

COURTS TO SCRUTINIZE ADVANCES PAID FOR LEGAL COSTS

Case Summary

The Supreme Court of Canada declined to hear the appeal of a number of directors who were denied an advance of their legal costs under an indemnity agreement.

The leave to appeal motion related to the Ontario Court of Appeal's decision in *Cytrynbaum v. Look Communications Inc.*, 2013 ONCA 455 ("Cytrynbaum"), which was issued July 4, 2013. In that decision, Justice Sharpe found that if a corporation brings an action against a director or officer, section 124(4) of the *Canada Business Corporations Act* requires that that officer or director obtain court approval before receiving an advance under an indemnity agreement to cover the legal costs of defending that action.

In *Cytrynbaum*, a number of directors and officers of Look Communications Inc. ("Look") were granted certain rights to compensation based on the appreciation of the company's shares under a Share Appreciation Rights Plan (the "Plan").

By 2008, Look's business was in decline. As a result, the Board arranged a sale of key assets to a third party partnership. Prior to closing of the sale, the Board passed a resolution to pay bonuses and equity cancellation payments (the "Impugned Payments") to the directors and officers (the "payees"), purportedly to compensate them in accordance with their rights under the Plan. Contrary to the terms of the Plan, however, the payments were made on the basis of a valuation of \$0.40 per share, which was twice the actual market price of \$0.20 per share.

Once disclosed, the Impugned Payments attracted strong shareholder criticism. In response, the Board passed a resolution to authorize Look to advance \$1.5 million pursuant to an indemnity agreement, which took the form of retainers to be used for paying the legal costs incurred by the payees in defending the action. The payees then resigned from the Board.

Look's new Board then brought an action against the payees claiming the repayment of the Impugned Payments, on the basis of, among other things, fiduciary breach, negligence and unjust enrichment. The new Board then refused to make the previously authorized advance. The payees commenced applications to obtain the advances.

The applications judge dismissed the payees' claims for the advancements. He considered the language of section 124(4) of the *Canada Business Corporations Act*, which requires court approval for any advances made to directors "in respect of an action *by or on behalf of the corporation*". (Although not considered by the application judge, section 136(4.1) of the Ontario *Business Corporations Act* uses similar language.) Although the marginal notes to the statute describe section 124(4) as relating to "[i]ndemnification in derivative actions", the applications judge found that the court's judicial oversight of advances extended also to non-derivative actions brought by the corporation.

The Court of Appeal affirmed the order of the applications judge. Justice Sharpe found that the language of the provision supported a broader scope of oversight, which outweighed the language of the marginal note in ascertaining Parliament's intent. He also declined to follow the approach taken in Delaware in which an advance must be paid under an indemnity agreement, whether or not there is a *prima facie* case of bad faith, because to do otherwise would allow the corporation to withdraw its prior promise of indemnity. In rejecting that approach, Justice Sharpe noted that the language of section 124(4) represents a fundamentally different policy choice taken by Parliament than was taken in Delaware.

As a result of this decision, where a court finds a strong *prima facie* case that the director or officer has engaged in bad faith dealings, it must deny the advance of legal costs under section 124(4) of the *Canada Business Corporations Act*, notwithstanding the terms of any indemnity agreement.

Author

James Gibson
Toronto
416.367.6238
jagibson@blg.com