EYB2015DEV2273

Développements récents en droit des assurances (2015), Service de la formation continue du Barreau du Québec, 2015

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Characterizing D&O Insurance Policies in Québec Civil Law

Indexation

Assurances ; dommages ; responsabilité ; obligation de défendre de l'assureur ; Sociétés et compagnies ; administrateur ; responsabilité

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1. Introduction

Although directors' and officers' (hereafter « D&O ») insurance has existed in the United States since the 1930s, D&O policies arrived more recently in Québec. Québec-issued D&O insurance policies have generally been based on policies issued in the United States. This has raised some interesting questions on the application of Québec insurance law to these policies. Although there is a lot of jurisprudence on D&O insurance in the United States and some in the rest of Canada, there is remarkably little on the subject in Québec. The recent Superior Court decision in *Boralex inc.* v. *AIG Insurance Company of Canada*[1] constitutes a first Québec case in which a D&O insurance policy – and more specifically an « indemnity » policy – is categorized as a liability insurance policy within the meaning of the *Civil Code of Québec*. This, in turn, has consequences including modifications to the written terms of many D&O insurance policies in Québec.

In this article, we discuss the origins, purpose and nature of D&O insurance policies, the way such policies are categorized outside of and in Québec, and the effects of the categories.

2. Origins, Purpose and Nature of D&O Insurance Policies

a. Sources of D&O Liability

Directors and officers of corporations, whether incorporated under the *Canada Business Corporations Act*[2] (hereafter « CBCA ») or the Québec *Business Corporations Act*[3] (hereafter « QBCA »), face significant exposure to liability. In recent decades, through the introduction of numerous statutes, their exposure has increased significantly.

The following are some notable sources of directors' and officers' liability.[4]

Liability towards Corporation

Section 119 of the QBCA requires directors and officers of corporations to act with prudence and diligence, honesty and loyalty, and in the best interests of the corporation. Section 122 of the CBCA contains similar requirements. Although the directors and officers owe fiduciary duties solely to the corporation, jurisprudence provides that their duty to exercise the care, diligence and skill of a reasonably prudent person must take into account not only the corporation and its shareholders but also other stakeholders such as employees, creditors and customers, although this liability is subject to the business judgment rule.[5]

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1. *Boralex inc.* v. *AIG Insurance Company of Canada*, 2015 QCCS 972, EYB 2015-249344, [2015] J.Q. No. 1939. The decision is currently on appeal at the Quebec Court of Appeal. The author Catherine Tyndale and our colleague John Nicholl represented AIG in this matter.

2. *Canada Business Corporations Act*, R.S.C. 1985, c. C-44.

3. *Business Corporations Act*, CQLR, c. S-31.1.

4. Each province has its own statute for corporations but, for the purposes of this article, we refer only to the QBCA and the CBCA where applicable. Where other federal and Quebec legislation applies, we refer to it. Securities legislation is the only exception, where we refer to Quebec and Ontario statutes.

5. *Peoples Department Stores inc. (Trustee of)* v. *Wise*, 2004 SCC 68, [2004] 3 S.C.R. 461, [2004] S.C.J. No. 64.

Oppression Lawsuits

Under sections 439 and 450 of the QBCA and sections 238 and 241 of the CBCA, the following « complainants » or « applicants » :

a) past or present registered holders or beneficial owners of a security of a corporation or any of its affiliates ;

b) past or present directors and officers of a corporation or its affiliates ; or

c) any other person who, in the discretion of the court, has the interest required to make an application ;

can apply to a court for an order when, amongst other things, the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer.

The courts have the power to order a party to compensate or pay money to a complainant or applicant.

Prejudicial, oppressive, and unfair conduct comes in a variety of forms including :[6]

- stronger interests exercising power to the detriment of the equitable rights of less powerful stakeholders ;
- discriminatory effects arising from poor management ;
- unjustified disregard for the complainant's / applicant's interests in the decision-making process.

Securities Litigation

Securities are regulated by the provinces.

In Québec, chapters I and II of Title VIII of the *Securities Act*[7] establish rules for civil liability (*i.e.* actions for damages) against directors, officers and others, resulting from the subscription, acquisition or disposition of securities, with respect to primary and secondary market violations. That said, actions for damages in a securities context can still be brought under ordinary rules of civil liability.

The Ontario *Securities Act*[8] contains similar provisions for civil liability for directors and officers for primary and secondary market violations. The Ontario statute sets out secondary market liability with respect to « reporting issuer » corporations (including those that are publicly listed in Canada) and those with a « real and substantial connection to Ontario » at sections 138.1 and following.

Wages and Salaries

Under section 154 of the QBCA, directors are liable to the employees of a corporation for all debts not

6. Steven DONLEY & Nigel KENT, « Directors and Officers Liability in Canada : A review of Exposures and Coverages Available under D&O Policies » (June 2008), Clark Wilson LLP at 5 ; Dennis H. PETERSON, *Shareholder Remedies in Canada*, (Markham, Ont. : LexisNexis, 1989) (Loose-leaf updated 2007) at 18.25, 18.26, 18.31.3.

7. *Securities Act*, CQLR, c. V-1.1, ss. 213.1 and following.

8. *Securities Act*, R.S.O. 1990, c. S.5, ss. 130 and following. Other provinces have primary and secondary market liability provisions modeled on Ontario's statute.

exceeding six months' wages payable to each employee for services performed for the corporation, subject to certain restrictions.

Section 119(1) of the CBCA provides for similar liability for directors of federal corporations.

Taxes, Deductions and Contributions

Pursuant to section 227.1 of the *Income Tax Act*,[9] a director is liable for a corporation's failure to deduct or withhold an amount of taxes and remit it as required under the *Act*.

In Québec, section 24.0.1 of the *Tax Administration Act*,[10] provides for the liability of directors where a corporation has failed to remit, deduct or collect amounts when it was required to do so under a fiscal law, or where the corporation has failed to pay employer's contributions required under a number of statutory regimes (including for the Québec pension plan, parental insurance, and the *Régie de l'assurance maladie*).

Environmental Liability

In Québec, section 115.50 of the *Environment Quality Act*[11] provides that directors and officers of a corporation having defaulted on the payment of amounts owed under the statute or regulations are solidarily liable with the corporation for the payment of the amount, subject to due diligence defences. Section 115.40 of the *Act* provides that directors and officers are presumed to have committed the same offense as the corporation, unless they can show due diligence. Section 115.36 of the *Act* also sets out fines and penalties applicable to individuals, which are doubled if an offence is committed by the director of officer of a corporation.

Section 280 of the *Canadian Environmental Protection Act*[12] provides for the liability of directors and officers of corporations for penalties in respect of offences committed by the corporation, if the director or officer « directed, authorized, assented to, acquiesced in or participated in the commission of the offense ».

b. Mechanisms to Mitigate D&O Liability

The above-mentioned liabilities, while understandable from a policy perspective, are quite substantial and can pose major risks to the patrimony of a director or officer of a corporation. An absence of adequate financial protection can lead to a flight from boardrooms and a dearth of qualified candidates for the positions of directors and officers.[13]

There are different mechanisms geared towards reducing and mitigating the risks of directors' and officers' liability.

There are statutory provisions that set out the circumstances in which directors and officers can or

9. *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s 227.1.

10. *Tax Administration Act*, CQLR, c. A-6.002, s. 24.0.1.

11. *Environment Quality Act*, CQLR, c. Q-2, s. 115.50.

12. *Canadian Environmental Protection Act*, S.C. 1999, c. 33, s. 280.

13. This was the case during the D&O crisis of the 1980s. See William KNEPPER & Dan BAILEY, *Liability of Corporate Officers and Directors, Volume 2*, 8th ed. (Matthew Bender, 2014) at 23-1-23-2.

should be indemnified by the corporation and when the corporation can advance funds for the costs of defending certain proceedings. Sections 159 to 161 of the QBCA set out when corporations must indemnify directors and officers, when they may not, when they may provide an advance, and when monies must be returned to the corporation by the directors and officers. Section 124 of the CBCA contains the equivalent provisions for federal corporations.

Furthermore, corporations can supplement the statutory framework and can agree through contract, bylaws or other means to indemnify directors and officers in certain circumstances. Such mechanisms must, however, respect the statutory parameters set out above and cannot provide for indemnity where the law forbids it.

However, there are circumstances where the corporation's duty to indemnify (whether through statute or other mechanisms) might not apply or might provide insufficient protection. For example, present and former directors and officers may find themselves in trouble if the corporation is insolvent or has liquidity issues, or if they are in a conflict with the corporation. Furthermore, a corporation must obtain court approval to indemnify any directors or officers named as defendants in a derivative action (pursuant to section 124(4) of the CBCA and section 161 of the QBCA).

Moreover, the costs of defending a claim until its adjudication or settlement can be significant and prohibitive for many directors and officers, and even for the corporation that must indemnify them. Section 159 of the QBCA sets out certain circumstances in which a corporation must pay an advance to a director or officer to defend a claim, but this does not apply to a number of situations. Pursuant to section 124 the CBCA, there is the possibility but not a requirement for the corporation to advance the costs of defence. In light of the above, a director or officer might well be forced to defend himself or herself without an advance to pay legal fees and without any indemnification before the ultimate adjudication of a claim.

In this context, D&O insurance is an important tool that protects directors and officers (hereafter « Ds & Os ») from certain types of liability and defence costs, including amounts for which the corporation might not indemnify them. In light of corporations' duty to indemnify their Ds & Os, this insurance also benefits the corporations. As will be discussed further below with respect to side C coverage, D&O insurers have expanded the coverage offered in standard D&O policies to include other risks to corporations. As a result, the D&O policy constitutes an important tool for risk management. It goes without saying that the existence of a D&O policy can also be advantageous to claimants.

The QBCA and the CBCA allow corporations to purchase D&O insurance for their Ds & Os. At section 162, the QBCA stipulates the following :

> **162.** A corporation may purchase and maintain insurance for the benefit of its directors, officers and other mandataries against any liability they may incur as such or in their capacity as directors, officers or mandataries of another group, if they act or acted in that capacity at the corporation's request.

The CBCA's equivalent provision is at section 124(6) :

> (6) A corporation may purchase and maintain insurance for the benefit of an individual referred to in subsection (1) [a present or former director or officer of the corporation, or another individual who acts or acted at the corporation's request as a director or officer, or an individual acting in a similar capacity, of another entity] against any liability incurred by the individual

(a) in the individual's capacity as a director or officer of the corporation ; or

(b) in the individual's capacity as a director or officer, or similar capacity, of another entity, if the individual acts or acted in that capacity at the corporation's request.

As can be seen from the insurance provisions cited above, there are few restrictions to the scope of the D&O insurance that a corporation can buy. As we discuss below, this allows for scenarios in which a D&O insurer can indemnify a director or officer even when the corporation has no legal obligation or may not be allowed to do so.

c. Origins of D&O Insurance

D&O policies were first introduced in the United States in the 1930s, in response to the stock market crash and the introduction of securities legislation providing for the personal liability of directors in certain circumstances. In the 1960s, D&O policies were introduced in Canada. Their popularity grew in the 1970s and 1980s. However, in the mid-1980s, the United States – and Canada, to a lesser degree – faced a liability and insurance crisis. Liability exposure for directors and officers increased significantly, but the insurance offer contracted. Insurers refused to underwrite certain risks, new exclusions were added to policies, and insurance premiums increased significantly. Corporations faced the risk of losing Ds & Os or being unable to recruit qualified individuals for these positions. During that period and in following years, D&O insurance rose in prominence and D&O policies became a commonplace insurance purchase for corporations.[14]

In Québec, D&O policies gained traction in the 1980s, particularly with companies whose securities were listed in the United States, or who had operations there. Over the years, the wording of Québec-issued policies has evolved with the changing wording in the United States and the rest of Canada. However, until relatively recently, the wording of these policies has generally not been adapted to Québec law. We will discuss the consequences of this situation further below.

d. Typical Terms of a D&O Policy

While there is no standardized wording for D&O insurance policies, a typical policy will share the following characteristics.

First, D&O policies are usually comprised of three types of insuring agreements or coverages, often called Sides A, B and C.

- The Side A insuring agreement provides that the insurer will pay on behalf of Ds & Os loss (*i.e.* damages and defence costs) resulting from claims alleging their wrongful acts. However, Side A coverage only applies when the corporation does not indemnify the Ds & Os.

- The Side B insuring agreement provides that the insurer will pay on behalf of the corporation loss which Ds & Os are legally obligated to pay as a result of a claim and for which the corporation indemnifies them. In circumstances where a corporation is not able or permitted to indemnify its Ds & Os (such as the statutory restrictions discussed above), Side B coverage does not apply and

14. Ronald J. DANIELS & Susan HUTTON, « The Capricious Cushion : The Implications of the Directors and Insurance Liability Crisis on Canadian Corporate Governance », (1993) 22 *Can. Bus. L.J.* 182 at 189-198 ; Herbert S. SILBER, « Directors' and Officers' Liability Coverage : Directors' Liability and the Scope of Policy Exclusions in Canada », (1990) 8 *Can. J. Ins. L.* 95 ; KNEPPER & BAILEY, *supra*, note 13, at 23-1-23-2.

one must revert to Side A coverage.

- The Side C insuring agreement provides that the insurer will pay on behalf of the corporation loss which the corporation is legally obligated to pay as a result of securities litigation against it. Although, at first glance, Side C coverage does not appear related to directors' and officers' liability, it was developed long after Sides A and B, principally for the purpose of avoiding allocation disputes regarding the portion of loss due by the Ds & Os (which might be covered by Side A or B) and the portion due by the corporation in the event of securities litigation.

- On occasion, a D&O policy might include coverage for other types of liability of the corporation, such as for employment practices liability, or errors and omissions.

The insuring agreements set out above have been described summarily. However, the policies invariably contain nuances that require careful review. Terms such as « insured », « claim », « wrongful act » and « loss » are specifically defined and are circumscribed by the policy terms and conditions and by jurisprudence.

D&O policies are written on a « claims-made » basis, *i.e.* their coverage is triggered by claims that are made during the policy period,[15] as opposed to being « occurrence » based, *i.e.* coverage being triggered based on the timing of the wrongful acts at issue in the claim.

D&O policies generally stipulate that defence costs are included within and shall erode the policy limits. Typically, D&O policies provide for a deductible or self-insured retention (hereafter « SIR ») for Sides B and C of the policy, but not for Side A. The deductible or SIR is generally applicable to defence costs as well as to damages.

D&O policies may contain « duty to defend » provisions, or may provide for « reimbursement » or « indemnity ». Those with « duty to defend » provisions specify that the insurer pays for and directs the defence of the insured. On the other hand, a policy drafted on an « indemnity » basis generally provides that the insured will select defence counsel with the consent of the insurer and will direct the defence, with the insurer reimbursing the fees incurred on behalf of the insured, although most such policies provide that the insurer will advance rather than reimburse funds for defence costs. D&O « indemnity » policies generally provide that the insurer has the right to be involved in the defence, and its consent is required to settle a claim or to incur defence costs.

We discuss below the implications of the typical D&O wording in a Québec context.

e. Common Policy Exclusions

Here are some of the most common exclusions found in D&O policies :

- Prior knowledge : any actual or potential claim of which the insured was aware prior to the inception of the policy (or another specified date) ;

- Prior notice : any claim based up on facts or circumstances that were the subject of a notice under a prior policy ;

15. Most policies will also permit the insured to notify the insurer of circumstances which might give rise to a covered claim at a later date, and if sufficient information is provided in that notice, the insurer will treat the later claim as triggering the policy in force at the time the notice was given.

- Claims arising out of bodily injury, mental anguish, sickness or destruction of tangible property ;
- Claims arising from professional services ;
- Pollution and environmental liability ;
- Claims regarding pension fund liability ;
- Claims arising from fraudulent acts, criminal acts, or willful violation of the law ;
- Claims arising from the insured gaining a profit, advantage or remuneration to which the insured was not legally entitled ;
- Claims brought by one insured against another insured ;
- Claims by major shareholders.

We now focus on some of the exclusions which have been the focus of recent jurisprudence : prior notice and insured vs. insured.

Prior Notice

In *Onex Corporation et al.* v. *American Home Assurance Company et al.*,[16] the Ontario Court of Appeal interpreted and applied the prior notice provision for the first time. It had to determine whether a notice of circumstances which might later give rise to a claim under the policy, sent by the insured on the eve of the policy's expiry, was sufficient to trigger that policy rather than a later one. In this curious case, the insured argued that its notice was insufficient and that the claim should trigger the later policy, whereas the insurer made the opposite argument.

- The insured Onex purchased D&O policies in 2002-2003, 2003-2004 and 2004-2005 from American Home.
- Magnatrax was a former Onex subsidiary and Onex board members also sat on the Magnatrax board.
- The 2002-2003 policy contained an endorsement which provided that American Home was not liable for any loss arising out of claims brought by Magnatrax or any claim arising out of any breach of duty, act, error or omission of any director or officer of Magnatrax. The endorsement excluding Magnatrax had first been added during the 2002-2003 policy year, in anticipation of Magnatrax's filing for bankruptcy protection in the United States on May 12, 2003. American Home had issued a Magnatrax run-off policy at the same time that the endorsement excluding Magnatrax was added to the 2002-2003 Onex policy.
- The 2004-2005 Onex policy did not contain the endorsement excluding Magnatrax. It contained a clause 4(d) which excluded coverage where the claim was covered by a prior policy.

16. *Onex Corporation et al.* v. *American Home Assurance Company et al.*, 2013 ONCA 117, 114 O.R. (3d) 161, leave to appeal refused in *Onex Corporation et al.* v. *American Home Assurance Company et al.*, 2013 SCCA 178.

- Clause 7(c) of the 2002-2003 policy permitted an insured to give written notice to the insurer « of any circumstance which may reasonably be expected to give rise to a Claim ».

- On August 1, 2003, the attorney for the Magnatrax Creditors' Committee sent a letter to counsel for Magnatrax alleging that Magnatrax had claims against Onex and the directors and officers of Onex and Magnatrax. Furthermore, the Committee alleged breach of fiduciary duty and unjust enrichment. The Magnatrax letter was forwarded to Onex's broker. A few months later, on November 28, 2003, with the eve of the expiry of the 2002-2003 policy on November 29, the broker forwarded the letter to American Home, referenced the 2002-2003 policy and the Magnatrax run-off policy, and mentioned that the letter « contains information on a situation which could in future give rise to a claim under [those] polic[ies] ».[17]

- In 2005 (during the 2004-2005 policy), in the context of the bankruptcy in the United States, the trustee of the Magnatrax litigation trust filed an action in Georgia against Onex and its directors alleging breach of fiduciary duty and unjust enrichment on the basis that they engaged in transactions benefiting Onex at the expense of Magnatrax.

- Onex sought from its insurers the reimbursement of the substantial defence costs it incurred for the Georgia claim. American Home paid the Magnatrax run-off policy limits of $15 milllion. Onex argued that the 2004-2005 Onex policy should respond too, as insufficient notification had been provided under the 2002-2003 Onex policy to apply the 2004-2005 prior notice clause.

- The parties filed motions for summary judgment. The motions judge concluded that Onex had given a valid notice of circumstances in keeping with clause 7(c) of the 2002-2003 policy. As a result, the 2004-2005 policy would not apply due to the prior notice provision.

- The Court of Appeal agreed with the motions judge on the issue of prior notice and it dismissed the appeal on this issue.

On the issue of prior notice, *Onex* is a vivid illustration of the consequences of notices of circumstances and the importance of reporting claims during the correct policy periods.

<u>Insured vs. Insured</u>

On the issue of insured vs. insured exclusions, we turn again to the case of *Onex*[18] :

- Onex sought reimbursement of the substantial defence costs it incurred in the Georgia action, which was brought by the trustee of the Magnatrax litigation trust.

- The 2002-2003 Onex policy contained an endorsement which provided that American Home was not liable for any loss arising out of claims brought by Magnatrax or any claim arising out of any breach of duty, act, error or omission of any director or officer of Magnatrax.

- The Magnatrax exclusion endorsement was added on May 12, 2003 during the 2002-2003 policy

17. *Ibid.* at para. 53.

18. *Ibid.*

year, when Magnatrax ceased being a subsidiary of Onex upon filing for bankruptcy protection. Prior to that, the policy's insured vs. insured exclusion would have applied to an action brought by a trustee in bankruptcy. The wording of that exclusion read as follows :

The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against an Insured :

> (i) *which is brought by or on behalf of an Organization or any Insured Person*, other than an Employee of an Organization ; or which is brought by any security holder or member of an Organization, whether directly or derivatively, unless such security holder's or member's Claim is instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of, any Executive of an Organization or any Organization, provided, however, this exclusion shall not apply to : [...] (emphasis added)

However, when Magnatrax ceased being a subsidiary, it also ceased being an insured for the purpose of the insured vs. insured exclusion.[19]

- The motions judge adopted a narrow reading of the endorsement excluding Magnatrax, entitled « Specific Entity/Subsidiary Exclusion », which read as follows :

... the Insurer shall not be liable for any Loss alleging, arising out of, based upon or attributable to or in connection with any Claim brought by or made against the Entity listed below and/or any Insureds thereof. 1. MAGNATRAX Corporation (including any subsidiary or affiliate thereof).

- As the endorsement excluded only claims brought <u>by</u> (or against) Magnatrax and did not exclude claims by a third party, even if brought on Magnatrax's behalf – the trustee, in this case – against Onex's Ds & Os for their wrongful acts in relation to Magnatrax, the exclusion did not apply. American Home was ordered to pay Onex the $15 million limits under the 2002-2003 policy towards its defence costs.

- The Court of Appeal agreed with the motions judge that the Georgia action was not « brought by » Magnatrax. Therefore, it did not fall within the parameters of the endorsement exclusion. The Court further noted that the parties could have specified if they intended the exclusion to apply to claims brought by trustees in bankruptcy.

- However, the Court of Appeal disagreed with the motions judge's finding that the endorsement unambiguously excluded coverage for claims against the insureds acting as Magnatrax executives, but did not exclude claims against the insureds acting in their capacity as Onex executives. The Court of Appeal returned the matter to the Superior Court to allow it to make findings of fact regarding the parties' reasonable expectations or intentions.

It is interesting to compare the policy wording and interpretation in *Onex* and in the Québec Superior Court decision in *Peoples Department Stores* c. *Wise*.[20] In the Peoples policy, the insured vs. insured exclusion, like the specific entity exclusion in the Onex policy, did not explicitly exclude claims by those acting on behalf of the insured. The trustee was held to be a separate entity from the bankrupt corporation. As a result, the Court held that the insured vs. insured exclusion did not preclude coverage

19. *Ibid.* at para. 120 and following.

when a trustee in bankruptcy sued directors and officers.[21]

Finally, there is an interesting judgment of the Québec Superior Court which applies the insured vs. insured exclusion. In *Groupe Vidéotron ltée* v. *Compagnie d'assurances London Guarantee*,[22] the Court applies the exclusion in the context of a claim instituted in the United States by a 28 % shareholder against the directors of the corporation. The directors attempted to argue that the insured vs. insured exclusion was meant to avoid collusion and that they should be exempted from the exclusion as they were not colluding or in any way participating in the claim. However, the Court dismissed their argument and noted that they had the burden of proving that the exception to an exclusion might apply. As they had not provided evidence on the subject, their claim was dismissed.

While there is limited Canadian caselaw dealing with this exclusion, the American cases are numerous and varied. As with most subject matters, there is a U.S. decision to support virtually any position a party wishes to take. Some apply the exclusion strictly, based on its plain and obvious wording ; others infer that it is intended to apply only in situations where the parties are colluding in an attempt to get access to the insurance proceeds.

3. Categorizing D&O Insurance Policies

a. Indemnity Policy vs. Liability Policy

As explained above, D&O policies can either have « duty to defend » language or « indemnification » language. In the United States and in Canadian jurisdictions other than Québec, these wordings relate to liability policies and indemnity policies respectively.

Where indemnity policies are recognized and allowed, the insurer has no duty to defend and no such duty is read into the policy by the courts. Strictly speaking, in a pure indemnity policy, the insurer's duty to indemnify an insured for defence costs and damages owed pursuant to a judgment of settlement is determined only upon the resolution of the underlying lawsuit against the insured. The analysis can become more complex when, as is usual, such indemnity policies include provisions for an insurer to advance defence costs as they are incurred, but these policies nonetheless remain distinct from liability policies, which involve a duty to defend.[23]

b. Categorizing D&O Policies in Québec

The *Civil Code of Québec* (hereafter the « **C.C.Q.** ») provides the framework for insurance law in Québec. Article 2396 C.C.Q. provides for two categories of non-marine damage insurance : property insurance and liability insurance.

2396. *Damage insurance includes property insurance*, the object of which is to indemnify the

20. *Peoples Department Stores inc. (Trustee of)* c. *Wise*, [1998] Q.J. No. 3571, 23 C.B.R. (4th) 200, reversed on other grounds by the Quebec Court of Appeal, [2003] J.Q. No. 505, 224 D.L.R. (4th) 509, and affirmed by the Supreme Court 2004 SCC 68, [2004] 3 S.C.R. 461, [2004] S.C.J. No. 64. The trial court's decision on the applicability of the insured vs. insured exclusion was not appealed.

21. The same reasoning is applied in *Markham General Insurance Co. (Liquidator of)* v. *Bennett* (2006), 81 O.R. (3d) 389.

22. *Groupe Vidéotron ltée* v. *Compagnie d'assurances London Guarantee*, [2005] J.Q. No. 10049.

23. KNEPPER & BAILEY, *supra*, note 13, at 23-11.

insured for material loss, *and liability insurance*, the object of which is to protect the insured against the pecuniary consequences of the liability he may incur for damage to a third person by reason of an injurious act. (Emphasis added)

The legislator's use of the word « includes » in the English version of article 2396 (« *comprend* » is used in the French version) is curious. One could argue that it opens the door to types of damage insurance other than property and liability insurance. This could be an argument in favour of the acceptance of « indemnity » insurance in Québec, for instance. However, the titles of section III (« Damage Insurance ») and its sub-sections (1 – « Provisions common to property insurance and liability insurance » ; 2 – « Property Insurance » ; 3 – « Liability Insurance ») of the C.C.Q.'s Chapter XV on insurance suggest otherwise. Jurisprudence appears to be mum on the possibility of other types of liability insurance and at this stage, almost 25 years after the adoption of the C.C.Q., it appears to be trite law that damage insurance in Québec must be either liability or property insurance.[24]

As a result, D&O policies in Québec must be categorized as either property or liability policies. In the process, D&O policies undergo some changes as a function of article 2414 C.C.Q., the public order provision which nullifies policy clauses and stipulations which grant fewer rights to the policyholder or less protection for injured third parties than those contemplated by the insurance chapter of the C.C.Q. As we will see below, the need to categorize D&O policies and the application of article 2414 C.C.Q. transform « indemnity » policies in particular so thoroughly as to bring into question their use in a context where Québec law must apply.

D&O policies with « duty to defend » provisions may be categorized as liability policies. While they might not meet all the requirements of the C.C.Q. for liability insurance policies, their object is in keeping with article 2396. Furthermore, the duty to defend (discussed at article 2503 C.C.Q.) is an important defining characteristic of liability policies.

Can D&O policies with « reimbursement » or « indemnification » provisions truly fit within the category of a liability policy ? Could one argue that, insofar as the policy provides that the insurer's duty to indemnify an insured for defence costs and for damages is determined only upon the resolution of the underlying lawsuit, this type of D&O policy could fall within the parameters of a property policy as contemplated at article 2396 C.C.Q., *i.e.* as insurance meant to indemnify an insured for material loss ?

We respond to the latter question first. A review of the C.C.Q. provisions regarding property insurance (art. 2480 C.C.Q. and following) quickly shows that D&O policies with indemnification provisions cannot be categorized as property insurance without stretching the concept of property insurance beyond the bounds of the C.C.Q. While the C.C.Q. allows for incorporeal property to be the subject of a contract of insurance (article 2482 C.C.Q.), other provisions, including those pertaining to insurable interest (for example, article 2481 C.C.Q.) make it difficult to categorize a D&O policy as property insurance. There might an argument to be made that Side B coverage, *i.e.* where an insurer reimburses a corporation that has indemnified or must indemnify a director or officer, can constitute an insurable property loss which causes the corporation direct and immediate injury (to paraphrase article 2481 C.C.Q.). However, the analogy still requires.

In response to the former question, we must look at the policy as a whole. Ultimately, as D&O policies address the liability of directors, officers and corporations, common sense would require that we treat

24. Didier LLUELLES, *Précis des assurances terrestres*, 5th ed., Montreal, Les Éditions Thémis, 2009.

them as liability policies. As we will see in the next section, the Superior Court in *Boralex inc.* v. *AIG Insurance Company of Canada* envisages a solution to the absence of a duty to defend in certain D&O policies.

c. The Superior Court's View in Boralex inc. v. AIG Insurance Company of Canada

In the recent case of *Boralex inc.* v. *AIG Insurance Company of Canada*,[25] the Superior Court was presented with a D&O policy issued by AIG Insurance Company of Canada (hereafter « AIG ») entitled « Executive and Organization Liability Insurance Policy ». The policy contained the following clause :

> Notice : The insurer does not assume any duty to defend. The insurer must advance defence costs, excess of the applicable retention, pursuant to the terms herein prior to the final disposition of a claim.

The dispute arose from the following facts. On August 31, 2010, a lawsuit was instituted against Boralex and Boralex Power Income Fund (hereafter the « Fund ») by investors in the Fund. The investors did not sue the trustees of the Fund, who were Insured Persons under the policy. On September 1, 2010, the trustees received a letter from the investors advising them that if they participated in the conduct that the lawsuit against Boralex and the Fund was meant to prevent, they would be held liable for damages. AIG was notified of the lawsuit and of the letter. Certain trustees then decided to voluntarily intervene in the investors' lawsuit against Boralex. AIG was also notified of this voluntary intervention. AIG advised the insureds that the lawsuit did not constitute a claim within the meaning of the policy.

On July 10, 2014, Boralex sued AIG to obtain reimbursement of approximately $450,000 in legal fees that it had already paid on behalf of the trustees in the context of the investor lawsuit against it and the Fund and for the voluntary intervention of the trustees, and to seek payment of legal fees going forward.

AIG filed an exception to dismiss the action against it pursuant to article 165(4) of the *Code of Civil Procedure*, on the basis that the action was prescribed and therefore unfounded in law, even if the alleged facts were true. AIG argued that the 3-year prescription period started running as of August 31, 2010, when the action was filed by the investors against Boralex and the Fund, or as of September 1, 2010, when the trustees received a letter from the investors. AIG's argument was based on the principle that Boralex's action was predicated on AIG having a duty to defend.

As the jurisprudence has established,[26] prescription for the duty to defend begins running as of the moment the duty is first triggered by a claim. As the jurisprudence has also established, the duty to defend is not triggered anew and a new prescription period does not begin to run each time a payment is made towards legal fees.[27]

Boralex argued that its action against AIG was not based on principles of liability insurance. It invoked

25. *Supra*, note 1.

26. *Axa Boréal Assurances inc.* v. *Université Laval*, [2003] J.Q. No. 1453 [*Axa Boréal*] ; *Granby (Municipalité du Canton de)* v. *Lombard du Canada ltée*, [2003] J.Q. No. 3649 ; *Bédard Dodge Chrysler ltée* v. *Compagnie d'assurances MOAC (CNA)*, [2005] J.Q. No. 19907 [*Bédard*] ; *Leblanc* v. *Axa Assurances inc.*, 2008 QCCS 4554, EYB 2008-148231.

27. *Axa Boréal*, *ibid.*

the above-mentioned provision of the policy which stipulated that « the insurer does not assume any duty to defend ». Boralex submitted that its action was instead based on a duty to indemnify, and that the prescription period for such a duty would not start running until the rendering of a final judgment in the underlying lawsuit of the investors against Boralex.

The Court dismissed Boralex's arguments. As the policy definition of covered loss included defence costs, and as the policy provided that the insurer would advance defence costs, the Court concluded that the policy was one of liability insurance subject to the principles governing such insurance in the C.C.Q. The Court further noted that regardless of what the policy wording might say, a duty to defend is an obligatory component of a liability insurance policy in Québec and cannot be excluded, in light of the requirements of article 2503 C.C.Q.

The Court also dismissed the argument that Boralex sought the enforcement of a duty to indemnify.

It agreed with AIG's extinctive prescription argument regarding the duty to defend and dismissed Boralex's action against AIG.

Boralex has appealed the judgment.[28]

This decision is significant because it constitutes, to our knowledge, the only reported case in Québec where a D&O policy with « indemnification » wording is clearly placed into the C.C.Q. category of liability insurance. There are major implications of characterizing D&O policies as liability policies in Québec, some of which we address below.

4. Consequences of Viewing D&O policies as Liability Policies

a. Duty to Defend

In *Boralex*, the Court set out a few reasons for concluding that the D&O policy includes a duty to defend, even though the policy explicitly states that « [t]he insurer does not assume any duty to defend ».

The Court found that the policy wording itself provides for a duty to defend. It creatively interpreted the notion of « loss » and the policy's obligation to advance defence costs for this purpose :

> [26] Ce n'est pas, non plus, parce que AIG n'a qu'à avancer les « Defence Costs, excess of the applicable retention » que cette obligation n'est pas pour autant reliée à l'obligation de défendre.[29]

The Court also noted that the policy incorporated article 2503 C.C.Q. through the following Québec law endorsement :

> **QUEBEC LAW ENDORSEMENT**
>
> In consideration of the premium charged, it is hereby understood and agreed that where this policy is legally required to be interpreted in accordance with the laws of the Province of Quebec then the policy provisions shall be deemed to be amended to comply with the applicable mandatory provisions of the Quebec Civil Code, but only to the extent necessary to comply with such mandatory provisions of the Quebec Civil Code and only to the extent that such mandatory

28. *Supra*, note 1.

29. *Ibid.*, at para. 26.

provisions are contrary to the existing terms of the contract.

ALL OTHER TERMS, CONDITIONS AND EXCLUSIONS REMAIN UNCHANGED. [30]

Ultimately, however, the Court took the position that a duty to defend would be triggered regardless of the D&O policy language :

> [27] Qui plus est, l'obligation de défendre ne peut pas être exclue d'une police d'assurance responsabilité, telle que la Police, vu les dispositions claires de l'article 2503 C.c.Q. :
>
> > **2503.** L'assureur est tenu de prendre fait et cause pour toute personne qui a droit au bénéfice de l'assurance et d'assumer sa défense dans toute action dirigée contre elle.
> >
> > Les frais et dépens qui résultent des actions contre l'assuré, y compris ceux de la défense, ainsi que les intérêts sur le montant de l'assurance, sont à la charge de l'assureur, en plus du montant d'assurance.
>
> [28] Cette obligation de défendre est de rigueur au Québec, peu importe les dispositions contractuelles à l'effet contraire.[31](Emphasis added)

Thus, even if a D&O policy had no Québec endorsement and no provision for the advancement of defence costs, the courts would read into the policy a duty to defend.

While paragraphs 26 and 27 of the *Boralex* decision might constitute an *obiter dictum*, they are nonetheless rooted in established caselaw that provides that the courts can read a duty to defend into a liability policy on the basis of article 2503 C.C.Q. The Québec Court of Appeal judgment in *Canadian National Railway* v. *Chartis Insurance Company of Canada*[32] is one of the most prominent recent examples of this process and it is cited in *Boralex*.[33]

In the words of the Québec Court of Appeal in *Smith* c. *Ste-Adèle (Ville de)*, the duty to defend entails the following duties for the insurer :

> [12] L'obligation de défendre impose à l'assureur la prise en charge, en temps opportun, de la défense de la personne assurée. Il s'agit pour l'assureur de comparaître pour cette personne et d'assumer les frais et les coûts afférents à sa défense. L'assureur agit alors pour le compte de la personne assurée et en son nom, dans son seul intérêt et en toute loyauté.[34]

The insurer who has a duty to defend also has a number of rights, chief amongst which is control of the defence. In correlation to the insured's duties and rights is the duty of the insured to cooperate with the insurer and its representatives. The Court of Appeal spoke to this issue in *Zurich du Canada, compagnie d'indemnité* v. *Renaud & Jacob* :[35]

30. *Ibid.*, at para. 29.

31. *Ibid.*, at para. 27-28.

32. *Canadian National Railway* v. *Chartis Insurance Company of Canada*, 2013 QCCA 1271, EYB 2013-224894.

33. In that judgment, the Court of Appeal affirmed the primacy of the duty to defend provision of 2503 C.C.Q. over the terms of a policy by reading a duty to defend into an excess insurance policy with no duty to defend provision.

34. *Smith* v. *Ste-Adèle (Ville de)*, 2006 QCCA 411, EYB 2006-102725, at para. 12.

35. *Zurich du Canada, compagnie d'indemnité* v. *Renaud & Jacob*, [1996] R.J.Q. 2160, EYB 1996-65423.

> Par ailleurs, lorsque la défense de l'assuré est une obligation pour l'assureur, son exécution lui confère des droits. Le principal de ceux-ci est la conduite de la défense. Il choisit les avocats et les experts, définit l'orientation de la défense, de la procédure écrite comme de la plaidoirie éventuelle devant le tribunal, et même, éventuellement, décide de l'opportunité de régler ou non l'affaire. De plus, elle impose à l'assuré l'obligation de collaborer avec l'assureur et ses représentants.[36]

Over and above the control of the defence, article 2504 C.C.Q. provides that no transaction, *i.e.* settlement, made without the consent of the insurer may be set up against it. This does not mean, however, that an insured who has settled without its insurer's consent can never be compensated by it :

> L'article 2504 C.c.Q., il est vrai, énonce qu'« [a]ucune transaction conclue sans le consentement de l'assureur ne lui est opposable », mais cela ne signifie pas que l'assuré qui transige avec le tiers lésé sans le consentement de l'assureur ne peut jamais se faire indemniser par lui. L'inopposabilité de la transaction n'entraîne pas la déchéance du droit à l'indemnisation. Simplement, la transaction ne liant pas l'assureur, l'assuré devra faire la preuve de l'ensemble de ses prétentions, incluant la preuve de la conformité de sa réclamation à la police et celle de l'existence et du quantum des dommages-intérêts recouvrables, le cas échéant.[37]

While the insurer cannot escape its duty to defend, it can renounce or limit its right to control the defence of the insured. The type of language one might find in a D&O policy could be construed as an insurer's voluntary restriction of its right to control the defence. For example, a D&O policy drafted on an « indemnification » basis might stipulate that the insurer will reimburse defence costs and that the insured will appoint defence counsel and control the defence, but that the insured must obtain the insurer's approval for a settlement. In such a case, an insured could reasonably argue that the insurer has renounced control of the defence, except over the settlement. Another D&O policy might provide that the insured will control its defence unless the insurer decides to take control of the defence. In such a case, the insurer should be allowed to assert its right to control the defence, if and when it wishes to have such control.

A question arises as to whether an insurer ceding its right to appoint defence counsel and control the defence of its insureds constitutes a violation of article 2414 C.C.Q. Could it be seen as granting the insured fewer rights than those provided for in the C.C.Q. ? The answer may depend on the relative sophistication of the insureds. There is no doubt that a D&O insurer would prefer to appoint counsel and control the defence, rather than simply be kept informed of the decisions taken by the insureds and their counsel and be expected to pay the bills when submitted, with few, if any, questions asked. However, D&O insurance, when it is actually called upon, is a very personal type of coverage (the insureds are personally named, allegations are made against them which potentially affect their professional and personal reputations, and their personal assets are at stake) which serves a clientele that may have marked preferences as to lawyers and legal strategy and prior experience in this regard. As a result, many D&O insureds have historically preferred to control their own defence, including choosing their own defence counsel. On the other hand, insureds who are inexperienced in litigation and are not acquainted with any lawyers who know the subject matter may welcome the insurer's involvement, on the basis that the insurer will certainly designate the most appropriate and effective counsel, as it serves both its insureds' and its own interests to do so.

36. *Ibid.*, at 2165.

37. *Hoyos* v. *Chubb Insurance Company of Canada*, 2008 QCCA 1296, [2008] R.R.A. 529, EYB 2008-136237 at para. 38.

b. Defence Costs Outside of Limits

Articles 2500 and 2503 para. 2 C.C.Q. provide that liability insurance proceeds cannot be applied to defence costs (as they must remain available for injured third parties) and that the insurer must pay defence costs outside the policy limits :

> **2500.** The proceeds of the insurance are applied exclusively to the payment of injured third persons.
>
> **2503.** The insurer is bound to take up the interest of any person entitled to the benefit of the insurance and assume his defence in any action brought against him.
>
> Costs and expenses resulting from actions against the insured, including those of the defence, and interest on the proceeds of the insurance are borne by the insurer over and above the proceeds of the insurance.

The Court of Appeal recently reaffirmed these public order principles in *Canadian National Railway* v. *Chartis Insurance Company of Canada*.[38] In that case, the Court of Appeal reviewed an excess policy of $20 million, which provided that defence costs were included in the « Ultimate Net Loss » payable under the policy. It declared that, once the underlying insurance was exhausted and this policy was triggered, the C.C.Q. applied to it, regardless of the will of the parties and the policy wording that provided that the insurer's total exposure – in costs and indemnity – would be $20 million. The Court of Appeal put in stark terms the implications for the insurer of adapting this policy to Québec law :

> [78] En résumé, la primauté des dispositions du Code civil s'applique en matière d'obligation de défendre, de frais de défense, d'intérêts et frais et dépens payés à des tiers (art. 2500 et 2503 C.c.Q.). Dans le cas d'un sinistre majeur, Chartis pourrait donc devoir débourser beaucoup plus que la limite de 20 000 000 $ convenue à la police.[39] (Emphasis added)

D&O claims can be very expensive to defend, particularly claims such as securities litigation and class actions. The vast majority of D&O policies are written on a costs-within-limits basis. This has been a long-accepted means for insurers to manage exposure. Insurers have set premiums on the basis of this limited exposure. There will therefore be financial repercussions to transforming these policies into policies with unlimited costs outside limits.

While insurers might initially face losses with this transformation of their policies, the market in Québec will eventually have to adjust to the new legal reality : premiums for D&O policies might rise and/or the offer for D&O insurance might be reduced. As participants in this market are aware, however, the amount of insurance capacity available makes it unlikely that there will be any significant effect, at least in the short term.

c. Deductible and Self-Insured Retention

D&O policies can have substantial deductibles or SIRs, although these are generally applicable to Sides B and C (for the corporation's liability, whether as a result of its indemnification of its Ds and Os or its own direct liability) rather than Side A (directors' and officers' liability for which the Ds and Os are not indemnified by the corporation).

38. *Supra*, note 32, at paras. 75 and 78.

39. *Ibid.*, at para. 78.

As a result, determining which part of the policy is triggered by a claim can be a high stakes issue. For example, in the case of *Nortel Networks Corp. (Re)*,[40] the Ontario Superior Court of Justice seized pursuant to the *Companies' Creditors Arrangement Act*[41] (hereafter « CCAA ») applied a D&O policy with a $10 million deductible applicable to Side B and no deductible for Side A. The Court decided that, although the corporation was subject to an obligation to indemnify its Ds and Os for their legal fees prior to the CCAA filing, it was precluded from making the payment by the CCAA stay of proceedings. The judge concluded that, as the corporation was not permitted to indemnify the Ds and Os, the Side A insuring agreement would apply and there would be no deductible.

The significant deductibles and SIRs in D&O policies raise some other questions too. Are the amounts referred to as deductibles meant to be SIRs ? As it is often stipulated in policies that these underlying amounts apply to all components of a « loss », including defence costs, can they in fact be applied to defence costs in Québec ? And can claims that fall within these amounts trigger a duty to defend for an insurer ?

First, it should be noted that deductibles and SIRs are different concepts with different characteristics and effects, even though they are sometimes confused – even in insurance policies. Whether the underlying amounts assumed by insureds are called SIRs or deductibles in D&O policies, the amounts are usually meant to be treated as SIRs. The SIR closely resembles and can sometimes be assimilated to an underlying layer of insurance : most notably, the insurer's policy is not triggered until the SIR is paid and the SIR does not affect the limits of the insurance policy.

Canadian National Railway v. *Chartis* constitutes one of the rare interpretations of a SIR in Québec jurisprudence.[42] In that case, the policy at issue was framed as a $20 million excess policy with a $5 million underlying amount. The insured, Canadian National Railway (hereafter « CN »), was a sophisticated party that decided to self-insure for the underlying amount. However, the $5 million underlying amount could also have been insured by a primary insurer. The Court of Appeal did not treat the underlying amount as a deductible. Instead, it treated the underlying amount as it would a primary layer of insurance and CN as it would a primary insurer. CN's defence costs could not be tallied towards the $5 million underlying amount, but payments of settlements or judgments to third party victims could be tallied towards the amount. Upon exhaustion of the underlying amount through the payment of settlements or judgments, the $20 million Chartis excess policy would be triggered. We note that the fact pattern in that case (the substantial amounts at issue, the fact that the insurance policy was labelled an excess policy, and the conduct and level of sophistication of the parties) left little doubt that the underlying amount was a SIR and not a deductible « in disguise ». Some authors suggest that a different fact pattern might have brought about a different result.[43]

Although defence costs were not tallied towards the SIR in *Canadian National Railway* v. *Chartis*, we see no issue with the SIR applying to defence costs if the policy allows it. Applying the SIR to defence

40. *Nortel Networks Corp. (Re)*, 2012 ONSC 5653 ; leave to appeal denied in *Nortel Networks Corporation (Re)*, 2013 ONCA 518.

41. *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36.

42. *Supra*, note 32.

43. Jean-Louis BAUDOUIN & Patrice DESLAURIERS, *La responsabilité civile, Volume II – Responsabilité professionnelle*, 8th ed., Cowansville, Éditions Yvon Blais, 2014), n° 2-540.

costs would be less onerous for the insured, and therefore it should not trigger article 2414 C.C.Q.

Finally, there are some who would argue that neither a SIR nor a deductible could apply to defence costs.[44] There is no clear jurisprudence in Québec on whether a deductible can apply to defence costs. The author Mr. Didier Lluelles is of the view that article 2503 C.C.Q. does not allow for a deductible to be applied to defence costs.[45] We respectfully disagree. The argument presented in support of the notion that article 2503 C.C.Q. precludes applying a deductible or SIR to defence costs rests on its introductory paragraph (« [t]he insurer is bound to take up the interest of any person entitled to the benefit of the insurance and assume his defence in any action brought against him ») and that this implies that an insurer cannot require its insured to pay any portion of defence costs. We submit that there is nothing in the clear wording of this article to prevent an insurer and its insured from negotiating an arrangement whereby the insured takes on the first layer of defence costs, with the insurer stepping in and assuming defence costs beyond that layer. (There is in fact no clear wording in the C.C.Q. liability insurance provisions regarding deductibles or SIRs, whether on the topic of defence costs or of insurance proceeds.) There are both practical and economic reasons supporting the possibility for an insurer and insured to negotiate such an arrangement. An insured may want to retain control over matters which fall within a certain pre-agreed and accepted level of exposure, without having to turn them over to its insurer ; and it may also be prepared to take on that level of exposure in exchange for a lower insurance premium. An insurer may well (though not always, depending on the nature of the risk) be prepared to offer a zero deductible, if the insured is willing to pay the higher premium associated with such coverage.

d. Prescription

In *Boralex*[46], once the Court decided that the action was based on a duty to defend rather than a duty to indemnify and that the policy at issue was a liability policy, it had to conclude that extinctive prescription applied, as more than 3 years had elapsed since the duty to defend – if there was one – would have been triggered. The Court based itself on well-established jurisprudence that sets out when the duty to defend under a liability policy is triggered and when the 3-year prescription period of article 2925 C.C.Q. starts running.

In *Axa Boréal Assurances inc.* v. *Université Laval,*[47] the Court of Appeal set out the main principles on prescription, which were in turn adopted by the Court in *Boralex* :

- The insurer's decision regarding coverage is not the starting point for the duty to defend.

- The duty to defend is triggered when the claim is made (ex. when the lawsuit or demand letter is served), assuming that a coverage analysis reveals that the claim and surrounding facts meet the criteria for the duty to defend to apply.[48]

44. Louis CHARRETTE, Bernard LAROCQUE & Maude LAFORTUNE-BÉLAIR, « Les montants de rétention *self-insured retention* : quelle est leur étendue en droit civil québécois », in Service de la formation continue du Barreau du Québec, *Développements récents en droit des assurances*, Cowansville, Éditions Yvon Blais, 2011, p. 85.

45. *Supra*, note 24.

46. *Supra*, note 1.

47. *Axa Boréal*, *supra*, note 26.

- Once the duty to defend is triggered, it is not triggered anew and a new prescription period does not apply each time a payment is made towards defence costs.

In *Bédard Dodge Chrysler ltée* v. *Compagnie d'assurance M.O.A.C.* (C.N.A.),[49] the Court of Appeal added a further nuance to the prescription issue. In that case, the insurer had initially defended the insured against a claim. Years later, the insurer withdrew from the defence of the claim and advised the insured of its decision. As of the moment the insurer withdrew from the defence, the insured could seek the enforcement of the duty to defend. The prescription period therefore started to run upon the insurer's withdrawal from the defence.

e. Direct Recourse against the D&O Insurer

Articles 2501 and 2502 C.C.Q. stipulate the following with respect to liability insurance :

> **2501.** An injured third person may bring an action directly against the insured or against the insurer, or against both.
>
> The option chosen in that regard by the injured third person does not deprive him of his other recourses.
>
> **2502.** The insurer may set up against the injured third person any grounds he could have invoked against the insured at the time of the loss, but not grounds pertaining to facts that occurred after the loss ; the insurer has a right of action against the insured with respect to facts that occurred after the loss.

Article 2501 C.C.Q. provides injured third parties with a direct right of action against D&O insurers for the acts of their insureds. The injured third parties are not even obliged to sue the insureds. However, the insurer who is sued directly can avail itself not only of the insured's defences, but also of coverage defences which the insurer could have invoked at the time of the loss.

Peoples Department Stores v. *Wise*[50] is a prominent example of a case where the D&O insurer was sued along with its insureds.

f. Allocation of Defence Costs

Quebec courts have spoken in recent years on the allocation of defence costs between a liability insurer and its insured when a claim contains covered and uncovered allegations.

Quebec courts have concluded that an insurer who has a duty to defend covered claims cannot seek an allocation of defence costs based on the existence of uncovered claims alone. The insurer must demonstrate that the uncovered allegations have resulted in distinct and quantifiable costs so as to justify an allocation of costs.[51]

48. In this article, we do not discuss the criteria applicable to determine if a policy is triggered or if a duty to defend applies. For more on this issue see Dominic NAUD & Attieha CHAMAA, « L'obligation de défendre : les tribunaux ont-ils fait le tour du jardin ? », in Service de la formation continue du Barreau du Québec, *Développements récents en droit des assurances*, Cowansville, Éditions Yvon Blais, 2011, p. 69.

49. *Bédard*, *supra*, note 26.

50. *Supra*, note 5.

The position of the Quebec courts on this issue parallels that of the Ontario Court of Appeal in *Hanis* v. *Teevan* :

> [2] [...] I would hold that the question of apportionment of costs should be determined by the operative language in the policy. Where there is an unqualified obligation to pay for the defence of claims covered by the policy, as in this case, the insurer is required to pay all reasonable costs associated with the defence of those claims even if those costs further the defence of uncovered claims. The insurer is not obliged to pay costs related solely to the defence of uncovered claims.[52]

In the more recent case of *Tedford* v. *TD Insurance Meloche Monnex*, the Ontario Court of Appeal applies *Hanis* and adds interesting guidance :

> [22] Hanis establishes that an insurer is responsible for all reasonable costs associated with the defence of a covered claim. As Doherty J.A. commented, at para. 23, *the approach in Hanis is not unfair to the insurer : it does not result in an increase in the insurer's liability for defence costs*.
>
> [...]
>
> [24] I would direct, unless the parties otherwise agree, that the appellant's counsel be instructed *to defend both the covered and the uncovered claims, in a manner commensurate with the aggregate amount claimed*, and *that the respondent bear the costs of the defence, to the extent they exceed the reasonable costs associated with the defence of the covered claims. In determining the reasonable costs associated with the defence of the covered claims, it is appropriate to consider the quantum of the covered claims. It would be unfair to the insurer to fix it with defence costs that are disproportionate to the extent of its potential liability for the covered claim.*[53] (Emphasis added)

The reasoning in *Tedford* could reasonably be adopted by Québec courts, as the Québec and Ontario courts have based themselves on similar principles. The basic fairness argument, set out in *Hanis* and highlighted in *Tedford*, is particularly compelling.

g. Punitive Damages

D&O policies often provide coverage for punitive damages, insofar as such coverage is permitted in the applicable jurisdiction. We must therefore ask ourselves if there can be coverage for punitive damages under Québec law.

Article 2464 C.C.Q. provides some guidance : the insured is never bound to indemnify for injury resulting from the insured's intentional fault, with certain caveats.

> **2464.** The insurer is bound to indemnify for injury resulting from superior force or the fault of the insured, unless an exclusion is expressly and restrictively stipulated in the policy. However, the insurer is never bound to indemnify for injury resulting from the insured's intentional fault. Where there is more than one insured, the obligation of coverage remains with respect to those insured who have not committed an intentional fault.

51. *Zurich, compagnie d'assurances* v. *Gestion Guy Lamarre inc.*, 2013 QCCA 367, EYB 2013-218886 at para. 20. See also *Université de Montréal* v. *Desnoyers Mercure & Associés*, 2011 QCCS 3564, EYB 2011-193222 ; *Bissonnette* v. *Venturelli*, 2008 QCCS 5012, EYB 2008-150506.

52. *Hanis* v. *Teevan*, 2008 ONCA 678, at para. 2.

53. *Tedford* v. *TD Insurance Meloche Monnex*, 2012 ONCA 429, at paras. 22-24.

> Where the insurer covers injury caused by a person for whose acts the insured is liable, the obligation of coverage subsists regardless of the nature or gravity of the fault committed by that person.

However, in certain cases, Quebec law provides for punitive damages without requiring the presence of intentional fault. The punitive damages contemplated at section 272 of the *Consumer Protection Act*[54] (hereafter « CPA ») are an example. In *Dion* v. *Compagnie de services de financement automobile Primus Canada*, the Court of Appeal set out the criteria and process for the consideration of an award of punitive damages under the CPA :

> [121] In *Time*, the Supreme Court confirmed that in the absence of specific criteria in the enabling statute, then the criteria of Article 1621 C.C.Q. apply to the consideration of the awarding of punitive damages. Even though the granting of punitive damages is exceptional and the first goal is the prevention of prohibited practices, the Supreme Court added that a court must also take into account the purposes of the legislation under which the punitive damages are being granted. The Supreme Court foresees the following process for the consideration of an award of punitive damages :
>
> 1. A violation of an obligation under the C.P.A. giving rise to a recourse under 272 C.P.A. ;
>
> 2. Given the absence of specific criteria in Section 272, the application of Article 1621 in the context of the legislative purposes of the C.P.A. as follows :
>
> > i. the rebalancing of the relationship between consumers and merchants ;
> >
> > ii. the elimination of unfair and misleading practices that may distort the information available to consumers and prevent them from making informed choices ;
> >
> > iii. securing the existence of an efficient market in which consumers can participate confidently.[55]

The Court of Appeal also made an interesting observation while maintaining the punitive damage award against a set of defendants : it noted that the impugned behaviour was not antisocial and that the punitive damages were awarded so as to encourage and persuade the defendants to clarify their drafting. As this case makes clear, punitive damages can be granted to sanction behaviour that falls short of the level of intentional conduct.

Given the above, insurance lawyers should keep a close eye on developments in the law applying punitive damages. As the law evolves on this issue, certain types of punitive damages might become insurable and D&O policies might provide coverage for such punitive damages.

5. Conclusion

The *Boralex* judgment[56] is one of the rare cases where the Québec courts interpret and apply D&O policies. As the judgment is under appeal, the Court of Appeal might provide further guidance on this

54. *Consumer Protection Act*, CQLR, c. P-40.1 s. 272.

55. *Dion* v. *Compagnie de services de financement automobile Primus Canada*, 2015 QCCA 333, EYB 2015-248671, at para. 121.

56. *Supra*, note 1.

subject. This article is an invitation to not only contemplate the effects of the judgment but to keep in mind the purpose and context of D&O insurance and of typical policy provisions when interpreting D&O policies in Québec.