

Canadian Income Trusts: Trustees and Directors Not Adequately Protected by Traditional D&O Insurance

Income trusts have become a popular business structure in Canada. In 2005 alone, the cumulative market capitalization of income trusts grew from \$69 billion to \$190 billion as a result of 32 IPOs and 21 conversions from traditional corporate structures. Income trusts, publicly traded investment trusts, are subject to Canada's securities law amendment, Bill 198, which imposes an increased burden of continuous disclosure. Has insurance protection kept pace with the resulting growth in personal liability for trustees and directors?

The Simple Answer: No

Non-traditional corporate structures, including income trusts, limited partnerships, general partnerships and other non-incorporated entities, will likely find that their Directors and Officers liability (D&O) insurance does not fully protect their trustees, partners, directors and officers. Traditional D&O products were designed for corporations, their incorporated subsidiaries and their directors and officers. Conventional D&O policies fall short on a wide array of issues, ranging from competing interests in policy constructs to coverage gaps within the policies.

Competing Interests

Insurance Structure – There are often competing goals in purchasing D&O insurance: cost effectiveness, adequate protection of independent directors and/or trustees, coverage breadth including non-rescindability and severability. The entity itself may benefit from coverage under the policy, but do the individual insureds want to share the aggregate policy limits with the company? Only through informed dialogue among all parties will the collective goals be determined.

Control of Policy – Which entity controls the policy, having the right to structure the policy, report claims and amend/cancel coverage? In income trusts, competing

interests among the various entities, trustees, directors and officers may raise issues of prioritization of claims payments, adequacy of limits for each insured and severability of the application and exclusions.

Insured v. Insured – Trustees have the highest fiduciary duty to unit holders. Often, decisions are delegated to operating company managers. Conflicts of interest may permeate the structure where trustees are also managers. In an even more extreme case, trustees may find themselves legally obligated to seek legal recourse against the directors and officers for mismanagement.

Coverage Gaps

There are a number of common D&O policy exclusions that can be onerous to income trusts.

Insured v. Insured – Excludes all claims brought by one insured party against another insured party (for example, claims by a trustee against directors or management).

Taxes – Liability issues associated with taxes may be specifically excluded from coverage. This is especially problematic in the context of an income trust specifically designed for tax efficiencies.

Definition of Subsidiary – Trusts may not fit the definition of a subsidiary found in most traditional D&O policies and therefore may not be covered.

Income Trust Exclusions – Some policy wordings may also impose additional exclusions particular to income trusts.

Adequacy of Limits

The trust structure imposes a further layer of management to the traditional corporate structure. Additional insureds accessing the policy limits raise questions about the adequacy of those limits.

Indemnification

Executive Liability coverage is designed to follow an organization's indemnification provisions. A trustee's legal right of indemnification is more limited than that of a director or officer of a corporation. It is therefore important to conduct a comprehensive review of indemnification provisions when designing an insurance policy to respond to risks inherent in income trusts. Side A coverage, which responds where no indemnification is available from the entity, may be important in a trust structure.

Consideration of the financial capability to meet indemnification requirements is also important. This is a key issue for a flow-through entity such as an income trust where cash flow sustainability and access to assets may be contentious.

Prospective Strategies and Solutions

The use of innovative language and policy construction within a tailored insurance program provides the opportunity to redress the limitations of a traditional D&O product. Here are steps to develop such a program:

- Analysis of risk
- Technical review of coverage
- Program structure – are competing interests adequately protected?
- Review of limits adequacy
- Craft and purchase of a Side A DIC (difference-in-conditions) policy which is non-cancelable, non-rescindable, and provides dedicated personal asset protection for directors, officers and trustees in instances where traditional insurance and indemnification are non-responsive or unavailable
- Craft and purchase of Trustee Liability policies

Willis publishes a US and a Canadian Executive Risks Alert series; both are available at www.willis.com.

Executive Risks Canadian Contacts

For further information, please contact any of the following:

Jonathan Ashall
145 King Street West
Suite 1200
Toronto, ON M5H 1J8
P- 416 646 8351
F- 416 869 1649
jonathan.ashall@willis.com

Murn Meyrick
145 King Street West
Suite 1200
Toronto, ON M5H 1J8
P- 416 216 0774
F- 416 869 1649
murn.meyrick@willis.com

Catherine Richmond
1500-1095 West Pender Street
Vancouver, BC V6E 2M6
P- 604 605 5611
F- 604 683 5746
catherine.richmond@willis.com