Directors’ and Officers’ Indemnities: The Expanding Rights of Indemnification and Advancement

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Directors and officers are subject to the risk of being added as a party to litigation, or finding themselves the subject of litigation, as a consequence of their involvement in the corporation. In these circumstances, directors and officers face the prospect of having to fund an adequate defence and incur significant legal costs. Directors and officers of corporations incorporated in Ontario under Business Corporations Act\(^1\) or under the Canada Business Corporations Act\(^2\) can take some comfort in the indemnity provisions of these statutes (collectively, the “Indemnification Provisions”). The nearly identical provisions of these statutes cover legal proceedings of all kinds – civil, criminal and administrative. Indemnification is permitted in any civil action for all costs, charges and expenses, including amounts to settle an action or satisfy a judgment, where the director or officer has acted honestly and in the good faith with a view to the best interests of the corporation (the “Good Faith Requirement”).\(^3\) For criminal or administrative actions, the director or officer must also have reasonable grounds for believing that the conduct at issue was lawful (the “Lawful Conduct Requirement”).\(^4\)

Directors and officers may also be advanced money for legal expenses associated with a proceeding before any hearing has been held on the merits, but this money must be repaid to the corporation if the Court of Tribunal ultimately determines that the director or officer in question did not act honestly or in good faith.\(^5\) In the case of derivative actions against directors or officers brought by shareholders on behalf of the corporation, court approval is required before

\(^1\) R.S.O. 1990, c. B. 16 [“OBCA”].
\(^2\) R.S.C., 1985, c. C-44 [“CBCA”].
\(^3\) OBCA, ss. 136(1) and 136(3); CBCA, ss. 124(1) and 124(3)(a)
\(^4\) OBCA, s. 136(4); CBCA, s. 124(3)(b)
\(^5\) OBCA, s. 136(2); CBCA, s. 124(2).
any money is advanced or an indemnity is given. The corporation may choose to further protect its directors and officers by purchasing insurance for directors and officers in respect of any liability incurred as a director or officer, even where the corporation could not have indemnified the individual because of the Good Faith and Lawful Conduct Requirements (collectively, the “Conduct Requirements”).

In addition to the provisions permitting a corporation to advance money or indemnify its directors and officers for legal fees, the directors and officers have a right to be indemnified from any expense incurred in defending any civil, criminal, administrative or other proceeding other than a derivative action. However, the director or officer must still show that he or she fulfilled the Conduct Requirements, and further that he or she was not judged to have committed any fault or omitted to do anything that ought to have been done.

The corporate statutes offer a fairly comprehensive statutory regime for when indemnification may be granted. However, there are a number of matters the statues expressly exclude from the universe of matters for which a corporation can provide indemnity. For example, both the OBCA and CBCA prohibit indemnification where the officer or director fails to establish that the Good Faith Conduct Requirement has been met – i.e. that he or she did not act honestly and in good faith in the best interests of the corporation – but this will not be known until after the proceeding has been determined on its merits. As a result, the statutes contemplate advancement of legal expenses while the proceeding is ongoing, on the basis that the recipient has to repay the money if these conditions are ultimately not met.

6 OBCA, s. 136(4.1); CBCA, s. 124(4).
7 OBCA, s. 136(4.3); CBCA, s. 124(6)
8 OBCA, s. 136(4.2); CBCA, s. 124(5).
The indemnification provisions in both the OBCA and CBCA appear directed at actions brought by strangers to the corporation against the directors and officers (except for the provisions addressing derivative actions). However, where the corporation itself is either the plaintiff (with directors and officers as defendants) or the defendant (with directors or officers as plaintiff), is the corporation still required to advance money or indemnify officers and directors? Also left unclear by the statutes is what is the standard to satisfy the Conduct Requirements, who bears the onus of proving it, and how might that be determined when there has yet to be, or in the case of a settlement may never be, a determination on the merits.

**Blair v. Consolidated Enfield Corp. – The Good Faith Presumption**

The Supreme Court of Canada has commented on the Indemnity Provisions in *Blair v. Consolidated Enfield Corp.*\(^9\) In that case, a former president and director brought an application for an order that he be indemnified by the corporation for legal costs incurred in defending himself from allegations of a breach of fiduciary duty. At a shareholders’ meeting, the president and director had declared that a surprise candidate for the board of directors had received no votes after being advised by counsel that the proxy votes in favour of the candidate were invalid. The Ontario Superior Court had earlier found that the determination that the proxy votes were invalid was wrong in law, and that the president and director was in breach of his fiduciary duties (the “Fiduciary Duty Action”). The former president and director brought an application for an order that he be indemnified for legal costs incurred in defending the Fiduciary Duty Action, which was dismissed on the basis that he had failed to meet the Good Faith Conduct Requirement. On appeal, the question of who bears the onus of proving the Conduct requirement had been met was raised, and the Supreme Court stated:

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\(^9\)[1995] 4 SCR 5
What I do find persuasive is the proposition that persons are assumed to act in good faith unless proven otherwise... In this respect, contrary to the appellant’s submissions before this Court, I believe that a proper construction of the statute and law related to good faith issues reveals that [a director] is not required to prove his good faith, although he may certainly call evidence in this regard to counter evidence of bad faith adduced against him. To a large extent, the corporation must establish, to the satisfaction of the court, exactly what [the director] did that was inimical to its best interests.\textsuperscript{10}

This decision is instructive because there had already been a judicial determination that the director had breached his fiduciary obligations, and this would suggest that he was not entitled to be indemnified for costs incurred defending the corporation’s action to recover its costs from the director alone. Justice Iacobucci explained that in order to receive indemnification, three conditions must be satisfied:

1. The person must have been made a party to the litigation by reason of being a director or an officer of the corporation;

2. The costs must have been reasonably incurred; and

3. The person must have acted honestly and in good faith with a view to promoting the best interests of the corporation.\textsuperscript{11}

The director had satisfied all three conditions for receiving indemnification because the director had acted in his capacity as director, and there was evidence the costs had been reasonably incurred.\textsuperscript{12} Broad policy goals underlying indemnity provisions allow reimbursement for reasonable good faith behaviour, thereby discouraging hindsight application of perfection.\textsuperscript{13} In order to attract strong candidates, there must be enough leeway to encourage responsible

\textsuperscript{10} Ibid, ¶35
\textsuperscript{11} Ibid, ¶37.
\textsuperscript{12} Ibid, ¶ 38.
\textsuperscript{13} Ibid, ¶ 74.
behaviour and incentivize strong candidates to act as directors or officers.\textsuperscript{14} The Supreme Court also held that, while reliance on legal advice does not guarantee indemnification, reliance strongly militates against a finding of bad faith or fiduciary breach.\textsuperscript{15}

Based on these determinations, the Supreme Court of Canada held indemnification was required notwithstanding the earlier determination in the Fiduciary Duty Action that the former president and director had breached his fiduciary duties.

**Bennett v. Bennett Environmental Inc. – The Presumption Also Applies to the Lawful Conduct Requirement**

In *Bennett v. Bennett Environmental Inc.*,\textsuperscript{16} the Ontario Court of Appeal highlighted the issues directors and officers face in seeking indemnification. Here, the former CEO and director sought indemnification from fines and costs paid to the Ontario Securities Commission. Over a period of 11 months, the publically traded corporation announced in press releases that it had been awarded a large soil remediation project, when in fact a competitor had protested the awarding of the contract and it was going to be re-bid. The corporation eventually did win the contract, but for a smaller amount.

When the Corporation disclosed that it had been awarded the smaller contract and the status of the contract had been in dispute for 11 months, the share price fell almost 50\% in ten days. The former CEO and director, along with the company, was the subject of class actions and securities regulatory proceedings in Ontario and in the United States. The Ontario Securities Commission (the “OSC”) alleged that the former CEO had violated the continuous disclosure requirements of Ontario securities law. The OSC proceeding was settled, and in that settlement, the former CEO acknowledged “serious misconduct” in violation of the Securities Act, but also

\textsuperscript{14} Ibid., ¶74.
\textsuperscript{15} Ibid., ¶65.
\textsuperscript{16} 2009 ONCA 198.
expressly acknowledged that the former CEO had an honest but mistaken belief that the contract was enforceable and the dispute would ultimately be resolved in the corporations' favour. The former CEO sought indemnification from the corporation for both the fine and the costs incurred in the OSC proceedings. The corporation refused on the grounds that the former CEO had not acted in good faith, and did not have reasonable grounds for his belief when he did not consult with legal counsel.

Justice Lang, writing for the Ontario Court of Appeal, addressed a number of aspects of the indemnity provisions of the OBCA. At the outset, the corporation agreed that the admissions in the OSC settlement do not preclude indemnification, and the Court agreed, noting that if that were so, there would be no need for director indemnification for administrative penalties. The Court emphasized the policy rationale for permitting indemnification generally was to provide assurance to those who become corporate directors that they will be recompensed for any adverse consequences arising from well-intentioned entrepreneurism undertaken on the corporation’s behalf.

However, to encourage appropriate conduct, the corporate statutes include a legislative prohibition against indemnification where there has been misconduct. Ultimately, the court resolved this tension by imposing the burden of proving that the director failed to meet the Good Faith Conduct Requirement on the corporation. In doing so, the Court of Appeal applied the presumption of good faith in Blair v. Consolidated Enfield above and stated that from the former

18 Ibid, ¶39.
19 Ibid, ¶23.
21 Ibid ¶ 45.
CEO is assumed to have acted in good faith and that the corporation must rebut that presumption.\(^\text{22}\)

In respect of the Lawful Conduct Requirement, the Court of Appeal extended the presumption of good faith in *Blair* to this requirement as well, holding that the onus is on the corporation for proving whether the director or officer had reasonable grounds for the belief that his or her conduct was lawful.\(^\text{23}\) Both *Blair v. Consolidated Enfield* and *Bennett* stressed that a director’s reliance on professional legal advice militates against a finding of bad faith. In *Bennett*, the Court of Appeal affirmed the principle that professional consultation is not a prerequisite to indemnification, and added that a failure to obtain professional advice may raise questions about a director’s conduct or belief, obliging the Court to look to other evidence regarding the reasonableness of that belief.\(^\text{24}\)

**Bennett v. Bennett Environmental Inc., Redux — The Corporation Bears the Burden, in spite of Evidentiary Problems**

The Court of Appeal decision in *Bennett* was not the last word on that case. After the Court of Appeal’s decision, the corporation sought an order staying the application of the former CEO for indemnification of legal fees incurred in defending criminal proceedings brought by the United States Department of Justice (the “US DOJ”), while the former CEO brought a cross-motion seeking an advancement of funds pursuant to section 124(2) of the CBCA.\(^\text{25}\) Justice Wilton-Siegel noted that the corporation had the onus of proving that the Lawful Conduct Requirement had not been met, but that corporation was hampered in this by the US DOJ

\(^{22}\) *Ibid*, ¶45.
\(^{23}\) *Ibid*, ¶55.
\(^{24}\) *Ibid*, ¶ 50-51.
\(^{25}\) *Bennett v. Bennett Environmental Inc.*, 2010 ONSC 6030.
objecting to having witnesses in the US criminal proceedings testify in any Canadian proceedings prior to the trial.\textsuperscript{26}

The corporation identified four transactions upon which the criminal proceedings were based, and sought to demonstrate that these allowed the Court to draw the inference, on a balance of probabilities, that the former CEO had “such knowledge in respect of one or more of these transactions such that *mala fides*, as contemplated in *Consolidated Enfield*, has been established.”\textsuperscript{27} However, the corporation was unable to prove that the former CEO knew or knew the significance of these transactions, and the Court concluded that the corporation had failed to establish that the Good Faith Conduct Requirement or the Lawful Conduct requirement had not been met.\textsuperscript{28} As such, the former CEO was entitled to an advancement of monies pursuant to s. 124(2).\textsuperscript{29}

In dismissing the corporation’s motion, Justice Wilton-Siegel made two interesting points. He noted that the presumption of good faith make the corporation’s claim that it is unable to prove its case because of the US DOJ’s refusal to produce witnesses irrelevant.\textsuperscript{30} Second, Justice Wilton-Siegel explained that there is no concern of inconsistent findings in the US and Ontario proceedings because the two proceedings are governed by different statutes, and that the former CEO’s application need not be determined prior to completion of the US criminal proceedings.\textsuperscript{31}

**Re EnerNorth Industries Inc. – The Effect of a Corporation’s Bankruptcy**

\begin{itemize}
  \item \textsuperscript{26} Ibid, ¶4.
  \item \textsuperscript{27} Ibid ¶6.
  \item \textsuperscript{28} Ibid ¶9-22.
  \item \textsuperscript{29} Ibid, ¶23.
  \item \textsuperscript{30} Ibid, ¶25.
  \item \textsuperscript{31} Ibid, ¶26.
\end{itemize}
In the 2008 decision in *EnerNorth Industries inc. Re*, the Ontario Superior Court had held that the s. 136(4.2) of the OBCA only creates an unsecured right of indemnification for directors and officers. In that case, the corporation was bankrupt, and the directors brought an application for payment of legal expenses incurred in the Ontario Bankruptcy proceeding, as well as proceedings in India, and sought to have the indemnity on a preferred basis. The directors asserted their right to indemnity on s. 136(4.2) of the CBCA, under an indemnity By-Law of the corporation, and relied on the right of indemnification set out in the receivership order.

Justice Wilton-Siegel noted that the Trustee in Bankruptcy did not dispute that the directors were entitled to indemnification for reasonable legal expenses. Rather, the dispute was whether this indemnity had priority over other claims. In addressing this issue, a conceptual question was raised: are the legal costs of the directors *per se* legal costs of the estate of the corporation? The Court answered no, and concluded that the right to indemnification in s. 136(4.2) only provides an unsecured right of indemnification against the corporation, and nothing in the OBCA requires that director’s indemnity claims have a higher priority than other unsecured creditors. The Court noted that there is no security required for any repayment claim the corporation may have if the individual fails to demonstrate that the Good Faith or Lawful Conduct Requirements have been met, and this suggests that if the corporation does not have a secured claim against the directors, the directors also do not have a secured claim against the corporation.

**Med-Chem Health Care Ltd. v. Misir – An Action by the Corporation Against the Directors**

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32 2008 CarswellOnt 356 (S.C.J.)
34 *Ibid* ¶16.
The Ontario Court of Appeal further addressed the corporation’s ability and obligation to indemnify directors and officers in *Med-Chem Health Care Ltd. v. Misir*. The order under appeal was for the corporation to make advances for legal expenses incurred by former directors in defending the corporation’s action against the former directors for breaching their duties to the company. The alleged breaches concerned the funding arranged by the former directors to complete the corporation’s initial public offering. While the action was then at the pleadings stage, the corporation alleged that these funding arrangements lead to the corporation’s financial problems and ultimately its bankruptcy. The corporation was not disputing that it ultimately had an obligation to indemnify the former directors, but rather that it does not have an obligation to reimburse the former directors by way of advancement in these circumstances.

The analysis was complicated by a By-law of the corporation requiring the corporation to indemnify the former directors where the OBCA permits or requires indemnification. Justice Goudge, writing for the Court of Appeal, rejected the corporation’s argument that the By-law only requires the corporation to indemnify, rather than advance money, and held that the By-law requires everything that OBCA permits, including the advancement of defence costs. The Court explained that the legislation, in making advancement permissible, was “recognizing the reality that requiring an individual to fund his or her own costs of litigation until its conclusion before being provided with indemnification would seriously impair the objective of indemnification itself.” The Court also rejected the argument that the advancement provisions

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36 2010 ONCA 380  
37 Ibid., ¶15  
38 Ibid., ¶19  
39 Ibid., ¶20.
do not apply to former directors, finding that the reference to “other individuals” in s. 136(1) includes former directors.\(^{40}\)

The Court also addressed the manner in which the Court should exercise discretion under s. 136(4.1) in approving advances in a derivative action. Section 136(4.1) provides:

“A corporation may, with the approval of a court, indemnify an individual... or advance moneys... in respect of an action by or on behalf of the corporation or other entity to obtain a judgment in its favour, to which the individual is made a party because of the individual’s association with the corporation or other entity... against all costs, charges and expenses reasonably incurred by the individual in connection with such action, if the individual fulfils the [the Conduct Requirements].”

The Court rejected out of hand the suggestion that this exercise of discretion required an analysis of (i) whether there was proof of an inability to pay for the litigation without advances; (ii) the presence of insurance to fund them; and (iii) the former director’s delay in seeking the advancement.\(^{41}\) Instead, the overriding considerations were those of the trial judge: the By-Laws of the corporation, the onus on the corporation to prove the director or officer has not met the Conduct Requirements, any evidence of bad faith, and any prior judicial determination that the directors are entitled to indemnification.\(^{42}\)

**Jolian v. UBS – An Action by a Director against the Corporation**

The most recent decision concerning director and officer indemnity is that of Justice Marrocco in *Jolian Investments Ltd. v. Unique Broadband Systems Inc.*,\(^{43}\) which suggests that the corporation must advance money to pay for legal expenses, even where the defendant is the corporation itself. *Jolian* involved a former C.E.O. of the corporation whose personal services

\(^{40}\) *Ibid*, ¶23.
company, Jolian, sued the corporation for termination without cause of the agreement under which the former CEO’s services had been provided. The alleged termination arose when the corporation’s shareholders did not reappoint the former CEO to the Board of Directors and the new Board did not reappoint him as C.E.O. In the action, Jolian brought a motion for summary judgement on a claim for advancement of legal expenses incurred in bringing the action, as well as those incurred in defending the corporation’s counterclaim. Jolian relied upon a contractual indemnity contained in the services agreement, the By-laws of the corporation, and ss. 136(1) and 136(2) of the OBCA.

In granting the motion, Justice Marrocco noted that the indemnification agreement made mandatory what the OBCA permits.\(^\text{44}\) The agreement provided for indemnification for “all reasonable legal... expenses” incurred in connection with the agreement, and with respect to “any other matter” relating to the corporation.\(^\text{45}\) The agreement went on to state that “the Corporation hereby agrees to indemnify [the former CEO] to the fullest extent permitted by law, notwithstanding that such indemnification is not specifically authorized by the... this Agreement, the Corporation’s Articles or Bylaws, or by the statute.”\(^\text{46}\) This language was broad enough to encompass Jolian’s lawsuit against UBS. Had UBS intended to prohibit such an outcome, this should have been addressed at the time the indemnity was drafted.\(^\text{47}\) The court noted that the former CEO had undertaken to repay the advanced money if required to do so, but that the corporation’s promise to indemnify and advance funds “will generally imply an acceptance of the risk that the legal fees advanced might not be re-paid.”\(^\text{48}\)

\(^\text{44}\) Ibid, ¶71.
\(^\text{45}\) Ibid, ¶39.
\(^\text{46}\) Ibid, ¶67.
\(^\text{47}\) Ibid, ¶57.
\(^\text{48}\) Ibid, ¶76.
With regard to the Good Faith Conduct Requirement, Justice Marrocco applied prior jurisprudence holding that directors seeking advancement are presumed to have acted in good faith, in the absence of evidence to the contrary.\textsuperscript{49} He appeared unimpressed by arguments made by UBS that this presumption should be displaced on the facts of the case.

Justice Marrocco also rejected an argument based on s. 136(4.1) of the OBCA, which requires court approval before a corporation can indemnify or advance money to an officer or director in an action “by or on behalf of the corporation”, and requires the individual seeking advancement to demonstrate to the court that he has fulfilled the obligation to act honestly and in good faith. Justice Marrocco interpreted this provision narrowly to apply solely to derivative actions, relying in part upon the heading to the subsection.\textsuperscript{50}

The \textit{Jolian} decision raises an important question regarding what limits should be placed on indemnification and advancement. The typical corporate indemnification by-law grants these rights ‘to the maximum extent permitted by law”, but these provisions are typically drafted by those who will later seek to rely upon them. It is up to the courts and legislature to set limits on these rights. As a matter of public policy, it makes little sense to force a corporation to underwrite litigation against itself. In this case, the outcome was dramatic: shortly after this decision, the corporation sought protection against its creditors under the \textit{Companies’ Creditors Arrangement Act}, R.S.C., 1985, c. C-36 relying in large part upon the potential liabilities triggered by this decision.

\textbf{Conclusion}

\textsuperscript{49} \textit{Ibid.}, ¶54.  
\textsuperscript{50} \textit{Ibid.}, ¶122-125.
Sections 136 of the OBCA and 124 of the CBCA provide indemnify and advancement for directors and officers acting in this capacity. As the Supreme Court of Canada stated in *Blair v. Consolidated Enfield Corp*: “permitting [a director] to be indemnified is consonant with broad policy goals underlying indemnity provisions; these allow for reimbursement for reasonable good faith behaviour, thereby discouraging the hindsight application of perfection.”51 The Conduct Requirements are meant to be a check on director’s and officer’s behaviour, deterring irresponsible behaviour by requiring advanced money to be repaid and prohibiting indemnity if those standards are not met. However, in *Blair v. Consolidated Enfield Corp.*, Supreme Court cemented the presumption of honest and good faith behaviour, such that the onus shifts to the corporation to prove the director or officer will not meet these standards.

Corporations face an uphill battle in demonstrating that the Conduct Requirements have not been met, especially when there has yet to be a hearing on the merits or, in the case of settlement, there may never be one. Corporate indemnification By-Laws may also make mandatory what the OBCA and CBCA permit, and guarantee that indemnification and advancement will be available for directors and officers.

Nonetheless, there remains a serious unanswered public policy issue about (1) the limits that ought to be imposed on indemnification and advancement when the corporation is being asked to fund litigation against itself, and (2) what threshold a corporation would need to satisfy to establish that the Good Faith and Lawful Conduct Requirements have not been met before the hearing on the merits.