Is Your Indemnity Working For You?

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I have been asked on more than a few occasions to review corporate by-laws to confirm for clients whether or not there is an indemnity clause in favour of directors and officers. Under an indemnity clause, the company agrees to indemnify its directors and officers and former directors and officers (which I will simply refer to as "Directors") if they are sued while acting in their capacity as Directors. Sometimes the request comes from the company, and sometimes it comes from an individual considering an invitation to sit on the board of directors of a company, whether for-profit, non-profit or charitable.

"Indemnify" is a legal term meaning "to save harmless". Essentially, the law in Manitoba is that a company may agree to reimburse its Directors for all liabilities they may incur as a result of being sued or prosecuted for something they did in their capacity as Directors of the company. In order to qualify for the indemnity, a couple of conditions must be satisfied: the Directors must have acted in good faith and in the best interests of the company, and, in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, the Directors must have had reasonable grounds for believing that their conduct was lawful. This indemnity provision is set out in section 119(1) of The Corporations Act (Manitoba), and it is permissive. The company may give the indemnity, but it does not have to.

Typically, the indemnity, if the company has agreed to give one, will be set out in the company's general by-law. Most corporate by-laws do contain some type of indemnity provision, but the terms can vary. If the wording of the indemnity is consistent with the provisions of section 119(1) of the Act, a Director will be entitled to indemnification, subject only to the satisfaction of the conditions.

It is pretty well settled law in Manitoba that payment on an indemnity given pursuant to section 119(1) of the Act need not await completion of the legal proceedings. Based on the indemnity, the company may pay on-going defence costs, although if it does so, the company will be entitled to reimbursement from the Director if conduct which would disqualify the Director from his or her entitlement to the indemnity subsequently comes to light.

Contrast that with section 119(3) of the Act, under which a Director's entitlement to an indemnity arises only after the legal proceedings have been concluded. Section 119(3) provides that if a Director is substantially successful on the merits in his or her defence of an action or proceeding brought against him or her in his or her capacity as a Director, then the company does not have an option; the company must indemnify a Director in those circumstances, but only after the fact. The Director would have to fund the costs of defending the litigation out of his or her own pocket.

It often arises that Directors are sued at a time when the company is or is nearly insolvent. In these circumstances, the indemnity may be of little value to the Directors, unless there are assets of the company remaining after the resolution of claims ranking in priority to the claims of Directors.

The Corporations Act (Manitoba) permits companies to purchase director and officer liability insurance. If purchased, such insurance would insure a Director against any liability incurred in his or her capacity as a Director, regardless of the company's obligation to indemnify, except where the liability related to a Director's failure to act honestly and in good faith with a view to the best interests of the company.

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