mcmillan

DO WE HAVE INSURANCE FOR THAT? – WHY DIRECTORS SHOULD OBTAIN LEGAL ADVICE WHEN BUYING COMPANY AND D&O INSURANCE

Posted on February 15, 2022

Categories: Insights, Publications

Directors of public companies are aware that the role comes with risk of personal liability. That risk can be effectively managed with the adoption by the company of insurance coverage tailored to address the particular risks and circumstances of the business. Directors are wise to determine whether a particular risk is covered by such a policy before the policy is adopted, and with the benefit of legal advice, rather than in the context of inquiring as to coverage when facing a claim. In the later case, where coverage is in doubt, little can be done to rectify the policy. This article: (A) reviews the major parties involved in negotiating insurance agreements; (B) identifies interpretative principles that apply to custom insurance agreements, as compared to standard form insurance agreements; and (C) illustrates the reasons why prudent companies should engage legal counsel to assist in negotiating insurance agreements and the review of existing policies.

The prudency of involving legal counsel before coverage under a policy is actually necessary is particularly true in rapidly emerging sectors such as cannabis, space travel, cryptocurrency, NFTs, and e-sports where industry players have notably faced shareholder claims, regulatory actions, product liability issues, and fraud. Companies operating in these sectors are looking for insurance to mitigate new risks, and insurance companies and brokers are correspondingly attempting to address those needs. A spokesperson from one major insurer, for example, recently noted that "[cryptocurrency assets] are becoming more relevant, important and prevalent on the real economy and we are exploring product and coverage options in this area."[1]

Despite insurers' and brokers' good faith actions in providing insurance, companies operating in these industries purchasing insurance for the first time face multiple issues in connection with their intended coverage. Company and directors and officers liability (D&O) policies catering to cannabis and cryptocurrency companies, in particular, carry bespoke exclusions and carve outs for shareholders claims, bankruptcy claims, and regulatory violations. Prudent companies and their boards of directors should engage legal counsel to assist their insurance broker in negotiating these new agreements. Companies would also be prudent to engage counsel to review existing policies to ensure that new product offerings and their associated risks remain within the bounds of insurance coverage the company understands that it has.

A. The Cast of Characters Involved in Negotiating an Insurance Contract

There are generally three parties that are integral to the formation of an insurance contract: an insurer, an insured, and an intermediary broker/agent.

a. Insurer

The party giving an undertaking to indemnify the other party from loss or liability in respect of an event that is uncertain to happen is referred to as the "insurer". The insurer and insured owe each other mutual duties of utmost good faith and fair dealing in negotiating insurance contracts and settling claims.[2] Insurers are chiefly subject to this duty during the settlement process, when a policyholder has sustained some type of loss. The insurer must investigate claims fairly, in a balanced, reasonable, and expeditious manner.[3]

b. Insured

The party obtaining the assurance of indemnity upon the loss occurring is referred to as the "insured." Insureds have a duty to disclose all matters relevant to the risk insured against.[4] This includes a requirement to respond honestly to questions posed by the insurer.[5] Insureds must be careful when answering questions – in some cases, insurers have denied coverage when an insured misunderstood a question and unintentionally provided a wrong answer.[6]

c. Broker/Agent

An insurance "broker" or "agent" acts as an intermediary between the insured and insurer. In Ontario, there is a critical distinction between the two: agents essentially work for a single insurer to place insurance, while brokers work for insureds.[7] Brokers offer clients a choice of products and price comparisons from various insurance companies.[8]

In Ontario, brokers are a self-regulated profession. They are subject to licensing, professional competence, and ethical conduct requirements established by the provincial regulatory body, the Registered Insurance Brokers of Ontario ("**RIBO**").[9] According to RIBO, "[e]very registered insurance broker must meet certain qualification standards and continuing education requirements, established by the Qualification & Registration Committee."[10]

As self-regulated professionals, brokers are subject to concurrent duties in contract, tort, and equity.[11] Brokers have a legal duty to provide information about available coverage, but also advice about which forms of coverage a client requires.[12] A broker must understand the nature of their client's business and assess the risks that should be insured against.[13]

This is a high standard to meet. The Supreme Court of Canada has articulated the specialized type of expertise

brokers should have:

> It goes without saying that an agent who does not have the requisite skills to understand the nature of his client's business and assess the risks that should be insured against should not be offering this kind of service.[14]

In practice, however, it can be difficult for experienced brokers to meet this standard. For example, the Ontario Court of Appeal has found that brokers are untrained in property appraisal and thus lack the requisite expertise to assess their clients' property values at risk when obtaining reconstruction cost insurance for buildings.[15] Brokers are likewise unqualified to provide meaningful advice about their clients' appropriate business interruption limit, given that it is "based on financial advice to which the insured, and not the insurance broker, is privy."[16]

Companies seeking insurance should also be wary of the fact that a broker's standard of care varies when a client seeks full insurance coverage versus a specific type of coverage only:[17]

- When the client requests full insurance coverage, the onus is on the broker to provide the full coverage sought. Should an uninsured loss occur, the broker will be liable unless he or she has pointed out the gaps in coverage to the client and advised them how to protect against those gaps.[18]
- Conversely, if the client asks for a specific type of coverage, the broker's duty is more limited. The broker will satisfy his or her duty by obtaining the specific insurance requested and is not required to advise on the type of insurance the client should have.[19] A client who unwittingly requests the wrong type or sufficiency of insurance may be vulnerable to gaps in coverage.

B. New Industries Require Non-Standard Insurance Agreements

Most insurance policies are drafted by insurers and follow a standard form. As discussed below, the Supreme Court of Canada has developed interpretative principles that apply to standard form insurance contracts. New industries like cannabis or cryptocurrency, however, present new risks, which are not necessarily encapsulated by standard form policies. When an insurer and insured negotiate custom exclusions and carve-outs into a policy, courts employ a different interpretative approach.

a) Interpreting a Standard Form Insurance Agreement

Insurance agreements are a distinct type of commercial contract. Most policies are structured identically and composed of four sections: 1) definitions; 2) the insuring agreement; 3) exclusions; and 4) conditions that an insured must fulfill in order to establish a claim. An insured is only entitled to coverage if its loss falls within the coverage provisions (which are usually within the insuring agreement) and is not excepted from such protection by the exclusion provisions.[20]

Under normal circumstances, insurers do not negotiate the detailed terms of commercial insurance policies with individual clients. Instead, insurers provide clients (or their brokers) with standard form policies that have been pre-drafted. It is then open to potential clients to accept the standard form terms or attempt to negotiate certain material terms. These standard form agreements are referred to as "contracts of adhesion."[21]

The Supreme Court of Canada has developed certain interpretative principles that apply to contracts of adhesion. Above all, where the language of an insurance policy is unambiguous, effect should be given to that clear language, reading the contract as a whole.[22] Where, however, the language is ambiguous, the policy should be interpreted to be consistent with the reasonable expectations of the parties, as long as that interpretation is supported by the language of the policy.[23]

If ambiguity still remains, courts will employ the *contra proferentem* rule. *Contra proferentum* states that the words of a contract are to be construed more strongly against the drafter – the insurer, in the case of contracts of adhesion. A corollary of this rule is that coverage provisions in insurance policies are interpreted broadly and exclusion clauses narrowly.[24]

b) Interpreting a Custom Drafted Insurance Agreement

Companies operating in evolving industries, like cannabis or cryptocurrency, will be negotiating insurance agreements that include bespoke contractual language and endorsements to cover new areas of risk. The policies that evidence these agreements are not standard-form in nature and are termed "manuscript policies."[25]

Manuscript policies are almost a certainty for cannabis companies seeking D&O coverage - in large part because companies in that industry run a high risk of facing D&O claims. Traditional business financing is generally inaccessible to cannabis companies, which causes companies to pursue capital from outside investors."[26] As reported in the *Cannabis Times*, the increased pool of investors that can file a D&O claim has led to a "steadily increasing" number of D&O class actions against cannabis companies.[27] Consequently, D&O insurers are drafting custom policies for cannabis companies, featuring unique exclusions and carve outs for shareholder claims, class actions, and regulatory violations.[28]

Similar issues arise for companies operating in the cryptocurrency space. GB&A, a speciality brokerage, noted that the D&O policies available to such companies tend to carry "aggressive exclusions", including tailored carve-outs for regulatory violations and bankruptcy claims.[29]

Some of the interpretative principles described above will continue to apply to manuscript policies. As always, when interpreting insurance contracts, courts give effect to clear and unambiguous language, having regard to the contract as a whole.[30] On the other hand, *contra proferentem* has no application to manuscript

policies negotiated between sophisticated parties with the ability to modify the wording of the policy.[31]

In addition, the parties' objective intentions when entering into an agreement become germane when interpreting manuscript policies. Parties do not negotiate contracts of adhesion so party intent is generally irrelevant to the interpretation of such contracts.[32] The reverse is true of manuscript policies, which are negotiated in detail. Courts will consequently interpret manuscript policies as they do other commercial agreements between sophisticated parties: by seeking the meaning of provisions in terms of the parties' reasonable intentions.[33]

C. Necessity for Legal Counsel When Negotiating Bespoke Insurance Contracts

Prudent companies operating in emerging sectors should engage legal counsel to review their insurance agreements for several reasons:

a) Insurers are Becoming More Stringent With Policy Wordings

Insurers are taking increasingly technical approaches to policy wordings. Faced with increased claims stemming from the COVID-19 pandemic, a rising number of shareholder class actions, and more frequent catastrophic weather events, insurers are approaching claims more forcefully.[34] Given this new reality, companies seeking coverage should have legal counsel review new policies with a fine-tooth comb to ensure that there is no disconnect between the companies' expectation as to coverage and what is provided for in the policy language.

Legal advice is particularly important for companies in emergent sectors because insurers are treating new and uncertain risk exposures with added caution. Insurers are creating bespoke insurance products that are tailored to these new industries, which will vary from the standard policies that brokers are accustomed to. Legal counsel can carefully review custom-drafted exclusions and carve-outs to ensure that a company's expectation of coverage matches the coverage it is actually entitled to receive under the policy.

b) Brokers and Legal Counsel Have Distinct Roles

As discussed above, brokers have a duty to provide information about available coverage and advice about which forms of coverage a client requires in order to meet their needs.[35] In practice, however, prudent companies should be engaging a broker **and** legal counsel to negotiate insurance agreements as a team.

Brokers are qualified to offer a variety of products from different insurers and make recommendations regarding sufficient coverage.[36] They also provide value by consulting on active insurance policies.[37] They are not qualified, however, to draft legal agreements and may not keep abreast of developments on the finer, but critical, points of insurance law. This is where legal counsel comes in. Lawyers can review insurance

agreements holistically, and spot vulnerabilities and gaps in coverage.

Companies, and the boards that direct them, should exercise caution in making assumptions about the type and sufficiency of coverage they require based solely upon broker advice. As discussed above, when a client asks for a specific type of coverage, a broker will satisfy her duty by obtaining the specific insurance requested and is not required to advise on the type of insurance the client *should* have.[38] A client who unwittingly requests the wrong type or sufficiency of insurance may be vulnerable to gaps in coverage and will have no remedy against a broker if loss occurs. Companies should engage legal counsel to avoid this type of error.

It is also critical for companies to obtain legal advice when answering insurer's questionnaires.[39] As discussed, insurers have denied coverage when an insured misunderstood a question and unintentionally provided a wrong answer.[40] Legal counsel can assist in interpreting and answering questions accurately, particularly related to corporate structure, compliance with regulatory schemes, and financial information. Even the most experienced brokers may not be able to clarify these types of questions without the assistance of legal counsel. Lawyers are also well positioned to identify questions that are unclear so that clarification might be sought from the insurer before answers to the unclear questions are finalized.

c) Forgoing Legal Advice Can Be Costly

It may give companies comfort that brokers attract liability if they do not obtain appropriate coverage on their clients' behalf. That comfort rings hollow, however, when an insured must expend significant time and resources to litigate an insurance dispute. Even if an insured is ultimately successful in a claim against their broker or insurer, disputes can take years to resolve. In the recent case of *2049390 Ontario Inc. v. Leung*,[41] eight years passed from the date of loss until the plaintiff's negligent advice claim against its broker was fully resolved. It is common for insurance disputes to span a decade or more.

Meanwhile, an insured mired in litigation must pay legal fees throughout. A successful litigant is only entitled to a portion of their legal costs at the conclusion of the litigation. Ongoing legal costs can put pressure on a company's cash flow, and an insured may even have to borrow money to finance its legal costs pending a successful outcome at trial. Borrowing costs, including interest, are not compensable.

There is an upfront cost associated with engaging legal counsel to review an insurance agreement *before* a poorly drafted agreement leads to litigation. This cost is dwarfed, however, by the cost and time expended in litigating a coverage dispute if an insurer denies a claim. Prudent companies, particularly those operating in emerging industries where bespoke policies of insurance are more common, should build upfront legal costs into their insurance expenses - after all, preventative upfront costs are another form of insurance.

[1] Olga Kharif, Brian Louis, Julie Edde, and Katherine Chiglinksy, "Stolen Crypto Millions Paid Back for Cents on

the Dollar, Guaranteed", *Bloomberg* (20 July, 2018) online.
[2] *Trial Lawyers Association of British Columbia v. Royal & Sun Alliance Insurance Company of Canada*, 2021 SCC 47 at paras. 36-37.
[3] *Trial Lawyers Association of British Columbia v. Royal & Sun Alliance Insurance Company of Canada*, 2021 SCC 47 at paras. 34, 36-37.
[4] *Whiten v. Pilot Insurance Co.*, 2002 SCC 18 at para. 83; *Trial Lawyers Association of British Columbia v. Royal & Sun Alliance Insurance Company of Canada*, 2021 SCC 47 at para. 35.
[5] *Trial Lawyers Association of British Columbia v. Royal & Sun Alliance Insurance Company of Canada*, 2021 SCC 47 at para. 35; *Cheetham v. TD Life Insurance Co.*, 2013 ONSC 4892 at para. 6; Craig Brown, *Insurance Law in Canada* (Toronto: Thomson Reuters Canada, 2021) at § 5:1.
[6] *Sandhu Estate v. Fidelity Life Assurance Co.*, [1987] B.C.W.L.D. 3272, 6 A.C.W.S. (3d) 271 (B.C. Sup. Ct.).
[7] *J.I.L.M. Enterprises & Investments Ltd. v. Intact Insurance*, 2012 ONSC 6923 at para 23; Financial Services Commission of Canada, "Working with a Home Insurance Agent or Broker" *Financial Services Commission of Canada* (4 September, 2018) online.
[8] Registered Insurance Brokers of Ontario, "Mission, Values & Vision", *Registered Insurance Brokers of Ontario* (2021) online.
[9] Registered Insurance Brokers of Ontario, "Mission, Values & Vision", *Registered Insurance Brokers of Ontario* (2021) online.
[10] Registered Insurance Brokers of Ontario, "Mission, Values & Vision", *Registered Insurance Brokers of Ontario* (2021) online.
[11] *Fine's Flowers Ltd. v. General Accident Assurance Co. of Canada*, 17 O.R. (2d) 529, 81 D.L.R. (3d) 139 (ONCA) at paras. 44, 56; *Central & Eastern Trust Co. v. Rafuse*, [1986] 2 S.C.R. 147 (S.C.C.) at para. 69; *Fletcher v. Manitoba Public Insurance Corp.*, [1990] 3 S.C.R. 191,1990 CarswellOnt 56 at para. 58.
[12] *Fletcher v. Manitoba Public Insurance Corp.*, [1990] 3 S.C.R. 191,1990 CarswellOnt 56 at para. 58.
[13] *Fine's Flowers Ltd. v. General Accident Assurance Co. of Canada*, 17 O.R. (2d) 529, 81 D.L.R. (3d) 139 (ONCA) at para. 44.
[14] *Fine's Flowers Ltd. v. General Accident Assurance Co. of Canada*, 17 O.R. (2d) 529, 81 D.L.R. (3d) 139 (ONCA) at para. 44.
[15] *2049390 Ontario Inc. v. Leung*, 2020 ONCA 164 at paras. 31-35.
[16] *2049390 Ontario Inc. v. Leung*, 2020 ONCA 164 at para. 33-34.
[17] *Sandborn Wholesale Ltd. v. Pottruff & Smith Insurance Brokers Inc.*, 2011 ONSC 1969 at para. 57.
[18] *Fletcher v. Manitoba Public Insurance Corp.*, [1990] 3 S.C.R. 191,1990 CarswellOnt 56 at para. 59.
[19] *Sandborn Wholesale Ltd. v. Pottruff & Smith Insurance Brokers Inc.*, 2011 ONSC 1969 at paras. 57, 63.
[20] Denis Boivin, *Insurance Law*, 2nd ed (Toronto: Irwin Law, 2015) at 281-282.

[21] *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 at para. 20.
[22] *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 at para. 49.
[23] *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 at para. 50.
[24] *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 at para. 51.
[25] *Canadian National Railway v. Royal & Sun Alliance Insurance Co. of Canada*, 2008 SCC 66 at para. 33.
[26] Kirk Miller, "Why Insurance Policies for Directors and Officers Are Essential in the Cannabis Industry", *Cannabis Business Times* (29 January 2020) online.
[27] Kirk Miller, "Why Insurance Policies for Directors and Officers Are Essential in the Cannabis Industry", *Cannabis Business Times* (29 January 2020) online.
[28] Kirk Miller, "Why Insurance Policies for Directors and Officers Are Essential in the Cannabis Industry", *Cannabis Business Times* (29 January 2020) online.
[29] GB&A, "ICO Seeking D&O? Here's What You Need To Know!", *GB&A Insurance,* online.
[30] *Dunn v. Chubb Insurance Co. of Canada*, 2009 ONCA 538 at para. 33.
[31] *Canadian National Railway v. Royal & Sun Alliance Insurance Co. of Canada*, 2008 SCC 66 at para. 33; *Nova Growth Corp. v. Kepinski* 2014 ONSC 2763 at para. 65.
[32] *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 at para. 28; Craig Brown, *Insurance Law in Canada* (Toronto: Thomson Reuters Canada, 2021) at § 8:3.
[33] *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 at para. 25, Craig Brown, *Insurance Law in Canada* (Toronto: Thomson Reuters Canada, 2021) at § 8:3.
[34] Willis Towers Watson, "Insurance Marketplace Realities 2021 Spring Update", accessed January 7, 2022 online.
[35] *Fletcher v. Manitoba Public Insurance Corp.*, [1990] 3 S.C.R. 191,1990 CarswellOnt 56 at para. 58.
[36] Denis Boivin, *Insurance Law*, 2nd ed (Toronto: Irwin Law, 2015) at 20.
[37] Denis Boivin, *Insurance Law*, 2nd ed (Toronto: Irwin Law, 2015) at 20.
[38] *Sandborn Wholesale Ltd. v. Pottruff & Smith Insurance Brokers Inc.*, 2011 ONSC 1969 at paras. 57, 63.
[39] *Trial Lawyers Association of British Columbia v. Royal & Sun Alliance Insurance Company of Canada*, 2021 SCC 47 at para. 35; *Cheetham v. TD Life Insurance Co.*, 2013 ONSC 4892 at para. 6; Craig Brown, *Insurance Law in Canada* (Toronto: Thomson Reuters Canada, 2021) at § 5:1.
[40] *Sandhu Estate v. Fidelity Life Assurance Co.*, [1987] B.C.W.L.D. 3272, 6 A.C.W.S. (3d) 271 (B.C. Sup. Ct.).
[41] *2049390 Ontario Inc. v. Leung*, 2020 ONCA 164.

by Georges Dubé, Jeffrey Levine, Nicole Rozario

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against

making any decisions based on this material alone. Rather, specific legal advice should be obtained.

© McMillan LLP 2022