

INDEMNITY AND INFIDELITY: ADVANCEMENT OF DEFENCE COSTS IN ACTIONS "BY . . . THE CORPORATION"

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I. INTRODUCTION

Indemnification of corporate directors refers to the financial protection provided by the corporation to its directors.¹ It shields directors from expenses and liability of legal proceedings alleging breaches of their duty to the corporation.² This is of concern for directors because, in addition to the potential liability they face if found blameworthy, the cost of funding an adequate defence can be staggering. To illustrate, since 2003, the Sun-Times Media Group Inc. (formerly Hollinger International Inc.) has paid U.S. \$107.7 million in *legal fees alone* to defend Conrad Black and other former officers in the criminal lawsuit launched by the U.S. government, as well as a bevy of civil suits in Canada and the United States.³

Corporate pundits rightly regard liberal indemnification provisions as necessary to recruit capable management⁴ and to encourage directors to act on behalf of the corporation in a manner

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1. Committee on Corporate Laws, "Changes in the Model Business Corporations Act — Amendments Pertaining to Indemnification and Advance for Expenses" (1994), 49 Bus. Law. 749 at p. 749. Although this article refers to "directors", the Canada Business Corporations Act, R.S.C. 1985, c. C-44 (CBCA) provisions respecting indemnity include "officers" as well, thus much of this article is applicable to the indemnification of corporate management generally. Potential distinctions pertaining to the indemnification of officers are beyond the scope of this article.
2. *Ibid.*
3. T. Tedesco, "Left Out to Dry; Hollinger: The Untold Story", *National Post*, December 8, 2007, p. FP7.
4. H.S. Wineberg, "Proposals for the Reform of Provisions of the British Columbia Company Act that Indemnify Directors" (1992), 50 The Advocate 523 at p. 523; J.E. Irenas and T. Moskowitz, "Indemnification of Corporate Officers, Agents and Directors: Statutory Mandates and Policy Limitations" (1984), 7 Seton Hall Legis. J. 117 at p. 117.

unfettered by fear of “tak[ing] good faith risks in the search for profit”.⁵ They emphasize the increased cost and volume of litigation and portend the grim consequences of limiting directors’ indemnification rights.⁶ Critics of indemnification see it as contributing to corporate malfeasance by permitting directors to waste corporate funds while avoiding personal consequences of misconduct. The high standards of conduct required of directors would be nullified if a company were permitted to relieve its directors from liability for breaches of their duties.⁷ The principle of indemnification strikes a delicate balance between seeking “the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all”.⁸

Legislatures in Canada, Britain and the United States recognize that there is a public interest in regulating the circumstances in which a company indemnifies its directors and officers. Statutory attempts to prescribe the indemnification rights of directors first emerged as short, narrow provisions that simply reiterated common law principles of agency.⁹ Today, they have matured into “one of the most complex and most controversial problems of contemporary corporation law”.¹⁰ The principle common to indemnification statutes is that directors acting in good faith and in the best interests of the corporation should not be liable to third parties and should not bear litigation expenses incurred in their defence.¹¹ Where, however, it is alleged that a director has breached a duty owed *directly* to the corporation, it is the corporation that must pursue its

5. Joseph F. Johnston, Jr., “Corporate Indemnification and Liability Insurance for Directors and Officers” (1978), 33 *Bus. Law.* 1993 at p. 1994.
6. Wineberg, *supra*, footnote 4, at p. 523.
7. British Columbia Ministry of Finance and Corporate Relations, *Company Act Discussion Paper* (January 1991), at p. 31 (BCCA Discussion Paper).
8. Johnston, *supra*, footnote 5, at p. 1994. As noted by Iacobucci J., speaking for the Supreme Court of Canada in *Blair v. Consolidated Enfield Corp.*, [1995] 4 S.C.R. 5, 128 D.L.R. (4th) 73, at para. 74: “Permitting [a director] to be indemnified is consonant with the broad policy goals underlying indemnity provisions; these 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.”
9. See, e.g., The Canada Joint Stock Companies Act, 1877, 40 *Vict.*, c. 43 (1877), s. 57.
10. R.V.W. Dickerson, J.L. Howard and L. Getz, *Proposals for a New Business Corporations Law for Canada* (Ottawa, Information Canada, 1971), vol. 1, Commentary, p. 83, para. 243.
11. Wineberg, *supra*, footnote 4, at p. 523.

directors, either directly or derivatively.¹² Different indemnity principles will apply in such cases.

The purpose of this article is two-fold. First, to demonstrate that, although it appears that Canada's current federal statutory indemnification scheme, s. 124 of the Canada Business Corporations Act¹³ was intended to provide a comprehensive scheme for dealing with indemnification, it does not encompass actions brought *directly* by a corporation against its directors for a breach of duty to the corporation. This is the only section of the CBCA that permits indemnification.¹⁴ If a director were to receive indemnification or advancement of legal expenses for an action brought directly by the corporation, then it must be found here. Although direct actions would seem to fall naturally into s. 124(4), which authorizes indemnification for actions "*by . . . the corporation*", this was intended to apply only to derivative actions. Nor can direct actions be appropriately accommodated by s. 124(1), which is intended to deal with indemnification in actions brought by third parties.

The second purpose is to review policy issues raised by advancement of defence costs to directors incurred in both derivative actions and direct actions by the corporation. Derivative suits brought by corporate stakeholders and direct suits brought by the corporation itself are not the same; in direct suits the corporation and its management are truly adverse. Is the advancement of expenses of litigation in such cases appropriate? It is contended that it is not; judicial inclination to interpret direct actions as falling within the purview of the section should be avoided.

This article begins with s. 124. The historical development of the section is canvassed to demonstrate that direct actions were never considered within its purview. Canadian federal indemnity laws have been heavily influenced by American corporation law, particularly that of Delaware, New York and the Model Business Corporations

12. The CBCA provides a statutory derivative action that allows shareholders and others to sue directors on behalf of the corporation for liabilities that directors may owe to the corporation. The proceeds of a successful action are paid to the corporation directly, rather than the plaintiff (ss. 239 and 240).

13. *Ibid.*, s. 124. Section 136 of Ontario's Business Corporations Act, R.S.O. 1990, c. B.16 (OBCA), is the same in substance as that of s. 124 of the CBCA, so the comments in this article apply equally to the indemnification provisions of the OBCA. Although all other provinces have included statutory indemnity provisions in their corporate laws, their analysis is beyond the scope of this article.

14. *Canada Business Corporations Act Discussion Paper: Directors' Liability* (November 1995) (CBCA Discussion Paper), p. 26, para. 90, online: <<http://dsp-psd.pwgsc.gc.ca/Collection/C2-280-7-1995E.pdf>>.

Act. The impact of these statutes on the development of s. 124 is considered, concluding with a discussion of the merits of interpreting this section to encompass direct actions.

II. OVERVIEW OF THE CURRENT FEDERAL STATUTORY SCHEME SECTION 124 OF THE CBCA

To be eligible for indemnification under s. 124 of the CBCA, a director must have acted honestly, in good faith and in the best interests of the corporation and, in the case of a criminal or administrative proceeding, the director must also have had reasonable grounds for believing that his or her conduct was lawful.¹⁵ These requirements set minimum standards of conduct that delineate the outer boundaries of indemnification that a corporation may, at its discretion, extend to a director,¹⁶ and reflect the statutory duties imposed on directors by s. 122 of the CBCA.¹⁷ In actions brought other than “by or on behalf of the corporation”,¹⁸ a director who satisfies these minimum standards of conduct has an enforceable right to be indemnified by his corporation, as long as he is not judged by a court to have committed any fault or omitted to do anything he ought to have done.¹⁹ Where a director *is* adjudged liable to a third party, then as long as he has met the minimum standards of conduct owed to the

15. CBCA, *supra*, footnote 1, s. 124(3). In considering the analogous provision of s. 136(1) of the OBCA, *supra*, footnote 13, Iacobucci J., speaking for the Supreme Court of Canada, noted that there are three conditions that the director must fulfill in order to receive indemnification for the costs of defending in litigation: (1) the person must have been a party to the litigation by reason of being a director or 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. Persons are presumed to act in good faith unless proven otherwise: *Blair, supra*, footnote 8, at paras. 35-36. The above criteria appear to set an objective test: see *Catalyst Fund General Partner I Inc. v. Hollinger Inc.*, [2006] O.J. No. 944 (QL), 266 D.L.R. (4th) 228 (C.A.), at para. 106, where Cronk J.A. states: “In the final analysis, given the situation that existed in June 2005, White had no business resisting Hollinger’s Removal Motion. That he may have done so in the subjective belief that he was acting in the best interests of Hollinger does not assist him on the Indemnity Appeal. Objectively, that was not the case and he cannot make out a claim for indemnification by relying on an unreasonable subjective belief.”

16. Committee on Corporate Laws, *supra*, footnote 1, at p. 749.

17. CBCA, *supra*, footnote 1, s. 122(1).

18. CBCA Discussion Paper, *supra*, footnote 14, p. 27, paras. 132-33.

19. CBCA, *supra*, footnote 1, s. 124(5): . . .

- (a) was not judged by the court or other competent authority to have committed any fault or omitted to do anything that the individual ought to have done; and
- (b) fulfils the conditions set out in subsection (3).

corporation, the statute endows the corporation with the discretion to indemnify the director for all of his or her reasonably incurred costs, charges and expenses, including the amount of any settlement or judgment.²⁰ Court sanction or approval is not required.²¹ Additionally, under s. 120(5) of the CBCA, the granting of indemnity is excluded from the general rule that a director may not vote on a contract in which he or she has a material interest.²² In other words, the director is entitled to vote for contracts that set the terms of his indemnification.

Subsection 124(2) permits advancement of expenses to directors before the final outcome of an action is known.²³ This reflects the view of the legislature that a director who serves a corporation in a representative capacity should not be required to finance his or her own defence. Moreover, given the potentially enormous costs of litigation, responsible individuals may be unwilling to serve as directors unless they have assurance that their corporation will have the power to advance their expenses.²⁴ There is, however, an important distinction between advancement of expenses and indemnification. Indemnification is retrospective, providing reimbursement for expenses *after* the outcome of a proceeding is known. This enables the individuals making the decision to indemnify to do so on the basis of known facts.²⁵ Advancement of expenses is necessarily prospective, so that the individuals making the decision to indemnify generally have fewer facts on which to base their decision.²⁶ For this reason, s. 124(2) stipulates that, if it were ultimately determined that a director has not fulfilled the minimum standards of conduct necessary for indemnification, the director must repay the money to the corporation.²⁷

20. *Ibid.* Section 124(1) provides: "A corporation may indemnify a 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 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."

21. *Ibid.*

22. *Ibid.*, s. 120(5).

23. *Ibid.* Section 124(2) provides: "A corporation may advance moneys to a director, officer or other individual for the costs, charges and expenses of a proceeding referred to in subsection (1). The individual shall repay the moneys if the individual does not fulfil the conditions of subsection (3)."

24. Committee on Corporate Laws, *supra*, footnote 1, at p. 765.

25. *Ibid.*

26. *Ibid.*

27. CBCA, *supra*, footnote 1, s. 124(4).

The legislation also addresses indemnification in derivative actions.²⁸ Generally speaking, a derivative action is instigated by a stakeholder²⁹ of the corporation — not for the stakeholder's direct benefit, but for the benefit of the corporation. The stakeholder is empowered to bring an action in the name of the corporation — and on the corporation's behalf — against parties who have caused harm to the corporation.³⁰ Often, derivative suits are brought against officers or directors of a corporation alleging violations of fiduciary duties owed to the shareholders. The proceeds of a successful action are paid to the corporation rather than to the stakeholder who brings the action.

There are policy reasons for refusing indemnity to directors who are found liable to their company in derivative actions. Derivative actions put squarely at issue the question of whether the director has breached his statutory duties to the corporation and its shareholders. It seems unjust to transfer shareholders' money to those who have failed to perform their fiduciary obligations. Additionally, if a company were required to indemnify a director for liabilities incurred by his unsuccessful defence of a derivative action, then indemnification would involve a circularity of payment that would render the derivative action superfluous. This is illustrated by the following example:

A stockholder sues the directors. He says, "You took a million dollars from the corporation." He wins. The court says to these fellows, "Pay that million dollars to the corporation." But [the court] doesn't say that they were grossly negligent or guilty of willful misconduct. He just says that they were negligent or guilty of ordinary misconduct. Usually courts are quite charitable to the insiders in these cases. So they pay the million dollars to the corporation. The corporation, however, doesn't get the million dollars because the court allows the plaintiff's counsel a fee of \$100,000 out of the million dollar recovery. So the corporation has recovered \$900,000. But the defendants are entitled to be indemnified for the amount paid the corporation, so they get back the \$900,000 and they also get back their counsel fees, which we will say are another \$100,000. The net result is that

28. *Ibid.* Section 124(4) provides: "A corporation may with the approval of a court, indemnify an individual referred to in subsection (1), or advance moneys under subsection (2), in respect of an action by or on behalf of the corporation or other entity to procure 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 as described in subsection (1) against all costs, charges and expenses reasonably incurred by the individual in connection with such action, if the individual fulfils the conditions set out in subsection (3)."

29. *Ibid.* The action is initiated by a "complainant", who is defined in s. 238 to be a shareholder, director, officer, the CBCA director, or any other person who, in the discretion of the court, is a proper person to make an application.

30. *Ibid.* Section 239 provides for the commencement of a derivative action.

the corporation, having triumphed, is \$200,000 poorer than it was before.³¹

Thus, if a corporation is permitted to reimburse a director for the very amounts paid to the corporation as a judgment, then a “successful” derivative action results in a net loss to the corporation.³² This logic also forecloses indemnification for amounts paid to settle derivative actions.³³ In derivative actions court approval is required as a pre-condition to indemnification, in addition to directors meeting minimum standards of conduct.³⁴

The implied premise of s. 124(4) is that, if a derivative action in the name of the corporation has been brought against a director, then the director has probably not been acting in the interests of the corporation and therefore, his conduct should be scrutinized.³⁵

Section 124 of the CBCA does not contemplate indemnity for actions brought *directly* by a corporation against its directors for a breach of duty to the corporation, although this would appear to be authorized under s. 124(4), on the basis of the reference to actions “by . . . the corporation”. This section was intended to apply only to derivative actions, as evidenced by the marginal caption, “*Indemnification in derivative actions*”. The text of the subsection refers to a derivative suit as an action “by or on behalf of the corporation”,³⁶ being an action *by* the corporation in the sense that the action is commenced for the corporation and *on behalf* of the corporation, because it is commenced by a stakeholder for the corporation’s benefit. Derivative actions have been variously referred to as “actions ‘in the right of the corporation’, ‘secondary actions by shareholders’, or ‘actions to enforce a secondary right on the part of shareholders’”,³⁷ and the usual definitions of the word

31. J.W. Bishop, “Indemnification of Corporate Directors, Officers and Employees” (1965), 20 Bus. Law. 833 at p. 841.

32. “Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation” (1963), 76 Harv. L. Rev. 1403 at p. 1403.

33. *Wood v. Noma Elec. Corp.*, 96 N.Y.L.J. 1121 (N.Y. City Ct., 1936). Some academics have pointed out, however, that there may be less objection to a corporation indemnifying settlement payments because a corporation can derive tangible benefits from the prompt resolution of the action and to encourage rapid disposition of refractory litigation. See, for example, K.G.J. Pillai and C. Tractenberg, “Corporate Indemnification of Directors and Officers: Time for Reappraisal” (1981), 15 U. Mich. L.J. Reform 101 at p. 105; M. Kuykendall, “A Neglected Policy Option: Indemnification of Directors for Amounts Paid to Settle Derivative Suits — Looking Past ‘Circularity’ to Context and Reform” (1995), 32 San Diego L. Rev. 1063.

34. CBCA, *supra*, footnote 1, s. 124(4).

35. Dickerson, *supra*, footnote 10, at p. 84, para. 247.

36. *Ibid.*

37. Comment, “The Right of Directors to Indemnification in Actions Brought Directly by the Corporation: A Study of BCL Sections 722 and 723” (1971), 39

“derivative” do not encompass the direct action by the corporation. While indemnification may be appropriate in certain direct suits, particularly when the director’s defence is successful, the advancement of defence costs to directors in such suits may never be appropriate and is not provided for by statute, as demonstrated by the following historical review of Canadian statutory indemnification law.³⁸

III. HISTORICAL DEVELOPMENT OF CANADIAN INDEMNIFICATION LAW

1. Indemnification at Common Law

The notion that a director should be reimbursed by the company for liability that he incurs in service to it derives from the common law of agency. The common law holds that an agent should not bear liability arising from simply carrying out his principal’s instructions; those losses more appropriately rest with the principal who gives the instructions.³⁹ There are two exceptions. First, an agent is not entitled to seek indemnity from his principal where he carries out instructions that he *knows* to be unlawful.⁴⁰ Second, an agent may not seek indemnification if the loss is attributed to his “fault” or lack of skill in carrying out the task.⁴¹

Fordham L. Rev. 743 at p. 744; H.G. Henn, *Handbook of the Laws of Corporations and Other Business Enterprises*, 2nd ed. (St. Paul, West Publishing Co., 1970), § 358, at p. 751.

38. D.H. Mazur, “Indemnification of Directors in Actions Brought Directly by the Corporation: Must the Corporation Finance Its Opponent’s Defense?” (1994), 19 J. Corp. L. 201.

39. K.P. McGuinness, *Canada Business Corporations Law* (Markham, LexisNexis, 2007), p. 1091, s. 11.298; *Adams v. Morgan & Co.*, [1924] 1 K.B. 751 (C.A.); *Hollebone’s Agreement (Re)*, [1959] 2 All E.R. 152 (C.A.).

40. *The Koursk*, [1924] 1 P. 140 (C.A.), at p. 155; *Weir v. Bell* (1878), 3 Ex. D. 238 (C.A.), at p. 248. Note that this is a separate and distinct issue from that of the right of contribution under Ontario’s Negligence Act, R.S.O. 1990, c. N.1.

41. McGuinness, *supra*, footnote 39. This was decided by Neville J., in *Brazilian Rubber Plantations and Estates Ltd. (Re)*, [1911] 1 Ch. 425, which was followed by Romer J. at first instance in *City Equitable Fire Insurance Co. Ltd. (Re)*, [1925] 1 Ch. 407 (C.A.); see also *New Zealand Farmers’ Co-operative Distributing Co. v. National Mortgage Agency Co. of New Zealand*, [1961] N.Z.L.R. 999. In such cases, the principal would remain liable to third persons in a civil suit for the torts of his agent, even if the principal did not authorize or know of such misconduct or even if he forbade the acts, or disapproved of them, so long as they were committed within the scope of an agent’s ostensible authority. Moreover, if the principal were held to be vicariously liable for damages caused by the agent’s negligence, then the agent would be subject to an implied obligation to indemnify his principal — a logical consequence of the duty of care that an agent owes to his principal in carrying out the principal’s instructions. See, for example, *Keppel v.*

The traditional principal-agent relationship does not perfectly analogize to the relationship of a director and corporation, however. Directors are not agents in the strict technical sense; a traditional agency relationship arises primarily in contract, whereas a director's powers derive from statute rather than by a contractual delegation of authority from the corporation or the stockholders who elect them.⁴² Nonetheless, as writers have pointed out, directors are agents acting on behalf of both the corporation and its shareholders in all practicality, and it is by so doing that they are exposed to liability.⁴³ The courts of Britain and Canada share a pragmatic view of the unique capacity of directors, holding that they *are* properly conceived to be agents for a corporation,⁴⁴ but not *only* as agents. For instance, directors should also be thought of as trustees for a company with respect to the exercise of their powers, since they cannot lawfully use their powers except for the company's benefit, or intended benefit.⁴⁵ It follows, then, that directors should also be entitled to indemnification, as agents, against losses incurred by them in carrying out their duties on behalf of the corporation.⁴⁶ A test for determining whether a director's impugned act is made on behalf of the corporation is to examine whether the act is allegedly for the director's own benefit or for the benefit of the corporation.⁴⁷

Thus, directors in England and Canada were owed indemnity from a corporation in accordance with common law principles.⁴⁸ Through

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- Wheeler*, [1927] 1 K.B. 577 (C.A.); *Hillcrest General Leasing Ltd. v. Guelph Investments Ltd.* (1970), 13 D.L.R. (3d) 517 (Ont. Co. Ct.), at p. 522, *per* Grossberg Co. Ct. J. See also *McGowan & Co. v. Dyer* (1873), L.R. 8 Q.B. 141.
42. W.J. White and J.A. Ewing, *A Treatise on Canadian Company Law* (Montreal, C. Theoret, 1901), p. 283. The authors note, however, that they are agents in the fact that, in many cases, their acts, otherwise voidable, become valid by the ratification of the stockholders. See for example, *Charitable Corporation v. Sutton* (1742), 2 Atk. 400; *Middlebury Bank v. Rutland Rwy. Co.*, 30 Vt. 159 (1858) at p. 169; *Grant v. United Kingdom Switchback Rwy. Co.* (1888), 40 Ch. D. 135 (C.A.).
43. White, *ibid.*; McGuinness, *supra*, footnote 39, at p. 1091, s. 11.300.
44. See, for example, *Halsbury's Laws of England*, vol. 5 (London, Butterworth & Co., 1910), para. 358, which states: "The true position of directors is that of agents for the company. As such they are clothed with the powers and duties of carrying on the whole of its business, subject, however, to the restrictions imposed by the articles and any statutory provisions." See also *Faure Electric Accumulator Co. (Re)* (1888), 40 Ch. D. 141. But note that the director is not an agent of the shareholders: *Gramophone and Typewriter, Ltd. v. Stanley*, [1908] 2 K.B. 89 (C.A.) at p. 106.
45. *Halsbury's Laws of England, ibid.*, at para. 360.
46. *Halsbury's Laws of England, ibid.*, at para. 477.
47. *Halsbury's Laws of England, ibid.*, at para. 480. See also *McGowan, supra*, footnote 41; *Northern Life Assurance Co. of Canada v. McMaster, Montgomery, Fleury & Co.*, [1928] S.C.R. 512, [1928] 3 D.L.R. 497 at pp. 499-500.
48. McGuinness, *supra*, footnote 39, at p. 1093, s. 11.301.

a certificate of incorporation, the by-laws, a resolution or an agreement approved by shareholder majority, a corporation could indemnify its directors at common law. This power would become an obligation if the corporation agreed to pay the legal expenses of the directors. Further, an agent could contract with his principal for indemnification rights that were more or less extensive than those provided by the common law.⁴⁹

2. The Rise of Statutes Limiting Indemnity Rights

In 1845, British legislation codified these common law principles. The first statutory indemnification clause, found in Britain's Companies Clauses Consolidation Act, 1845⁵⁰ stated, in substance, that a director executing any contract on behalf of a company or otherwise acting on his directorial powers was not to be held legally responsible, and was entitled to be indemnified by the company for all payments made or liability incurred in execution of his powers.⁵¹

As time passed, it became clear that the seemingly trivial distinction between directors, whose powers derived from statute, and "true" agents, whose powers derived from contract, could be problematic. Since "true" agency relationships were a product of contract, agents who sought indemnification rights that were more extensive than those at common law had to *bargain* with their principals for those rights.⁵² Conversely, the corporation's contractual indemnification obligations were being created by the very people who would benefit from them,⁵³ so that there were no effective controls on the scope of the rights that directors could choose to allocate to themselves. This resulted in company articles containing extremely generous clauses purporting to indemnify directors against the consequences of not only their negligence or breach of duty, but even breach of trust.⁵⁴ The sweeping scope of indemnification rights that companies were granting their directors provoked a reaction from British and Canadian legislatures, causing

49. *Ibid.*

50. The Act is formally titled An Act for consolidating in One Act certain Provisions usually inserted in Acts with respect to the Constitution of Companies incorporated for carrying on Undertakings of a public Nature, 1845 (U.K.), 8 Vict., c. 16 (Companies Clauses Consolidation Act).

51. *Ibid.*, s. 100.

52. *Ibid.*

53. McGuinness, *supra*, footnote 39, at p. 1093, s. 11.302.

54. *Tomlinson v. Liquidators of Scottish Amalgamated Silks Ltd.*, [1934] S.L.T. 101 (HL) at p. 104, *per* Lord Clyde.

them to revise the statutes to set minimum standards of conduct for directors to fulfil in order to attain corporate indemnification.⁵⁵

Britain's Companies Act, 1929⁵⁶ implemented a provision that prohibited indemnification "in respect of any negligence, default, breach of duty or breach of trust". An exception was carved out for a director's defence costs arising from civil or criminal liability "in which judgment is given in his favor or in which he is acquitted".⁵⁷ Similarly, Canada's first statutory indemnification clause, s. 57 of The Canada Joint Stock Companies Act, 1877,⁵⁸ and Ontario's first statutory indemnification clause, s. 72 of The Corporations Act, 1953,⁵⁹ both provided that a director could be indemnified out of company funds for costs, charges and expenses incurred in the execution of his duties as a director, unless they were "occasioned by his own *wilful* neglect or default".⁶⁰

55. *Halsbury's Statutes of England and Wales*, 2nd ed., vol. 3 (London, Butterworth & Co., 1949), p. 624 (Notes).

56. 1929 (U.K.), 19 & 20 Geo. 5, c. 23.

57. *Ibid.*, s. 152. See also *Halsbury's Statutes of England and Wales* (Notes), *supra*, footnote 55, at p. 624.

58. The Canada Joint Stock Companies Act, 1877, *supra*, footnote 9. Section 57 provides: "Every Director of the Company, and his heirs, executors and administrators and estate and effects respectively may, with the consent of the Company, given at any general meeting thereof, from time to time, and at all times, be indemnified saved harmless out of the funds of the Company, from and against all charges, costs and expenses whatsoever which he shall or may sustain or incur in or about any action, suit or proceeding which shall be brought, commenced or prosecuted against him, for or in respect of any act, deed, matter or thing whatsoever, made, done or permitted by him, in or about the execution of the duties of office; and also from and against all other charges, costs and expenses which he shall sustain or incur, in or about, or in relation to the affairs thereof, except such costs, charges or expenses as shall be occasioned by his own wilful neglect or default." This wording was adopted in The Companies Act, 1902 (U.K.), 2 Edw. VII, c. 15, s. 67, and subsequent federal corporation statutes, remaining essentially unaltered in Canada for more than 100 years, until 1975 with the enactment of the Canada Business Corporations Act, S.C. 1974-75, c. 33 (CBCA (1975)).

59. S.O. 1953, c. 19, s. 72.

60. *Ibid.* (emphasis added). In *City Equitable*, *supra*, footnote 41, the Court of Chancery determined that "wilful neglect or default" is an act or an omission to do an act where the person who acts or omits to act knows what he is doing. Accordingly, where that act or omission amounts to a breach of that person's duty and, therefore, amounts to negligence, then he is not guilty of willful neglect or default unless he knows that he is committing — and intends to commit — a breach of his duty or is recklessly careless in the sense of not caring whether or not the act or omission is a breach of his duty. See also *Brazilian Rubber*, *supra*, footnote 41.

3. Influential Developments in the United States: The *McCollum* Case

Directors' indemnification rights were codified in Canada and Britain much earlier than in the United States where there was no clear common law basis for indemnification. The existence of the right seemed to depend upon the benefit that accrued to a corporation as a result of director's defence.⁶¹ Although there were few cases on the subject,⁶² a successful defence of an action seemed to play a major role in the determination of the existence of a benefit to the corporation.⁶³ The mere fact that the director was unsuccessful, however, did not preclude the courts from finding that a benefit existed, thus permitting indemnification.⁶⁴

Following the 1929 stock market crash, Senate hearings on stock exchange practices raised the issue of director malfeasance into national visibility.⁶⁵ The United States' Securities Act of 1933,⁶⁶ the Securities Exchange Act of 1934⁶⁷ and other antitrust laws⁶⁸ were enacted to address director misconduct and to bring about substantial changes in the general behavior of directors.⁶⁹ The

61. See, e.g., *Wickersham v. Crittenden*, 106 Cal. 329, 39 Pac. 603 (1895); *Godley v. Crandall & Godley Co.*, 181 App. Div. 75, 168 N.Y. Supp. 251 (1st Dept., 1917).

62. See Comment, "Corporations — Indemnification of Management for Litigation Expenses" (1954), 52 Mich. L. Rev. 1023 at p. 1025.

63. G.T. Washington, *Corporate Executives' Compensation* (New York, The Ronald Press Co., 1942), p. 334. For example, in the 1906 decision of *McCourt v. Singers-Bigger*, 145 F. 103 (8th Cir., 1906), unsuccessful directors were denied indemnification because, at p. 114, "[T]hey did nothing to recover or save a trust fund, or to prevent its waste or dissipation, but everything in their power to prevent its recovery or restitution to the original owner. Their proceedings, while in the name of the old company . . . were adversary to its equitable rights."

64. See, e.g., *Kanneberg v. Evangelical Creed Congregation*, 146 Wis. 610, 131 N. W. 353 (1911); *Godley*, *supra*, footnote 61, at p. 78.

65. *Stock Exchange Practices, Hearings on S. Res. 84 Before the Senate Committee on Banking and Currency*, 72nd Cong., 1st Sess. (1932); *Stock Exchange Practices, Hearings on S. 84 and S. 239 Before a Subcommittee of the Senate Committee on Banking and Currency*, 72nd Cong., 2nd Sess. (1933); *Stock Exchange Regulation, Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852*, 73rd Cong., 2nd Sess. (1934).

66. 48 Stat. 74 (1933).

67. 15 U.S.C. § 78a *et seq.* (1934).

68. Section 14 of the Clayton Act, 38 Stat. 736 (1914), 15 U.S.C. § 24 (1955), recognized the director's responsibility for corporate violations and provided a variety of sanctions that could be used against him.

69. *Halsbury's Statutes of England and Wales* (Notes), *supra*, footnote 55, at p. 1412. Although compensatory relief was one aim of the civil remedies, it was clear that Congress looked on them as a means whereby private actions might enforce adherence to standards and requirements embodied in the acts. As one commentator wrote in 1935, "[s]ince the Acts are partial substitutes for a

financial environment of the 1930s made directors fearful of unfounded derivative suits.⁷⁰ In tandem with new exposures of American directors to personal liability, indemnification clauses became increasingly common in corporate charters and bylaws.⁷¹ The common law provided that directors held liable in derivative actions for breaching their duties to the corporation were not entitled to indemnification; yet, where a director *successfully* defended a derivative action, it was unclear whether or not a right to indemnification could arise under agency law.⁷²

Then came the sour decision in *New York Drydock Company, Inc. v. McCollum*⁷³ in 1939, a case so notoriously unpopular that its backlash extended beyond the United States, spurring the development of Canada's modern indemnification statutes. In *McCollum*, directors of the New York Drydock Company were sued by a disgruntled stakeholder in a derivative suit that alleged losses to the corporation of \$11 million. The directors successfully defended the action on the merits⁷⁴ and an appeal was subsequently dismissed for lack of prosecution.⁷⁵ The directors asked the corporation for over \$86,000 in legal fees and related costs. The corporation, unsure of whether or not it had the power to make the payment, sought a declaratory judgment in the Supreme Court for Onondaga County, New York. The case was referred by consent⁷⁶ to a distinguished former judge of the Court of Appeals of New York, Leonard C. Crouch, as an "Official Referee".⁷⁷ At the hearing, the

comprehensive system of control over finance, compensation must assume secondary importance". Comment, "Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act" (1935), 44 Yale L.J. 456 at p. 457.

70. See J.J. Hanks, Jr. and L.P. Scriggins, "Protecting Directors and Officers from Liability — The Influence of the Model Business Corporation Act" (2000), 56 Bus. Law. 3 at p. 5.
71. G.E. Bates and E.M. Zuckert, "Directors' Indemnity: Corporate Policy or Public Policy?" (1942), 20 Harv. Bus. Rev. 244 at p. 244.
72. For example, in *Figge v. Bergenthal*, 130 Wis. 594, 109 N.W. 581 (1907), the Wisconsin Supreme Court implied that success, not benefit, was the criterion in saying, at p. 625, that "if no case is made against defendants, it is not improper or unjust that the corporation should pay for the defence of the action". Conversely, in *Griesse v. Lang*, 37 Ohio App. 553, 175 N.E. 222 (1931), payment was denied by the Ohio Court of Appeals after the successful defence of a stockholder's derivative action because the court was of the opinion that the corporation had received no benefit from the legal services.
73. 16 N.Y.S.2d 844 (Sup. Ct., 1939).
74. *Ibid.* With the exception of one issue that was dismissed for lack of evidence.
75. *Ibid.*, at p. 845.
76. See Hanks and Scriggins, *supra*, footnote 70, at p. 5.
77. *Ibid.*

directors argued first that the corporation had an implied obligation to pay their legal expenses in successfully defending the derivative action;⁷⁸ second, that their successful defence of a shareholder's derivative action served "in a substantial way to benefit the corporation" so that payment of their reasonable legal expenses was justified;⁷⁹ and finally, that there was a social necessity for indemnification because it would otherwise be difficult to induce responsible men to act as directors.⁸⁰

In considering whether the corporation had an implied legal obligation to indemnify the directors, Judge Crouch acknowledged the common law principle that agents, trustees and receivers were entitled to indemnity for their legal expenses at common law, but he rejected the application of these analogies to the director-corporation relationship.⁸¹ Contrary to the conclusion reached by Canadian and British courts, Judge Crouch stated:

So far as the case of principal and agent is concerned, the analogy is not close enough to prevail alone . . . [A] director of a corporation is not an agent either of the corporation or of its stockholders, except in a convenient rhetorical sense, though he may sometimes act in the nature of an agent in dealing with third parties. He derives his power and authority neither from the stockholders nor from the corporation. His status is *sui generis*. His office is a creature of the law.⁸²

Judge Crouch concluded that "there is no legal obligation in the strict technical sense contended for by the defendants".⁸³ He then went on to explore whether corporations could have a legal obligation to indemnify their directors in the wider "equitable" sense.⁸⁴ He found that the case law on reimbursement of successful directors was scarce⁸⁵ and cited a Yale Law Journal note⁸⁶ that posited that directors voluntarily assumed the risk of being sued when they agreed to act as directors.⁸⁷ Judge Crouch concluded that if a director could clearly demonstrate to the court that, in conducting his own defence, he brought some *definite benefit* to the corporation or otherwise conserved some substantial interest of the corporation, the court could authorize the reimbursement.⁸⁸

78. *McCollum*, *supra*, footnote 73, at p. 847.

79. *Ibid.*

80. *Ibid.*, at p. 850.

81. *Ibid.*, at p. 846.

82. *Ibid.*, at p. 847.

83. *Ibid.*, at p. 847.

84. *Ibid.*

85. *Ibid.*, at p. 848.

86. Note, "Defence of Directors by Corporation Against Suit Brought in Its Behalf" (1934), 43 Yale L.J. 661.

87. *Ibid.*, at p. 663.

The fulcrum of Judge Crouch's decision was that the corporation had not received any benefit from the expenditure. Judge Crouch was of the opinion that, because a derivative action is brought for the corporation's benefit, a corporation only stands to benefit when the plaintiff wins. He concluded, "there was nothing to show that any interest of the corporation had been conserved or that the corporation had received any benefit from the expenditure, so that indemnification was unauthorized and illegal".⁸⁹ Judge Crouch apparently reasoned that, since the directors were not liable, there was no recovery for the corporation and therefore, there could be no accompanying benefit to the corporation.⁹⁰ Although unstated, the essence of Judge Crouch's position was that it would be up to the legislature or a higher court to fashion what he believed to be a new rule requiring indemnification for legal expenses incurred by directors in the successful defence of a derivative suit.⁹¹

4. Reaction to McCollum: The Rise of Statutes Extending Indemnity Rights to Successfully Defended Derivative Actions

The financial environment in the 1930s made directors fearful of "blackmail suits"⁹² by stakeholders. As noted by one commentator, "there seemed to be no action which a director could take that was not surrounded with the risk of financial loss, notoriety and all the annoyances possible from a long and bitterly fought law suit".⁹³ *McCollum* created a "Catch-22" for directors seeking indemnity in the context of derivative lawsuits. If the director proved that he had not harmed the corporation and won the lawsuit, then no benefit would be seen as being conferred to the corporation because it would not collect a judgment from the director. Conversely, if the director lost the suit, then he had been adjudged to have violated his duty to the corporation and could not then show a benefit from his failed

88. *McCollum*, *supra*, footnote 73, at p. 849.

89. *Ibid.*

90. Hanks and Scriggins, *supra*, footnote 70, at p. 7.

91. *Ibid.*, at p. 8.

92. Generally speaking, the term "blackmail suit" — also referred to as a "strike suit" or "hold-up suit" — referred to a derivative suit brought primarily for its nuisance value by a small shareholder whose interest in the corporation was insignificant. Knowing that the cost of defending such a suit is high, the shareholder sued in the hope of attaining a private settlement and with no intention of benefiting the corporation on whose behalf the suit was theoretically brought. See H.G. Henn and J.R. Alexander, *Laws of Corporations and Other Business Enterprises*, 3rd ed. (St. Paul, West Pub. Co., 1983), at § 358.

93. Hanks and Scriggins, *supra*, footnote 70, at p. 12; Bates and Zuckert, *supra*, footnote 71, at p. 265.

conduct.⁹⁴ In describing the state of the law at the time, one author observed that the *McCollum* decision turned “into hopeless confusion a field of law where ample bewilderment already existed”.⁹⁵

The reaction to *McCollum* was, first, a spate of bylaws that empowered corporations to indemnify their directors for legal expenses incurred in successfully defended derivative actions⁹⁶ and shortly thereafter, the enactment of state legislation authorizing the same. In 1941, New York became the first state to enact a statutory indemnification clause: s. 27-a⁹⁷ of the General Corporation Law (GCL). The wording of this clause is so substantially similar to that of the Canadian indemnity provision then in existence⁹⁸ that it must

94. Mazur, *supra*, footnote 38.

95. Hanks and Scriggins, *supra*, footnote 70, at p. 12; Bates and Zuckert, *supra*, footnote 71, at p. 246. As stated by Professor Joseph Bishop, one of the foremost authorities on the issue of indemnification: “The decision was nonsense. A corporation will practically never benefit directly from defeating its own cause of action. It is hard to think of cases in which it would. But what the court didn’t understand was that the benefit to the corporation comes from inducing valuable executives to serve it by promising them protection against unjustified litigation. It is like paying them their salary . . . But the judge didn’t see that. New York was stuck with the so-called ‘benefit rule’, that a corporation had no power to indemnify individual executives, no matter how innocent they were, unless there is some direct benefit to the corporation.” Bishop, *supra*, footnote 31, at p. 839.

96. Bates and Zuckert, *supra*, footnote 71; Hanks and Scriggins, *supra*, footnote 70, at p. 12.

97. Law of April 2, 1941, ch. 209, § 1, [1941] N.Y. Laws 164th Sess. 813. Section 27-a, ch. 209, 1941 N.Y. Laws 813, gave corporations the power to grant indemnification rights to their directors through a certificate of incorporation, bylaw or resolution, except no indemnification could be made to a director adjudged liable for negligence or misconduct. Section 27-a states: “The certificate of incorporation . . . or the bylaws . . . or a resolution in a specific case . . . may provide that each director of the corporation shall be indemnified by the corporation against expenses actually and necessarily incurred by him in connection with the defence of any action, suit or proceeding in which is made a party to by reason of his being or having been a director of the corporation, except in relation to matters as to which he shall be adjudged in such action suit or proceeding to be liable for negligence or misconduct in the performance of his duties as such director . . . (Act of April 2, 1941).

98. *E.g.*, s. 107 of the Companies Act, R.S.C. 1927, c. 27, provides:

Every director of the company . . . may, with the consent of the company . . . be indemnified and saved harmless out of the funds of the company, from and against,

- (a) all costs, charges and expenses whatsoever which such director sustains or incurs in or about any action, suit or proceeding which is brought, commenced or prosecuted against him, for or in respect of any act, deed, matter or thing whatsoever, made, done or permitted by him, in or about the execution of the duties of his office;
- (b) all other costs, charges and expenses which he sustains, or incurs, in or about or in relation to the affairs thereof, except such costs, charges or expenses as are occasioned by his own wilful neglect or default.

have served as a template for New York's provision. Yet the Canadian codification was intended to *limit* what was perceived as overly broad attempts by corporations to indemnify their directors, whereas New York's legislature intended its statutory provision to deal with the problem immediately confronting it — to assure directors of a right to be indemnified for the costs of successfully defending a derivative action.⁹⁹ Section 27-a was intended to reverse the holding of the *McCullum* case and nothing more.¹⁰⁰ Thus the law of indemnification in the United States was developed specifically to deal with derivative actions.

The New York drafters did seem to recognize that all their indemnity problems could not be solved by simply importing a foreign indemnity clause into their GCL.¹⁰¹ Thus, New York made a substantive addition to section 27-a, setting out that indemnification would “*not* be deemed exclusive of any other rights to which those indemnified may be entitled, under any by-law, agreement, vote of stockholders, or otherwise”.¹⁰² The New York draftsmen believed that their courts would be guided by public policy considerations in deciding whether to enforce an indemnification contract or bylaw that extended beyond a statute's scope.¹⁰³ This type of catch-all phrase, known as a “non-exclusivity” clause, has become standard in

99. *Halsbury's Statutes of England and Wales* (Notes), *supra*, footnote 55, at pp. 1406-1407.

100. Mazur, *supra*, footnote 38, at p. 207.

101. *Halsbury's Statutes of England and Wales* (Notes), *supra*, footnote 55, at pp. 1406-07. Del. Code Ann. tit. 8, § 122(1) (1943); N.Y. Laws, ch. 231 (1941), s. 27(a).

102. Del. Code Ann. tit. 8, § 122(1) (1943); N.Y. Laws, ch. 231 (1941), s. 27(a).

103. See, for example, J.W. Bishop, “Sitting Ducks and Decoys: New Trends in the Indemnification of Corporate Directors and Officers” (1968), 77 *Yale L.J.* 1078. As stated by D.A. Oesterle, “Limits on a Corporation's Protection of its Directors and Officers From Personal Liability” (1983), *Wis. L. Rev.* 513 at p. 539: “[T]he statutes establish a minimum permissible level of indemnification and allow courts to expand that level if they are so inclined. The draftsmen thus attempted to cut off budding restrictive judicial precedent while saving whatever liberal treatments could be coaxed out of the courts.” In the interim, a number of courts had rejected the reasoning in *McCullum* and abandoned the benefit theory, based upon similar public policy considerations. See *Solimine v. Hollander*, 129 N.J. Eq. 246, 19 A.2d. 344 (Ch. 1941) and *Dissolution of E.C. Warner Co. (Re)*, 232 Minn. 207, 45 N.W.2d, 388 (1950), emphasizing that the directors' successful defences aided the corporation by defending the “corporate image” and retaining in office the chosen representatives of the shareholders. Recognition was also given to the necessity of such indemnity in order to attract qualified persons and encourage directors to contest “strike suits” brought for the sole purpose of coercing settlements.

statutory indemnity provisions in the United States, although they are not seen in Canada.

Shortly after enacting section 27-a, New York enacted section 61-a,¹⁰⁴ a procedural clause that buttressed section 27-a by endowing courts with the discretion to assess a director's expenses in a successful derivative action as "special costs" against the corporation. It was in New York's section 61-a that the origins of a derivative suit being described as an action "*by the corporation, or in the right of the corporation*" first appeared:¹⁰⁵

61(a) In any action, suit or proceeding, against one or more officers or directors . . . *brought by the corporation, or brought by or on behalf of one or more stockholders* . . . the reasonable expenses, including attorneys [sic] fees, of any party plaintiff or party defendant incurred in connection with the successful prosecution or defense of such action, suit or proceeding shall be assessed upon the corporation. . .¹⁰⁶

Although section 61-a specifically referred to actions "*brought by the corporation,*" this wording is misleading and imprecise because the New York legislature did not actually include direct actions by a corporation against its directors. This is evidenced not only by the purpose of the clause itself, but also by the official commentary and judicial interpretation.¹⁰⁷ First, as Professor Mazur has noted, the purpose of section 61-a, in and of itself, precluded any application to direct actions by a corporation. "Any party plaintiff or party defendant" was permitted to recover expenses from the corporation, as assessed by a court. The term "party plaintiff" could only refer to a *derivative* stakeholder since the "party plaintiff" in a *direct* action will be the corporation. The section could not refer to direct actions, because there would be no reason for a court to assess a corporation's costs against itself. Notwithstanding the reference to actions "*by a corporation*", direct suits by the corporation against its directors were not contemplated.¹⁰⁸

That the legislature did not intend these laws to protect directors sued directly by their corporations is further evidenced by the amendments to New York's indemnity provisions four years later.¹⁰⁹ In 1945, pursuant to recommendations by New York's Law Revision Commission, the phrase "*brought by the corporation or brought on its*

104. Law of April 14, 1941, ch. 350, § 1 [1941] N.Y. Laws 164th Sess. 1034 (repealed 1945).

105. Mazur, *supra*, footnote 38, at p. 207.

106. Section 61-a of the New York General Law, ch. 350, 1941 N.Y. Laws 1034 (Act of April 14, 1941) (emphasis added).

107. Mazur, *supra*, footnote 38, at p. 207.

108. *Ibid.*, at p. 207.

109. *Ibid.*, at p. 208.

behalf” in section 61-a was replaced with the words “*action suit or proceeding*” (a phrase that was first utilized in Canada’s Joint Stock Companies Act, 1877).¹¹⁰ Since New York’s section 27-a used the phrase “*action, suit or proceeding*”, the Law Revision Commission proposed that the wording in section 27-a and 61-a be made consistent. These sections were renumbered as sections 63 and 64 of the GCL. The Commission proposed that former section 61-a be expanded to set up better procedural machinery for enforcing reimbursement by a corporation of litigation expenses of its directors and officers in derivative actions. These new clauses dealing with the procedural aspects of indemnification were inserted as sections numbered 65, 66, 67 and 68.¹¹¹ The 1945 amendments were codified as a new “Article 6A” of New York’s general company law. Article 6A was inserted as an addendum to the section of company law dealing solely with derivative suits, “Article 6”.¹¹²

Notwithstanding that the phrase “*action, suit or proceeding*” is seemingly broader than the wording of the former section 61-a, “*brought by the corporation or brought on its behalf*”, the New York legislature did not intend the change to extend the scope of the new Article 6A beyond *derivative* actions.¹¹³ The official commentary to the GCL stated that “[a]ll essential provisions of section 61-a which regulate the granting of allowances in actions *brought on behalf of a corporation* are incorporated in new sections 64 - 67, inclusive”,¹¹⁴ and further, that:

This section embodies the essential provisions of the present section 61-a providing for the assessment of certain litigation expenses as “special costs” of a *derivative action* in so far as that section applies to defendant officers and directors. It broadens the scope of that section in several respects in order to make it consistent with section 27-a, amended and renumbered as section 63 by these amendments.¹¹⁵

The New York courts concluded that the phrase “*by or on behalf of a corporation*” refers only to *derivative* actions.¹¹⁶ In *Schwartz v. General Aniline & Film Corp.*,¹¹⁷ the New York Court of Appeals was asked to determine whether the article extended indemnity rights to

110. *Ibid.*

111. *Ibid.*

112. *Schwartz v. General Aniline & Film Corp.*, 305 N.Y. 395, 113 N.E.2d 533 (1953) at p. 536.

113. Mazur, *supra*, footnote 38, at p. 208.

114. *Ibid.*, at p. 208. Act of April 18, 1945, ch. 869, 1945 N.Y. Laws 1971 (emphasis added).

115. Act of April 18, 1945; *ibid.*, at p. 1973 (emphasis added).

116. *Ibid.*

117. *Schwartz*, *supra*, footnote 112.

directors charged by the government with criminal antitrust violations. The court held that indemnification provisions under article 6A could not encompass the costs of a criminal defence. The court reviewed the history of New York's indemnity legislation and affirmed that the provisions were adopted in response to *McCollum*, a derivative suit, and were only intended to cover derivative suits. Article 6-A was a supplement to Article 6, which authorized derivative suits, so that the two articles were required to be considered in conjunction.¹¹⁸ In *Schwartz*, suits brought "by or on behalf of a corporation" referred to derivative suits under New York's Article 6. No expanded scope was intended from the word "by".¹¹⁹

The *Schwartz* court speculated as to why the legislature used the term "*action, suit or proceeding*" in the former section 27-a and in amended sections 63 and 64 if it did not mean *all* actions, suits or proceedings instead of only derivative actions. The court concluded that, although the legislature was only considering derivative suits, the phrase "*any action suit or proceeding*" was intended to cover all procedural bases for bringing derivative suits.¹²⁰

Notwithstanding the original reference to actions "*by the corporation*" in New York's indemnity law, there is substantial evidence that direct actions by the corporation were not contemplated: first, the fact that New York's indemnity provisions were enacted specifically to deal with the problem of *McCollum*, a derivative action; second, the fact that the purpose of the clause in which that wording arose could not apply to direct actions in any event; third, the nature of the subsequent amendments and commentary to the GCL, which speak to the fact that "*by the corporation*" referred only to derivative actions, not to direct actions by the corporation against its directors; and fourth, the fact that the reasoning of New York's judiciary is consistent with this conclusion.

In 1943, two years after the enactment of New York's original indemnification statute, Delaware adopted its first statute authorizing corporations to indemnify directors for successful derivative actions. It was modeled on the New York indemnification provisions and included the phrase "*action, suit or proceeding*".¹²¹ In 1946, the Committee on Corporate Law submitted

118. *Ibid.*, at p. 535.

119. Mazur, *supra*, footnote 38, at p. 208.

120. *Schwartz*, *supra*, footnote 112.

121. 44 Del. Laws ch. 125 (1943), s. 122(1). See also S.S. Arsht, "Indemnification Under Section 145 of the Delaware General Corporation Law" (1978), 3 Del. J. Corp. L. 176; Hanks and Scriggins, *supra*, footnote 70, at p. 14.

a “Draft of Suggested Form of Business Corporation Act”, which it posited could be helpful to the states in amending their various business corporation laws.¹²² Four years later, in 1950, the committee presented its first version of the Model Business Corporations Act (MBCA).¹²³ Section 3, dealing with indemnity, had been heavily influenced by the 1943 Delaware statute,¹²⁴ which had, in turn, been influenced by New York’s statute. Each of them purported to indemnify directors for expenses in defending an “*action suit or proceeding*” as a result of his service to the corporation, absent a judgment of negligence or misconduct. Thus, the first statutory indemnification schemes appearing in the United States, including that of New York, Delaware and the MBCA, were all intended to assure indemnification exclusively for directors sued in *derivative* actions, and who were not held liable for negligence or misconduct.

5. The Rise of Statutes Expressly Extending Indemnity Rights to Actions Brought by Third Parties

The state statutes were intended only to address indemnification in derivative actions; they did not settle questions about the propriety of indemnification in third-party proceedings.¹²⁵ Although there were good policy reasons to deny indemnity in derivative actions where directors were found to breach a duty to the corporation, in proceedings brought against a director by the government or by private third parties, the question of whether or not a director had properly discharged his duty to the *corporation* was usually not in issue. Actions brought by third parties might not be based on any wrongdoing to the corporation at all, but rather on something that the director may have done on the corporation’s behalf or for its benefit, but which was alleged to have harmed a third party.¹²⁶ In such cases, the issue of whether the director was found liable for negligence or misconduct to the third party would not trigger the same policy concerns.¹²⁷ Yet, there was a general concern that the broad reference to the “*action, suit or proceeding*” used in most state indemnity statutes might nonetheless be interpreted by courts to include actions by third parties, thereby limiting a corporation’s

122. Hanks and Scriggins, *ibid.*, at p. 15.

123. Model Business Corporations Act (Revised), 6 Bus. Law. 1 app. (1950); *ibid.*

124. Hanks and Scriggins, *supra*, footnote 70, at p. 15.

125. *Halsbury’s Statutes of England and Wales* (Notes), *supra*, footnote 55, at p. 1403.

126. *Tomlinson*, *supra*, footnote 54.

127. As noted by J.W. Bishop, “Current Status of Corporate Directors’ Right to Indemnification” (1956), 69 Harv. Law. Rev. 1057 at p. 1058. See also *Halsbury’s Statutes of England and Wales* (Notes), *supra*, footnote 55, at p. 1403.

ability to indemnify its directors in those cases, based on the overly-restrictive statutory criteria intended specifically for derivative suits.¹²⁸

In 1961, in response to these concerns, New York revamped its statutory indemnification scheme to deal expressly with actions brought against directors by third parties, by standards that were different and more lenient than in the case of derivative suits.¹²⁹ Sections 63 through 68, comprising Article 6A of New York's GCL were renumbered once again as ss. 721 through 727. These amendments revived the clumsy reference to a derivative action first seen in the old section 61-a, and which persists in modern Canadian indemnification legislation. Section 722 addressed indemnification where a director was faced with a derivative action, which the statute referred to as an action "*by or in the right of the corporation*". As noted by the official comment to s. 722: "[t]his section is a substantial re-enactment of General Corporation Law §63, modified to the extent that it has been made applicable to *derivative actions only*".¹³⁰ Under this section, a corporation could not indemnify a director who had been adjudged liable to his corporation in a derivative suit, either for legal expenses or for the amount of the judgment.¹³¹

Section 723 dealt with actions brought by the government or third parties, referred to as actions "*other than one[s] by or in the right of the corporation*".¹³² The only requirement for indemnification in third-party suits was the finding that the director acted in good faith and in the corporation's best interests. The more lenient standard for indemnification in third-party suits was justified by the legislature on the basis that the director had not breached any fiduciary duty owed to his corporation.¹³³ As explained by the official comment to s. 723:

The purpose of this section is to codify the common law principle that directors or officers are reimbursable by the corporation for expenses incurred and amounts paid in defense of actions or proceedings *other than derivative actions*. In contrast with indemnification in *derivative actions*, indemnification is permissible under this section for expenses incurred and

128. Bishop, *ibid.*, at p. 1073; Note, "Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation" (1963), 76 Harvard L.R. 1403 at p. 1403.

129. N.Y. Bus. Corp. Law, ss. 721 to 727 (McKinney 1963).

130. *Ibid.*, s. 723 cmt.

131. Mazur, *supra*, footnote 38, at p. 211, fn. 55.

132. N.Y. Bus. Corp. Law, *supra*, footnote 129, ss. 721-727.

133. J.H. Cheek, "Control of Corporate Indemnification: A Proposed Statute" (1969), 22 Vand. L. Rev. 255 at p. 278; Bishop, *supra*, footnote 127, at p. 1073.

amounts paid in settling threatened as well as pending *non-derivative actions* or proceedings.¹³⁴

In addition to ss. 722 and 723, the revisions to the New York statutory scheme in 1961 included other sections dealing with the procedural aspects of indemnification rights.¹³⁵ In 1967, the drafters of the Delaware corporation law and the Committee on Corporate Laws, joined together, using at least one common drafter, to revise their indemnification provisions by using the New York model as a guide.¹³⁶ After the collaboration, the Delaware indemnification provisions and the MBCA were almost identical.¹³⁷ Like the New York statutes, both the Delaware statute and the MBCA granted indemnification rights in two general categories of litigation, derivative suits and third-party suits. As a result, almost every indemnification statute in the United States, whether modeled on the indemnity law from New York, Delaware or the MBCA, is ultimately rooted in the New York model.¹³⁸ The phrase “*by or in the right of the corporation*” found its way into the indemnification statutes of 46 of the 50 states.¹³⁹ Both Delaware and the MBCA copied the phrase verbatim from the 1961 New York ss. 722 and 723, even though they, like New York, never intended that indemnification rights apply to suits actually brought directly *by* a corporation against a director for breach of fiduciary duty.¹⁴⁰

In the more than 50 years since the enactment of the original New York indemnification statute, not one reported decision considered whether direct actions by the corporation had been contemplated by the statute¹⁴¹ and only one law review article addressed the issue. The article was written by a student in 1971, who concluded that director suits were within the scope of the New York indemnification statute

134. N.Y. Bus. Corp. Law, *supra*, footnote 129, s. 723 cmt. (emphasis added).

135. Mazur, *supra*, footnote 38.

136. Hanks and Scriggins, *supra*, footnote 70, at p. 16; Mazur, *ibid.*, at p. 212.

137. Hanks and Scriggins, *ibid.*, at p. 17; Mazur, *ibid.*

138. Mazur, *ibid.*

139. See J.W. Bishop, “The Law of Corporate Officers and Directors: Indemnification and Insurance” (Boston, Warren, Gorham Lamont, 1981 and Supp. 1992), §§ 6.08 to 6.58; Mazur, *ibid.*

140. Mazur, *ibid.* As noted by the author, there is no indication that the drafters ever intended the acts to apply to direct suits by the corporation. The official comments to the MBCA repeatedly refer to subsection (b) — suits “by or in the right of the corporation”— only in terms of derivative actions: “[S]ubsection (a) deals with third party suits; subsection (b) with derivative actions . . . Under (b), which pertains to derivative actions, indemnification is permitted only for expenses . . . A new standard of conduct is applicable both in third party suits and in respect of derivative actions . . . In respect of a derivative action it is provided in subsection (b) . . .”, MBCA, § 5 cmt. (1969).

141. Mazur, *ibid.*, at p. 214.

based entirely on the word “by” in the phrase “by or in the right of the corporation”. Instead of questioning the precision of this phrase in light of the legislative history and official comment, the author took the phrase at face value and decided that the official comment must have been misguided and incorrect.¹⁴²

6. Changes to Canada’s Federal Indemnification Laws: Section 124 of the CBCA

Throughout the development of indemnification statutes in the United States, Canada’s indemnity legislation persisted in the form first enacted in the Joint Stock Companies Act, 1877.¹⁴³ In 1974, a three-man committee led by Robert Dickerson recommended an overhaul of Canada’s corporation law.¹⁴⁴ Dickerson’s committee proposed a Draft Act that radically changed Canadian company law by following the enabling philosophy behind the company law of New York, Delaware and the MBCA.¹⁴⁵ Among the committee’s numerous proposed changes were indemnity provisions and the creation of a statutory derivative action along American lines.¹⁴⁶ Dickerson acknowledged that his amendments were “much influenced by the New York model”,¹⁴⁷ on the basis that:

[p]robably the most comprehensive statutory provisions are those set out in ss. 721 and 726 of the New York Business Corporation Law. In addition to being far more detailed than English and Canadian law, they create an exclusive regime that applies to every New York business corporation irrespective of any other provisions contained in the corporation’s articles or by-laws.¹⁴⁸

Dickerson’s proposed indemnity statute closely followed the New York regime in particular, distinguishing between derivative actions, which he referred to as actions “*by or on behalf of the corporation*”, and third party actions.¹⁴⁹ There is no suggestion in Dickerson’s report that direct actions were contemplated by the wording “*by . . .*

142. Mazur, *ibid.*; Comment, *supra*, footnote 37.

143. See, e.g., The Companies Act, 1902 (U.K.), 2 Ed. II, c. 15, s. 67; The Companies Act, R.S.C. 1906, c. 79, s. 79; Companies Act, R.S.C. 1952, c. 33, s. 92; Canada Corporations Act, R.S.C. 1970, c. C-32, s. 93;

144. Dickerson, *supra*, footnote 10.

145. Committee Law Review Steering Group, “Modern Company Law for a Competitive Economy: The Strategic Framework”, *Consultation Document* (February 1999, U.K.) at p. 24, para. 4.3 (Committee Law Review).

146. *Ibid.*, at p. 25, para. 4.5.

147. Dickerson, *supra*, footnote 10, p. 82 at para. 244.

148. *Ibid.*

149. *Ibid.*, p. 84, at paras. 246-247.

the corporation". With respect to indemnification for derivative actions, his report states:

Subsection (2), which refers to *a derivative action in the name of the corporation* against its directors and officers, sets up several tests in addition to the general standards of subsection (1). Note that indemnification here does not include amounts paid to settle an action or to satisfy a judgment. The implied premise of this subsection is that if a *derivative action* in the name of the corporation has been brought against a director or officer, he has probably not been acting in the interests of the corporation and therefore his conduct should be more closely scrutinized. This is particularly true in respect of settlements of actions where directors, having in their own interests profited from dealings that were prejudicial to the corporation, then seek indemnity from the corporation because they are compelled to settle a *derivative action* alleging that misconduct, a practice that has appropriately been castigated as "double looting" in some U.S. jurisdictions. Subsection (2) also requires court approval as a pre-condition to payment.¹⁵⁰

The federal government closely followed Dickerson's recommendations with respect to s. 124 of the CBCA,¹⁵¹ first enacted in 1975.¹⁵² The original s. 124(1) endowed corporations with the general authority to indemnify a director for all reasonable "costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment" in respect of any "civil, criminal or administrative action or proceeding" to which the director was made a party by reason of his being a director, so long as "he acted honestly and in good faith with a view to the best interests of the corporation" and, in the case of a criminal or administrative proceeding, "he had reasonable grounds to believe that his conduct was lawful".¹⁵³ A separate category dealing specifically with indemnification in derivative actions was prescribed in s. 124(2), under the caption "*Indemnification in derivative actions*", with the text referring to the derivative proceeding "*by or on behalf of the corporation*" in the same manner as in the U.S. state legislation.¹⁵⁴ This phrase has continued

150. *Ibid.*, at para. 244 (emphasis added).

151. CBCA (1975), *supra*, footnote 58, s. 124.

152. Committee Law Review, *supra*, footnote 145, at p. 24, para. 4.3.

153. CBCA (1975) *supra*, footnote 59, s. 124(1) provides:

Except in respect of an action by or on behalf of the corporation or body corporate to procure a judgment in its favour, a corporation may indemnify a 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 by him in respect of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of such corporation or body corporate, if

- (a) he acted honestly and in good faith with a view to the best interests of the corporation; and
- (b) in the case of a criminal or administrative proceeding that is enforced by a monetary penalty, he had reasonable grounds for believing that his conduct was lawful.

through to the current version in s. 124(4). The plain language of the statute may be interpreted in a manner almost “perfectly opposed to almost every indication of what the language was intended to mean”.¹⁵⁵ Contrary to its apparent meaning, the phrase “*by or in the right of the corporation*” in s. 124(4) of the CBCA was never intended to include a direct suit brought by a corporation against its directors for breach of their fiduciary duty.

7. Canadian Judicial Interpretation of the Phrase “By or In the Right of the Corporation”

The words of an Act “are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament”.¹⁵⁶ Upon determining the “ordinary meaning”¹⁵⁷ of the words, the court must go on to consider the context of the provision, the purpose and scheme of the legislation as well as the consequences of adopting the ordinary meaning and any other relevant indicators of legislative meaning.¹⁵⁸ As noted by Weiler J.A. of the Ontario Court of Appeal, speaking for the court:

Having determined the ordinary meaning . . . [t]he court must adopt an interpretation that best fulfils the objects of the legislation. Having regard to this broader context, the court may modify or reject the application of the presumption that favours an interpretation in accordance with the ordinary meaning. However, the interpretation adopted must be plausible in the sense that it is one that the words are reasonably capable of bearing.¹⁵⁹

154. *Ibid.*, s. 124(2), which states:

A corporation may, with the approval of a court indemnify a person referred to in subsection (1) in respect of an action by or on behalf of the corporation or body corporate to procure a judgment in its favour, to which he is made a party by reason of being or having been a director or officer of a corporation or body corporate, against all costs, charges and expenses reasonably incurred by him in connection with such action if he fulfils the conditions set out in paragraph (1)(a) and (b).

155. Mazur, *supra*, footnote 38, at p. 215.

156. *York Condominium Corp. No. 382 v. Jay-M Holdings Ltd.*, [2007] O.J. No. 240 (QL), 154 A.C.W.S. (3d) 1205, at para. 11 (C.A.), *per* Weiler J.A., citing E.A. Driedger, *The Construction of Statutes*, 2nd ed. (Toronto, Butterworths, 1983), p. 87. The court further noted, at para. 11, that this approach has been widely endorsed by the Supreme Court. See *Bell ExpressVu Limited Partnership v. Rex*, [2002] 2 S.C.R. 559, 212 D.L.R. (4th) 1, at para. 26. Note that the interpretative factors set out by Driedger need not be canvassed separately in every case: *Bell*, at para. 31.

157. The ordinary meaning of legislation has been judicially defined as “the natural meaning which appears when the provision is simply read through”: *Canadian Pacific Air Lines Ltd. v. Canadian Air Line Pilots Assn.*, [1993] 3 S.C.R. 724, 108 D.L.R. (4th) 1, at p. 22.

158. *Bell ExpressVu*, *supra*, footnote 156, at paras. 29-30.

159. *York Condominium No. 382*, *supra*, footnote 156, at paras. 13-14.

Case law on the CBCA's indemnity provisions is sparse. Only one case in Canada has considered the application of the indemnity provisions of the CBCA to a direct action. In *Amirault v. Westminer Canada Ltd.*,¹⁶⁰ an Australian mining company, the Western Mining Company (WMC), took over a Nova Scotia gold mining company, Seabright, based on reports about ore mining prospects. After the closing date for the acquisition of Seabright, it was discovered that the ore was of too low a grade to support a mine.¹⁶¹ WMC and Seabright brought an action in Ontario against Seabright's former directors on the basis of fraud, conspiracy, breach of duty, negligence, negligent misrepresentation and insider trading. After receiving the statement of claim, the directors made it known that they were seeking funding arising out of Seabright's indemnity by-laws and insurance. Before any defences were filed in that action, WMC and Seabright amended their statement of claim against the directors by removing all allegations of negligence and substituting allegations of willful misrepresentation in an effort to eliminate any opportunity for funding. The former directors countered with their own actions in Nova Scotia, claiming damages for Seabright's refusal to indemnify them for losses resulting from the claim against them under Seabright's by-laws.¹⁶² As a defence, the mining companies averred dishonesty on the part of the directors and attached the statement of claim from their Ontario action.¹⁶³

At the trial of the indemnity action in Nova Scotia, the judge concluded that the Ontario action brought by the mining companies against the former directors was entirely unfounded and had been commenced solely for the purpose of causing injury to the directors and to detract attention from the failed mining investment.¹⁶⁴ The court found that the WMC set out deliberately and intentionally to "crush" the directors; the mining companies acted together in concert for the predominant purpose of causing them injury.¹⁶⁵ The trial judge found the mining companies liable for the tort of conspiracy, in addition to being liable to the directors for indemnity.¹⁶⁶ Only one short paragraph of the judge's 125-page decision was devoted to the

160. [1994] N.S.J. No. 12 (QL), 127 N.S.R. (2d) 241 (C.A.), varying re costs 39 A.C.W.S. (3d) 898, 120 N.S.R. (2d) 91 *sub nom. Coughlan v. Westminer Canada Ltd.* (S.C.), leave to appeal to S.C.C. refused 182 N.R. 400n *sub nom. Coughlan v. Westminster Canada Ltd.*

161. *Amirault* (C.A.), *ibid.*, at para. 11.

162. *Ibid.*, at paras. 14-15.

163. *Ibid.*, at para. 16.

164. *Amirault* (S.C.), *ibid.*, para. 661 A.C.W.S.

165. *Ibid.* at paras. 633 and 634 A.C.W.S.

166. *Ibid.*

issue of whether s. 124 of the CBCA permitted indemnification of the directors in the context of actions brought against them directly by their corporation:

[S]ection 124 excepts actions by the corporation itself against former directors while the by-law does not. However, again there is another plaintiff besides the corporation and in my view that guarantees the application of the indemnity corporations to the favor of the plaintiff.¹⁶⁷

The judge thus implicitly, but without discussion, regarded direct actions by the corporation as falling within the subsection dealing with derivative actions. The judge further concluded that the fact that one of the plaintiffs to the Ontario action was WMC, a third party, was sufficient to negate the statutory restrictions applied to indemnity in the case of derivative actions. This decision was upheld on appeal without any further consideration of s. 124.¹⁶⁸

IV. POLICY RATIONALE FOR DIFFERENT TREATMENT OF DIRECT AND DERIVATIVE ACTIONS: ADVANCEMENT OF DEFENCE COSTS

1. Advancement of Defence Costs under s. 124(4) of the CBCA

At first glance, the similarities between direct and derivative suits may appear to provide justification for treating these actions identically with respect to s. 124(4). Both types of suits are intended to benefit the corporation and, if the actions are successful, the judgment is paid to the corporation directly.¹⁶⁹ Yet, if courts are to interpret “by or in the right of the corporation” to include direct suits, then the question of whether expense advances are appropriate in that context must be considered.¹⁷⁰ With respect to derivative suits and third-party suits the interests of the corporation’s management are, for the most part, aligned. However, these considerations clearly do not apply to direct suits:

Perhaps a better way to look at indemnification rights is in terms of “us” and “them”. Corporate management is “us”; anyone outside management is “them”. From the time of the first indemnification statutes, corporations have looked for ways to insulate their directors from suits by “them”. Third-party suits are clearly brought by “them,” persons outside management. To a public corporation, *every* shareholder derivative suit is a strike suit, a nuisance, and something to get rid of. Indemnification is the system of statutory rights designed to discourage suits by outsiders and to help the corporation defeat them if they are brought.¹⁷¹

167. *Ibid.*, at para. 612 A.C.W.S.

168. *Amirault (C.A.)*, *supra*, footnote 160.

169. Mazur, *supra*, footnote 38, at p. 215.

170. *Ibid.*

One of the primary goals of indemnification is to encourage competent people to serve as directors. A policy goal of indemnification is to “promote the desirable end that corporate officials will resist what they consider to be unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation they have served if they are vindicated”.¹⁷² A corporation’s definition of “unjustified suits and claims” does not contemplate the corporation’s *own* direct suits and claims. Derivative suits, which are brought by corporate stakeholders, and direct suits brought by the corporation itself, are fundamentally different. Only in direct suits are the corporation and its management true adversaries.¹⁷³ Since directors will stipulate the indemnification rights to which they are entitled and their interest is to maximize indemnification in all possible circumstances, the tendency is for corporations to adopt unconditional and mandatory advancement rights.¹⁷⁴ The typical corporate indemnification by-law purports to endow directors with indemnification and advancement rights “to the maximum extent permitted by law”.¹⁷⁵ It is therefore up to the courts and legislature to set appropriate policy limits on indemnification.¹⁷⁶

While indemnification and advancement are closely related concepts, they are not identical. Advancement often works in concert with indemnification, but unlike indemnification, advanced

171. *Ibid.*

172. *Ibid.*, at p. 216.

173. *Ibid.*

174. Bishop, *supra*, footnote 103, at p. 1079: “With a few honorable exceptions, the object of the draftsmen of the first generation of by-laws seemed to be to virtually immunize management from personal liability. The most brazen of these older by-laws purported to permit executives adjudged guilty of breaching their duty to the corporation to be indemnified not only for their counsel fees but also for the very sums they had been ordered to pay the corporation. The recent trend among sophisticated counsel has been to eschew such naively hoggish attempts to nullify the stockholder’s judicial remedy, which courts would in any case be likely to invalidate as against public policy.”

175. Another way to describe this by-law is to say that it makes mandatory all indemnification that the statute permits but does not require. See, *e.g.*, *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d. 138 at p. 142 (Del. Sup. Ct., 1974).

176. These legal boundaries were considered in the federal discussion paper on indemnification prepared in 1995: “Although the issue does not appear to have been judicially considered, most commentators have argued that the intention of the legislature in spite of the silence of the law is that CBCA indemnification provision is not exclusive. This would mean that a corporation may provide for indemnification of its directors and others through contracts, articles, bylaws, directors resolutions, etc. in situations which are not covered in s. 124, but are not contrary to public policy nor prohibited by statute.” CBCA Discussion Paper, *supra*, footnote 14, p. 36, para. 128.

funds are “contingent” funds. “[A]dvancement can be thought of as an extension of credit, the final repayment of which is conditioned on whether a corporate official is ultimately entitled to indemnification.”¹⁷⁷ Since advanced funds are necessarily forwarded to a director before the outcome of litigation is known, a director is required to repay advanced amounts if it is ultimately determined that he or she has not met the standard of conduct required for indemnification in connection with the proceeding.¹⁷⁸

Prior to 2001, s. 124 of the CBCA did not expressly permit corporations to advance defence costs to their directors before the outcome of litigation was known, although the issue of whether a corporation could nonetheless do so was considered in two cases involving federal legislation. In *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*¹⁷⁹ the liquidator of the Canadian Commercial Bank sued the bank’s directors, officers and senior managers for various acts of negligence relating to the bank’s management. The officers and senior managers sought full funding, in advance, of their litigation expenses, by relying on the indemnity provisions of the federal Bank Act, which paralleled those in the CBCA. The Court of Appeal affirmed the decision of the trial judge, that “the right to indemnity was triggered by the result of the action”,¹⁸⁰ so that the statutory indemnity provisions did not entitle the officers and managers to immediate funding.

In *Chromex Nickel Mines Ltd. v. British Columbia (Securities Commission)*,¹⁸¹ the Securities Commission had begun hearings into the conduct of the President of Chromex. The company’s Board of Directors passed a resolution that the President had, to its satisfaction, acted honestly and in good faith with a view to the best interests of the corporation and had reasonable grounds to believe that his conduct was lawful, thus fulfilling the CBCA’s requirements for indemnification. The Board then sought a declaration that it was authorized to advance the President his legal expenses prior to the hearings’ conclusion. Errico J. held that the CBCA leaves the decision of compliance with the good faith requirements entirely up to the directors, who remain personally liable if they fail to ensure that those requirements are met, but that

177. *Fasciana v. Electronic Data Systems Corp.*, 829 A.2d 178 at pp. 182-83 (Del. Ch., 2003).

178. M.W. Pierce, “Indemnification of Directors and Officers: Delaware and Tennessee” (2005), 6 *Transactions Tenn. J. Bus. L.* 395.

179. (1989), 68 *Alta. L.R.* (2d) 194, 61 *D.L.R.* (4th) 161 (C.A.).

180. *Ibid.*

181. [1991] B.C.J. No. 2347 (QL), 4 *B.L.R.* (2d) 189 (S.C.).

“[t]his does not suggest that they must await the outcome of the proceeding to grant indemnity, although it might be prudent for them to do so”.¹⁸² In holding that the Board could provide advance costs to the President, Errico J. distinguished the *Canada Deposit* case on the basis that it applied only to derivative actions.¹⁸³

The advancement of defence costs was considered in a 1995 federal discussion paper considering proposed amendments to s. 124. The discussion paper considered the competing policy considerations underlying advancement: “If the corporation will not provide advance funding, directors may find themselves unable to finance their own defence”,¹⁸⁴ and yet “. . . [the] director should also be required to satisfy from his or her personal assets not only any adverse judgment but also legal expenses incurred in connection with the proceeding. Any other rule could encourage socially undesirable conduct.”¹⁸⁵ The discussion paper recognized that “*during the early stages of legal proceedings, neither the corporation nor the court is likely to be in a position to determine the ultimate propriety of indemnification*”.¹⁸⁶ The corporation should be able to extend funds to the director for his legal fees, subject to repayment if it was determined that he or she was ultimately disentitled to the funds. These conclusions instigated the most recent amendments to s. 124 of the CBCA, enacted on November 23, 2001. Section 124(2) expressly permits corporations to advance funds to their directors sued in third-party actions to cover the director’s legal costs. The advanced funds are only for the costs, charges and expenses of legal proceedings,¹⁸⁷ and must be repaid if the director ultimately does not satisfy the minimum standards of conduct. The obligation to repay need not be secured, nor is the corporation required to take into account the director’s financial ability to repay before it begins to pay the director’s legal bills.

With respect to derivative actions, advancement is permitted but under more restrictive conditions than apply in the case of third party actions. Section 124(4) states: “[a] corporation may with the approval of the court . . . advance moneys . . . in respect of an action by or on behalf of the corporation . . . if the individual [acts honestly in good faith with a view to the best interests of the corporation]”.¹⁸⁸

182. *Ibid.*, at para. 12 B.L.R.

183. *Ibid.*

184. CBCA Discussion Paper, *supra*, footnote 14, at p. 28, para. 96.

185. *Ibid.*, at p. 26, para. 91.

186. *Ibid.*, at p. 28, para. 96 (emphasis added).

187. CBCA, *supra*, footnote 1, s. 124(2).

188. *Ibid.*, s. 124(4).

Accordingly, two preconditions must be satisfied in order for a director to qualify for advancement of his defence costs in derivative actions. The first precondition is that of court approval. The second precondition is that the director must have acted honestly and in good faith with a view to the best interests of the corporation. On its face, this precondition creates a dilemma since, as noted above, the corporation will generally have an insufficient basis for determining whether a director has satisfied the statute's conduct requirements at the outset of litigation. This is the very reason that the statute requires repayment of the defence costs if the director is ultimately found to have breached his fiduciary obligations.

The solution to this dilemma may be found in *Blair v. Consolidated Enfield Corp.*¹⁸⁹ In that case, the Supreme Court of Canada considered a director's claim for indemnification of expenses incurred in defending a shareholder's derivative action. The director relied on the provisions of the OBCA mirroring those of s. 124, as well as a by-law enacted by the corporation that provided for mandatory indemnification if the director acted honestly and in good faith with a view to the best interests of the corporation. The court stated:

What I do find more 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 the 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 whatever evidence of bad faith may be adduced against him. To a large extent, it is the corporation that must establish, to the satisfaction of the court, exactly what [the director] did that was inimical to its best interests.¹⁹⁰

In a derivative action, it is a *complainant* rather than the corporation directly, who is alleging that a director has committed a wrong. When a director brings an application for advance funding of his defence costs as soon as a derivative suit is filed, the corporation itself is unlikely to have cause to challenge the good faith presumption as described in *Blair* and thus, the propriety of the advancement.¹⁹¹ The practical effect is that the precondition in s. 124(4) that a director act honestly and in good faith in order to qualify for advancement is unlikely to present a significant obstacle for the director seeking advancement. The views of the corporation and the director regarding the advancement will, generally speaking, be aligned.¹⁹²

189. *Blair, supra*, footnote 8.

190. *Ibid.*, at para. 35 (emphasis added).

191. *Ibid.*

192. Mazur, *supra*, footnote 38, at p. 238.

Conversely, where a corporation initiates a direct action against its director, it possesses evidence of directorial misconduct sufficient to prompt litigation against one of its own. Corporations probably did not intend their indemnification obligations to apply, for example, where they believe that directors have lined their pockets at the expense of the corporation. The policy rationale underlying advancement — that a corporation lacks sufficient information to draw a conclusion about the director's conduct at the outset of litigation — is not applicable, since the corporation has already had the opportunity to investigate the allegations in its own suit and will not file suit unless it believes the allegations have merit.¹⁹³ The corporation then will be of the opinion that the director is no longer entitled to the benefit of the doubt.¹⁹⁴ The corporation would not wish to put itself in the highly undesirable position of financing its opponent's defence.¹⁹⁵ An unfaithful director who might otherwise have settled the action would be encouraged to litigate almost endlessly, thereby inflicting delay and expense on the corporation in order to defeat an otherwise meritorious claim.¹⁹⁶ Further, since the obligation to repay need not be secured, it is unlikely that the corporation would be able to recover the advanced funds if the director is ultimately disentitled to them.¹⁹⁷

On an action or application by a director seeking advancement, the corporation will be highly motivated to rebut any presumption that its director, whom it has chosen to sue, has somehow acted in good faith or in its best interests. The inevitable result will be a full-blown trial of the director's conduct at the advancement proceedings, superseding the corporation's direct action. This places the director in the position of plaintiff, since it is the director who will have the effective control over the forum and method of litigation. This was the result in *Amirault*,¹⁹⁸ where the plaintiff companies had initiated a direct action in Ontario against the directors, and the directors subsequently initiated an action for indemnity in Nova Scotia. Although *Amirault* was unusual in that the corporations' direct actions were found to have been initiated for an improper purpose, it nonetheless illustrates potential procedural complications that may arise in treating direct actions as falling within the scope of s. 124(4).¹⁹⁹ Effective control of the litigation is wrested from the

193. *Ibid.*

194. *Ibid.*

195. *Ibid.*

196. *Ibid.*

197. *Ibid.*

198. *Supra*, footnote 160.

corporation and placed in the hands of its opponent with no corresponding benefit to the director since he will have to litigate the issues raised in the main action to conclusion in the advancement proceeding, all without the benefit of the advancement. The benefit to the director of the advancement is undermined, since: “[t]he value of the right to advancement is that it is granted or denied while the underlying action is pending”.²⁰⁰

2. Advancement Rights in Other Jurisdictions: Lessons from Delaware

Insight may be gleaned from other jurisdictions. Delaware removes any conduct requirement from provisions authorizing advancement to directors.²⁰¹ If a corporation has undertaken to provide its directors with mandatory advancement rights, those advancement provisions can be “enforced as a contract”²⁰² in proceedings of a *summary* nature.²⁰³ The rationale is articulated by Delaware’s Supreme Court as follows:

The express purpose of 8 *Del. C.* § 145, which provides advancement and indemnification rights to officers and directors, is to “promote the desirable end that corporate officials will resist what they consider unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation they have served if they are vindicated.” . . . Clearly to be of any value to the executive or director, advancement must be made promptly, otherwise its benefit is forever lost because the failure to advance fees affects the strategy that the executive or director will be able to afford. To [do otherwise] would be to allow [the corporation] to be derelict in its contractual protection of directors/officers to compromise their own

199. *Ibid.* (S.C.).

200. *Morgan v. Grace*, No. Civ. A. 0430, 2003 WL 22461916, at p. 1 (Del. Ch., 2003).

201. Del. Code Ann. tit. 8 § 145(e) (1991): Expenses (including attorney’s fees) incurred by an officer or director in defending any civil, criminal, administrative or investigative action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the corporation as authorized in this section.

202. *Gentile v. SinglePoint Fin., Inc.*, 787 A.2d 102 at p. 106 (Del. Ch., 2001), aff’d 788 A.2d 111 (Del. 2001). See also *Delta Holdings, Inc. (Re)*, No. Civ. A 18604, 2004 WL 1752857, at p. 7 (Del. Ch., 2004), stating that rights to advancement “contained in a mandatory, expansive indemnification provision, are present contractual rights”.

203. Del. Code Ann. tit. 8, § 145(k) (1991): “The Court of Chancery is hereby vested with exclusive jurisdiction to hear and determine all actions for advancement of expenses or indemnification brought under this section or under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise. The Court of Chancery may summarily determine a corporation’s obligation to advance expenses (including attorney’s fees).”

litigation in the face of cost concerns, a result that is clearly against Delaware's policy of resolving advancement issues as clearly as possible.²⁰⁴

As a result, "the scope of an advancement proceeding under Section 145(k) . . . is limited to determining 'the issue of entitlement according to the corporation's advancement provisions and not to issues regarding the movant's alleged conduct in the underlying litigation'".²⁰⁵ For this reason, most advancement proceedings take place by way of an application on a paper record; the detailed analysis required to evaluate a director's conduct is seen as being both premature and inconsistent with the purpose of the summary proceeding.²⁰⁶ The method employed by Canada's s. 124(4), of trying the issue of advancement "simultaneous with the trial of the same lawsuits for which the corporate official is seeking provisional payment of his litigation expenses" has been rejected on the basis that it "results in an unacceptable cost; the effective elimination of the separate right of advancement".²⁰⁷

The difficulty created by Delaware's summary method is that all evidence of whether indemnification will be permitted at the end of the case is "irrelevant" to the right to advancement.²⁰⁸ Thus, charter, bylaw or indemnification provisions mandating advancement have been enforced in numerous cases brought directly by corporations against their former directors for breaches of fiduciary duty, fraud and the like, in cases where the corporation was confronted with very strong evidence of the director's malfeasance.²⁰⁹ As the courts of

204. *Homestore, Inc. v. Tafeen*, 886 A.2d 502 at p. 505 (Del., 2005), affg 888 A.2d 204 (Del., 2005).

205. *Kaung v. Cole National Corp.*, 884 A.2d 500 at p. 509 (S. Ct. Del., 2005) quoting *Homestore, ibid.*, at p. 503.

206. *Homestore, ibid.*, at p. 510.

207. *Reddy v. Electronic Data Systems Corp.*, No. Civ. A 19467, 2002 WL 1358761, at p. 8 (Del. Ch. 2002).

208. *Citadel Holding Corp. v. Roven*, 603 A.2d 818 at p. 822 (Del., 1992).

209. S.A. Radin, "Sinners Who Find Religion: Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing" (2006), 25 Rev. Litig. 251 at pp. 269-70. See, for example, *Citadel, ibid.* (claim by a corporation that corporate officers engaged in unlawful trading of stock); *Greco v. Columbia/HCA Healthcare Corp.*, No. Civ. A. 16801, 1999 WL 1261446 (Del. Ch. 1999); *Dunlap v. Sunbeam Corp.*, 1999 WL 1261339 (Del. Ch., 1999) (claims against two former corporate officers who had been terminated by the corporation in connection with restatements of financial statements); *Gentile, supra*, footnote 202 (claims brought by the corporation against a former officer and director who had been terminated by the corporation and removed by the board for breach of contract, breach of fiduciary duty and tortious interference with contract); *Radiancy, Inc. v. Azar*, No. Civ. A. 1547-N, 2006 WL 224059 (Del. Ch., 2006) (claims by the corporation alleging three former directors breached their fiduciary duties to the corporation, committed fraud and wasted corporate assets); *Pearson v. Exide Corp.*, 157 F. Supp.2d 429 (E.D. Pa., 2001) (claims brought by the corporation

Delaware have explained, “[t]he public policy of Delaware is to allow advancement . . . even in cases in which . . . the claims are for breach of fiduciary duty”.²¹⁰ The fact that a corporate officer “engaged in misconduct . . . has nothing to do with the agreement” to advance expenses²¹¹ and any argument to the contrary “blurs the distinct purpose of advancement provisions”.²¹² As stated in *Reddy v. Electronic Data Systems Corp.*,²¹³ “[b]y its own scrivener hand, [the corporation] has bound itself to advance funds to [its director] so long as the [Delaware General Corporation Law] allows it to do so”,²¹⁴ and “[h]aving been accorded the freedom to craft its bylaws as it wished, [the corporation] cannot point to its own drafting failures as a defence to [its director’s] advancement claim”.²¹⁵ This rationale has been heavily criticized by American scholars, particularly with regard to direct actions, as it incorrectly assumes that corporations will be motivated to exclude direct suits from indemnification coverage.²¹⁶

Under Delaware law, corporations are obliged to pay defence costs to faithless directors in any and all circumstances — throughout trial and appeal — even in cases where the corporation’s claims for breach of fiduciary duty are well-founded, and no matter what the director’s conduct. This situation has been described as “maddening”²¹⁷ to the courts and corporations who have concluded that former directors have committed wrongdoing that has injured the corporation and that there is strong evidence that the director will be disentitled to indemnification at the end of the proceeding. Most troublesome, even if the corporation ultimately prevails, there is often no realistic chance that the director will have the assets to repay the amounts advanced to fund their defence.²¹⁸

Delaware’s summary approach to the issue of advancement portrays the “other side of the scale” in finding a proper balance for

against corporate officers who had been terminated and whose conduct had become the subject of several lawsuits and criminal prosecutions for fraud).

210. *Delphi Easter Partners LP v. Spectacular Partners, Inc.*, No. Civ. A. 12409, 1993 WL 328079 at p. 8 (Del. Ch., 1993).

211. *Truck Components Inc. v. Beatrice Co.*, 143 F.3d. 1057, 1061 (7th Cir., 1998).

212. *Morgan*, *supra*, footnote 200.

213. *Reddy*, *supra*, footnote 207, at p. 3.

214. *Ibid.* at p. 3.

215. *Ibid.*, at p. 4.

216. As noted by Mazur, *supra*, footnote 38, at p. 240: “Even if advised that their bylaws can effectively prevent them from bringing a direct suit against a director who loots the corporation, many corporations will forgo the opportunity for a direct suit”.

217. *Reddy*, *supra*, footnote 207, at p. 5, quoted in *Morgan*, *supra*, footnote 200, at p. 2.

218. Radin, *supra*, footnote 209, at p. 278.

the scope of indemnification rights. Delaware's indemnification provisions strongly favour the rights of directors over and above those of shareholders. This approach completely disregards the fact that in direct actions, unlike in derivative and third party actions, the corporation will have evidence of bad faith against its director, which has given it sufficient cause to instigate its action directly. The corporation is not faced with a situation where it has little knowledge of the allegations against its director and is unable to make an assessment of a director's conduct.

A policy goal underlying the CBCA's indemnity provisions is that, where a director has breached his duty to the corporation, he should satisfy the resulting legal expenses incurred in connection with proceedings from his or her personal assets, since "[a]ny other rule could encourage socially undesirable conduct".²¹⁹ To permit corporations to advance expenses in direct actions effectively undermines this goal; once expenses are made to the faithless director, the money is gone and cannot be recovered. Corporations should be permitted to indemnify their directors who are proven meritorious in direct actions, but the rationale for advancement in such cases cannot be upheld.

V. CONCLUDING REMARKS

Payment of expense advances in direct suits violates public policy and should not be permitted by the courts. The corporation and its director are adversaries, unlike in a derivative action where the interests of the corporation and its director are aligned. That the corporation should be forced to fund the legal expenses of its opponent, the accused director, is fundamentally prejudicial to the corporation and its shareholders. The corporation is not faced with a situation where it has little knowledge of the allegations of its directors and so is unable to make an assessment of a director's conduct. If advancement is permitted in these direct actions, directors will be encouraged to litigate almost endlessly, thereby inflicting delay and expense on the corporation in order to defeat an otherwise meritorious claim. Corporations may ultimately be discouraged from initiating recovery actions against their unfaithful directors since a corporation will simply throw good money after bad; it is one thing to require repayment of monies advanced for legal expenses in the event that the corporation's case is made out, while it is another matter entirely to recover it.

219. CBCA Discussion Paper, *supra*, footnote 14, at p. 26, para. 91.

Canadian law, as embodied in the CBCA and OBCA, does not contemplate the advancement of legal expenses to directors in direct actions by the corporation, as distinct from derivative or third party actions. The foregoing review of the legislative history of indemnification provisions has demonstrated that requiring a corporation to advance money to fund the legal costs of an accused director in *direct* actions has never been part of Canadian law. It is only latterly that it has become accepted in U.S. law. The state of affairs that has developed in U.S. states such as Delaware, as outlined in the previous section, is not such that Canadian jurisdictions should be under any encouragement to follow suit.

In response to this contention, a question can be posed, “but what if the director cannot afford to fund his defence?” While this question may give pause, it should be no more than a momentary one. The corporation *itself*, not derivatively through the actions of a disgruntled shareholder, or by some third party, but directly, has taken action against one of its directors. Serving a claim and enclosing a cheque for a defence is something that the legislature has never intended. Likewise, allowing an accused director to take control of an action, as in *Amirault*, by suing for advancement of defence costs, is simply perverse. Canadian courts, if they are tempted down the easy path of lumping direct actions with derivative and third-party actions when it comes to applications to advance defence costs, should bear these matters in mind.