Commercial Bank* possibly tenuous.

The Manitoba Court of Appeal also cited, with approval, the decision of Errico J. in *Chromex Nickel Mines Ltd. v. British Columbia (Securities Commission)*<sup>8</sup> in which the British Columbia Supreme Court judge found that if the board of directors of a corporation decides to pay ongoing Defence Costs, payment need not await the completion of proceedings provided that the directors exercise due diligence in approving the payment of the costs<sup>9</sup>. The motions court judge in *Crocus* concluded that there is a discretion in the court to direct payment of ongoing Defence Costs, or to delay such payment until substantial completion of the proceedings. She also found that the former directors and officers had a legitimate need for legal representation, and that there was no evidence of dishonesty or bad faith on their part. Finding *Blair* to be persuasive, she found that it

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<sup>6</sup> (1989), 61 D.L.R. (4th) 161 (Alta. C.A.)

<sup>7</sup> *Willson v. Northland Bank* (1991), 83 D.L.R. (4<sup>th</sup>) 362 (Alta. C.A.)

<sup>8</sup> (1991), 4 B.L.R. (2d) 189 (B.C.S.C.)

<sup>9</sup> The downside to any director who votes for or consents to a resolution authorizing a payment of indemnity contrary to section 136 of the Ontario *Business Corporations Act* is that he will be jointly and severally liable to restore to the corporation any amounts so distributed or paid and not otherwise recovered by the corporation: subsection 130(2)(e), *OBICA*. Subsection 118(2)(d), *CBCA* is similar.

favoured payment of reasonable Defence Costs on an ongoing basis. The Manitoba Court of Appeal agreed, noting that while an amendment of the Manitoba corporations statute to expressly permit the advancement of Defence Costs “would remove any doubt about a corporation’s authority to advance costs”, even without that amendment, that a Manitoba corporation has the power to make such advances in appropriate cases:

The board of directors of a corporation has wide-ranging authority to manage the business and affairs of the corporation (see s. 97(1) of the Act). In my opinion it is within the power and authority of a board to decide that the corporation should advance defence costs to persons potentially indemnified by virtue of s. 119(1), so long as the board is satisfied that the three conditions referred to above (see para. 36) are satisfied. It would normally be expected that a board would require the kind of repayment undertaking that was required and obtained here.

Since a board of directors would have the authority described above, so would a receiver acting under court direction. It is, then, as the appellant accepts, a matter of a judge’s discretion whether and when to authorize or direct the receiver to advance defence costs. (paras. 47 and 48).

Because of the length of time it would take for the class action and the investigations to be concluded, and because the former directors and officers were presumed “so far” to have acted in good faith, the Manitoba Court of Appeal agreed with the motions court judge that they had an immediate and legitimate need for counsel and, under the present circumstances, ought not to be obliged to finance their own defence costs. One of the grounds for appealing the order was the failure of the motions court judge to consider the ability of the indemnified persons to repay. The Manitoba Court of Appeal accepted that it was within the judge’s discretion – as it would have been in the discretion of Crocus’s board of directors – not to require such security: “The implications of a decision to require

security might be significant, but no such decision was made here, so consideration of those implications will be left for another day” (para. 54).

The presumption that a director or officer is acting honestly and in good faith is a strong one and the burden lies on the corporation to prove bad faith. The concept of “bad faith” is not restricted to intentional fault, but can include wanton or reckless conduct.<sup>10</sup> In *Bennett* (fn. 10 below), Campbell J. ordered Bennett Environmental Inc. (“BEI”) to indemnify its former director and officer for a \$250,000 administrative fine and a \$50,000 contribution towards the OSC Staff’s cost of the investigation pursuant to a settlement. Bennett admitted, subject to certain caveats, to violations of the *Securities Act* in connection with the public disclosure made relating to a material contract to which BEI was a party and which was the subject of a dispute. Bennett submitted to Campbell J. that the OSC, in reaching its decision to approve Bennett’s settlement with Staff, had accepted that Bennett had an honest, but misguided, belief that the dispute relating to the contract would be resolved in favour of BEI.

Campbell J. found that there was no expert or other evidence presented by BEI that would lead to a conclusion that at the relevant point in time Bennett’s belief that BEI would prevail in the contractual dispute was unfounded or totally unreasonable. He noted that the OSC as regulator has recognized that the assessment of the standard of care of a director is *contextual* and is to be assessed on an individual basis. It is important to recognize the dangers of applying hindsight when examining the director’s conduct and there is a need to be careful not to look at the situation based on what subsequently happened:

A director will be held to an objective standard of care in carrying out his duties but there is as well a subjective element that takes into account the individual skill and training and the circumstances surrounding his or her actions. (para. 47)

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<sup>10</sup> *Bennett v. Bennett Environmental Inc.*, Court File No. 07-CL-7054 (March 4, 2008) per Colin Campbell J. at para. 42, quoting *Enterprises Sibeca Inc. V. Frelighsburg (Municipality)*, [2004] S.C.R. No. 57.

Campbell J. held that since BEI had not satisfied the burden of establishing that Bennett acted in bad faith or unlawfully, Bennett was entitled to indemnity and was not obliged to repay any amounts advanced or paid to date on his behalf to settle a US class action or securities regulatory proceedings by the OSC and the SEC.

The decisions cited above show that Canadian courts will approach the issue of indemnification and advancement of Defence Costs generously. While *Denton* decided that an investigation, without more, is not a “proceeding”, the decision pre-dates *Blair* and *Crocus* which adopt a more liberal interpretation of the corporations statute and view of the powers of a board of directors who have done the appropriate due diligence in authorizing advancement or indemnity.

### **Written Indemnity Agreements**

In practice, it is becoming increasingly more common for public corporations to enter into written indemnity agreements with their directors and officers which provide for the mandatory advancement of Defence Costs and which adopt a broad definition of the types of claims that can trigger a right to indemnity. Any type of investigation in which the director or officer becomes involved by reason of holding that position with the corporation, its subsidiaries or any outside entity who they serve at the request of the corporation can be included in the indemnity agreement. If directors and officers wish to maximize the level of personal asset protection that they can expect from a corporation, the preferred course of action is for them to execute an indemnity agreement with the corporation, which will create a contractual right which cannot be amended or revoked without the individual’s consent (unlike a company by-law which can be amended and does not confer contractual rights on a director or officer). If it is ultimately determined by a court that the corporation was not permitted to advance Defence Costs, the individuals would then look to any available directors’ and officers’ liability insurance policies (“D&O Policies”) to provide that protection. Because a corporate indemnity is only as good as the solvency of the granting corporation, D&O Policies are an important “back stop” protection in any event for directors and officers.

## Directors' and Officers' Liability Insurance

D&O Policies may provide protection for both directors/officers and the corporation against "Loss" (including Defence Costs) incurred by Insured Persons on account of certain "Claims" against the Insured Person for a "Wrongful Act". A typical definition of a Wrongful Act is as follows:

"Any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted by an Insured Person, individually or otherwise, in his Insured Capacity, or any matter claimed against him solely by reason of his serving in such Insured Capacity."

D&O Policies are not uniform and may vary in terms of the types of Claims that are covered. While the definition of Claim will often include regulatory or administrative proceedings, there is less uniformity in the types of investigations that are covered. Typically, the definition of Claim will include administrative or regulatory investigations only if those investigations constitute a "proceeding", with some policies referring to "formal" proceeding. To be covered, the investigation must usually be of the Insured Person. For example, the expression "Claim" might be defined as including a civil, criminal, administrative or regulatory investigation of an Insured Person:

1. Once such Insured Person is identified in writing by an investigating authority as a person against whom a civil, criminal, administrative, regulatory or arbitration proceeding may be commenced; or
2. In the case of an investigation by a provincial securities commission or other similar foreign securities authority, after the service of a subpoena upon such Insured Person.

If Canada adopts a process where third-party witnesses can be compelled to submit to interviews during the investigative stage of capital market criminal offences as an

investigative tool that the police can use to expedite investigations of securities fraud, D&O Policies as currently drafted would not cover the legal costs of a director or officer at the receiving end of an investigative summons unless the investigation was of the individual. It has been suggested that an investigative summons model could be devised to investigate securities fraud in a way that could withstand Charter scrutiny by adopting safeguards such as the right to counsel for the witness. However, there will have to be a modification made to D&O Policies to require them to fund the cost of individual counsel where an investigative summons is served.

In the securities regulatory environment, a securities commission may not immediately begin their investigation pursuant to the enforcement section of the relevant Securities Act. For example, the OSC may conduct a compliance review or continuous disclosure review under Section 20 or 20.1, Part VII of the Securities Act, and not pursuant to Part XXII. They may, in this manner, review and question transactions through inquiries that may ultimately lead to a formal investigation and hearing, with charges against the corporation and potentially its directors and officers. A compliance review or audit by a regulatory authority pursuant to powers other than enforcement powers may not trigger any defence or indemnity obligations under a D&O Policy even though it may be obvious to everyone where the compliance review or audit might eventually lead. The D&O Policy typically has a very “bright line” for where coverage begins and there may be a need for independent legal counsel for directors and officers to protect them long before the insurance policy is engaged.

A difficult issue that arises in the D&O insurance context is when the insurer should be notified about an investigation, either internal or regulatory. The policyholder’s common law obligations of good faith in the insurance context will require it to disclose, at the time of applying for insurance, its renewal or increasing the limits of an insurance policy, any matters that might influence the insurer’s underwriting decision (i.e. to issue the policy) or in establishing the premium. The fact that an internal investigation is underway – or a regulatory investigation is apprehended – may be material to the risk insured, even if it may

not be of such significance that it would be considered a material fact or a material change for purposes of securities law.

There may also be an advantage to reporting the existence of an investigation, internal or regulatory, to the insurer even though the circumstances may be such that they would not trigger coverage at that point in time. D&O Policies are written on a claims made and reported basis, with a fresh set of insurance limits purchased for each policy term (usually 12 months in length). D&O Policies will typically permit an insured to give notice of facts and circumstances (a "Notice of Circumstances") which the insured reasonably believes may give rise to a Claim in the future, with the result that when the Claim materializes, it will be deemed to be made during the Policy Period in which the Notice of Circumstances was given. Thus, the insurance limits from the earlier Policy Period will apply to the Claim and the limits available for the current Policy Period (when the Claim actually materializes) will not be eroded.

While the giving of a Notice of Circumstances will to some degree impact the premium and underwriting for the renewal, it should not be ruled out solely on this basis, particularly given the disclosure obligation that exists at the time of renewal. Consideration should therefore be given to making an early report of an investigation to the D&O insurers to enable the corporation to take advantage of the insurance limits that it has already paid for and to maximize its insurance protection by ensuring that fresh limits will be available subsequently for other liabilities. Note that when increased limits are purchased, insurers will typically require the applicant corporation to warrant that it is not aware of any Claims that have not been reported or of facts or circumstances that might give rise to a Claim, which is another reason why an early, timely Notice of Circumstances relating to an investigation may be prudent as it is unlikely that a corporation can improve its insurance situation by delaying disclosure. This is particularly true where the investigation relates to conduct that may be viewed by insurers as a systemic or recurring problem (e.g. market timing in mutual funds), because there will typically be an exclusion for that type of conduct added to the policy on its next renewal, making it impossible to be covered for the Claim when it materializes. There are therefore good reasons to report early if the fact of an

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internal or expected regulatory investigation causes the insured to anticipate a potential future claim that might be covered by the D&O Policy, if it ultimately materializes.

## **Conclusion**

Counsel who advise or represent corporations or individuals in internal or regulatory investigations should be aware of the protections that are available under the corporations' statutes and most corporate by-laws for individual directors and officers and their limitations. While Canada is moving in the direction of providing comprehensive personal asset protection for directors and officers, this protection is not yet uniform across the provinces. Public company directors and officers are, however, becoming more assertive in demanding indemnity agreements that provide for proactive and thorough protection.

The insurance industry is gradually moving in the direction of providing protection for directors and officers against the costs of investigations but its focus on individual protection is limited by requirements that the investigation be of the insured person and have reached a state of maturity where the individual is prospectively a target, not merely a compelled (or voluntary) witness. Consideration should be given to consulting with insurance coverage counsel where the corporation or any of its directors and officers are considering or are involved in an investigation, as there may be very good reasons to report early to the insurer even if the circumstances may not warrant public disclosure from a securities law perspective.