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# SUITABLY SHELTERED?

Indemnities and insurance for directors and officers



Guidance to in-house lawyers in English and Welsh companies on the corporate governance aspects of indemnities and D&O insurance

16<sup>th</sup> April 2009

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## Foreword

Each of our previous reports considered topics which are relevant to all in-house lawyers in England & Wales, regardless of the type of organisation they work for, or their speciality<sup>1</sup>.

This report considers some of the corporate governance issues raised by indemnities and insurance for directors and other officers (D&O) of companies incorporated in England & Wales and the in-house lawyer's role in dealing with these issues. We think that this is an important topic at any time, but especially now as the Credit Crisis and recession are exposing defects in some companies' corporate governance arrangements and other failings of their directors and officers.

This paper aims to:

- Discuss some of the corporate governance aspects of indemnities and insurance for directors and other officers.
- Suggest some ways in which the in-house lawyer can and should get involved in helping their company to obtain and maintain an appropriate level of insurance and indemnity protection for their directors and other officers and subsequently manage the process of claiming under these arrangements.

*The C&I Group Corporate Governance Committee*

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<sup>1</sup> *Reconciling the Irreconcilable?*, published in March 2005; *A Fine Line*, published in July 2006; *Whistleblowing*, published in April 2007; and *Data Protection*, published in January 2009.

## **A. Why is protection for directors and other officers required?**

### **A.1 Increased legal and regulatory exposure of directors and officers**

Over the last 30 years or so, there has been a steady increase in the legal and regulatory burden borne by directors of UK companies.<sup>2</sup> Lying behind this is the notion that applying civil and criminal sanctions to the management of companies is more likely to improve corporate behaviour than applying sanctions to the companies.<sup>3</sup>

Now, there is the prospect of a regulatory response to the Credit Crisis. Governments and regulators around the world have promised greater regulation of financial institutions, especially in the areas of remuneration, risk management and transparency. The FSA's regulatory philosophy has always placed a great deal of emphasis on the responsibilities of senior management. Recently, they have announced that they intend to renew their approach by seeking to hold more individuals accountable for wrongdoing at firms which they regulate, because they believe that action against individuals has a much greater impact in terms of deterrence than action against firms.<sup>4</sup>

Faced with this increasing legal and regulatory burden, directors will have to improve their own risk management skills and tolerate more scrutiny of their decisions, while still trying to drive their companies forward so that they can earn reasonable profits for their investors. They will in turn put pressure on their companies' senior management, including the senior in-house lawyer, to help them achieve these goals.

Directors and officers will never be able to eliminate entirely the risk of being investigated, sued or prosecuted, and they are likely to rely even more on their companies to provide them with a reasonable level of protection by way of indemnities and D&O insurance.<sup>5</sup>

### **A.2 The key Corporate Governance issue**

One can ask whether the practice of providing D&O insurance and indemnities to directors creates a hazard for companies. Namely, the leadership behaviour of senior management may be influenced by the comfort of such insurance and indemnities leading to excessive risk taking or the pursuit of profit in a manner which is ultimately detrimental to the organisation; and so, by

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<sup>2</sup>This is due to (a) UK and EU legislation, such as the Health and Safety at Work etc Act 1974, the Insolvency Act 1986, the Company Directors Disqualification Act 1986, the Data Protection Act 1998, the Financial Services and Markets Act 2000, the Enterprise Act 2002, the Companies Act 2006, and the Environmental Damage Regulations 2009; and (b) US law applying to UK companies doing business in the USA, in particular by virtue of class actions by investors and enforcement by the US Department of Justice and Securities and Exchange Commission (SEC) under US securities laws (the latter including investigations, potential prosecution and the risk of extradition by UK authorities to the USA under the Extradition Act 2003).

<sup>3</sup>See, for example, the conclusion in a discussion document issued by the Office of Fair Trading in November 2007 on the deterrent effect of competition enforcement following a survey by Deloitte of various UK companies and competition lawyers. The Deloitte report and the OFT consultation paper are both available at [www.offt.gov.uk](http://www.offt.gov.uk).

<sup>4</sup>Speech by Sheila Nicoll, Director, Retail Firms Division, FSA, on 17th September 2008, available at [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0917\\_sn.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0917_sn.shtml).

<sup>5</sup>The rationale of a system of corporate control which combines enterprise liability with personal "managerial" liability is summarised in Christopher Parsons, *Managerial liability, risk and insurance: an international view*, International and Comparative Corporate Law Journal, 3(1), pp 1-31.

providing directors and officers with protection against the consequences of their own behaviour, D&O insurance may reduce their incentives to act carefully.

One might expect insurers to mitigate this potential hazard by (1) pricing policies on the basis of their own assessment of the risk of having to compensate for losses, creating incentives for companies to minimise their individual risks, (2) monitoring the corporate governance practices of insured companies and pricing according to their perception of the companies' individual corporate governance arrangements and track records, and (3) influencing the defence (and settlement) of claims, thereby protecting themselves and the companies against unjustified payments. All of these could contribute to strengthening of corporate governance arrangements.

Some scholars in the United States suggest that providers of D&O insurance do not effectively do this because in practice (1) insurers generally do not carry out extensive due diligence on the insured companies, (2) pricing is often influenced by circumstances other than the insurers' risk assessments, (3) insurers do not provide effective loss prevention services to insured companies or monitor their corporate governance arrangements, and (4) insurers do not always effectively exercise their powers to manage claims and settlements.<sup>6</sup> Such commentators raise questions about the value of D&O insurance for shareholders and suggest that it undermines the deterrent effect of corporate and securities liability.

Professor Christopher Parsons, a UK scholar, comments as follows<sup>7</sup>:

*Generally, I think that the effect of liability insurance (and liability insurers) on the behaviour of insured persons (including directors) is pretty small. Realistically, insurers can never hope to closely monitor the behaviour of those they insure and then control it through pricing, policy terms, loss prevention etc. – especially in the case of small policyholders where the cost of doing so would be prohibitive. Equally, I don't think that having liability insurance changes people's behaviour very much, as liability insurance does not protect policyholders against many of the consequences of wrongful behaviour, including the stigma attached to it, potential loss of reputation, prospects of criminal prosecution, loss of employment etc. (Motor liability insurance certainly does not lead to careless driving, because most people realise that this is likely to result in injury to themselves as well as others – though D&O insurance is not analogous in this respect). In my view liability insurance provides a reasonable compromise between the need for victim compensation and the deterrence of wrongdoing by protecting insured persons against the consequences of inadvertent wrongdoing while not shielding them from the effects of criminality or wilful misconduct. Kraakman also makes the point that uninsured directors facing unlimited personal liability might become exceptionally risk averse and 'cheat' shareholders by adopting (excessively) low-risk strategies<sup>8</sup>. This counters, to some extent, the argument that D&O insurance encourages excessive risk taking.*

By permitting (albeit subject to various restrictions) companies to provide indemnities and D&O insurance to their directors, the Companies Act 2006 (the "Companies Act")<sup>9</sup> and (for listed

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<sup>6</sup> See for example Baker, Tom and Griffith, Sean J., *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market*. Chicago Law Review, Vol. 74, p. 487, 2007; and Baker, Tom and Griffith, Sean J., *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*. Georgetown Law Journal, Vol. 95, p. 1795, 2007.

<sup>7</sup> Professor Parsons kindly provided this comment in response to a previous draft of this report. He discusses this topic in greater detail in the article referred to in footnote 5 above, at pp 16-18.

<sup>8</sup> Kraakman, R. H., *Corporate Liability Strategies and the Costs of Legal Controls* (1984) 93 Yale Law Journal 857.

<sup>9</sup> Section 233 Companies Act (see Section B.7 below).

companies) the Combined Code of Corporate Governance (the “Combined Code”)<sup>10</sup> recognise the need for companies to provide a reasonable level of protection to their directors in respect of claims against them since, without indemnities and/or D&O insurance, suitably qualified individuals might be deterred from becoming directors or officers or, once appointed, might be deterred from remaining in their positions or from taking difficult decisions in a reasonable manner.

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<sup>10</sup> Paragraph A.1.5 of the Combined Code (see Section B.7 below).

## **B. What indemnities and D&O insurance and other protection are permitted?**

### **B.1 Funding directors' expenditure on defending proceedings**

#### ***B.1.1 Civil or criminal proceedings***

Section 205 of the Companies Act permits a company, without the need for shareholder approval, to provide a director with funds to meet expenditure incurred in defending any civil or criminal proceedings in connection with any alleged negligence, default, breach of duty or breach of trust by him in relation to the company or an associated company, or in connection with an application for relief. As an alternative to such funding, the company can enable the director to avoid incurring such expenditure, e.g. by providing a law firm with a guarantee relating to the costs of providing legal advice to the director.

Such funding or other liability is, however, only permitted if the terms provide that the director is obliged to repay the loan, or (as the case may be) discharge the liability, if the director is convicted in any criminal proceedings, or judgment is given against him in any civil proceedings, or he is unsuccessful in an application for relief. In those cases, the director has to repay the funding or discharge the company's liability no later than the date the conviction, judgment or refusal becomes final.

For listed companies, the FSA Listing Rules exempt such funding from the normal requirement for shareholder approval of related party transactions.<sup>11</sup>

#### ***B.1.2 Regulatory investigations or actions***

Pursuant to Section 206, the company can, also without shareholder approval, provide a director with funds to meet expenditure incurred in defending regulatory investigations or actions, or enable him to avoid such expenditure. Unlike with funding in connection with civil or criminal proceedings, there is no requirement that funding of defence costs in relation to regulatory investigations or actions must be conditional on repayment if the director is unsuccessful (e.g. if he is sanctioned by the regulator).

On the other hand, for listed companies, the Listing Rules do not exempt such funding from the normal requirement for shareholder approval of related party transactions. Accordingly, listed companies must obtain shareholder approval before making a loan to a director in relation to regulatory actions.<sup>12</sup>

### **B.2 Exemption of directors from liability is strictly prohibited**

Section 232(1) states that any provision that purports to exempt a director of a company to any extent from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company is void. Accordingly, a

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<sup>11</sup> See LR 11.1 and LR 11 Annex 1R - Transactions to which related party transaction rules do not apply.

<sup>12</sup> See LR 11.1.

company can neither exempt a director from a liability nor limit his liability in relation to the company.

Note that this prohibition would not apply to liability incurred by a director acting in another capacity, for example as company secretary or in-house lawyer.

### **B.3 Indemnification of directors only when permitted**

Under Section 232(2), a company is prohibited from (directly or indirectly) indemnifying (to any extent) a director of the company, or of an associated company, against a liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company, unless it is a provision of insurance, a QTPIP or a QPSIP (see Sections B.4 and B.5 below).

The prohibition does not extend to liabilities of officers other than directors. It therefore does not prevent companies from indemnifying officers such as the company secretary.

### **B.4 Qualifying third party indemnity provisions (“QTPIP”)**

To constitute a QTPIP, the relevant provision must satisfy the following conditions:

- It may only indemnify against liability incurred by the director to a person other than the company or an associated company.
- It must not provide any indemnity against any liability of the director to pay—
  - a fine imposed in criminal proceedings, or
  - a sum payable to a regulatory authority by way of a penalty in respect of non-compliance with any requirement of a regulatory nature (however arising); and
- It must not provide any indemnity against any liability incurred by the director—
  - in defending criminal proceedings in which he is convicted, or
  - in defending civil proceedings brought by the company, or an associated company, in which judgment is given against him, or
  - in connection with an application for relief in which the court refuses to grant him relief.

Section 236 provides that a company has to disclose QTPIPs in its directors’ report.

Sections 237 and 238 require the company to keep copies of QTPIPs available for inspection by any shareholder.

### **B.5 Qualifying pension scheme indemnity provision (“QPSIP”)**

Section 235 permits a company that is a trustee of an occupational pension scheme to indemnify its directors against liability incurred in connection with the company’s activities as trustee of the

scheme. As with QTPIPs, a QPSIP cannot be provided to cover criminal fines, regulatory penalties or costs incurred by the director in defending criminal proceedings in which he is convicted. Unlike a QTPIP, a QPSIP may enable a company to indemnify a director in respect of liability incurred by that director to the company.

Sections 236-238 regarding disclosure of indemnities and availability of copies for inspection apply to QPSIPs as well.

## **B.6 Ratification**

Section 239 codifies the right of a company's shareholders to ratify a director's negligence, default, breach of duty or breach of trust in relation to the company by passing an ordinary resolution, unless the articles require a higher majority or unanimity. Such ratification relates to a breach which has already occurred, as distinct from an exemption or an indemnity granted prior to a breach.

A significant change made by the codification of law under the Companies Act 2006 is that the votes of the director concerned (if he is also a shareholder) and those of any persons connected to him must be disregarded with respect to the ratification resolution (Section 239(3)).<sup>13</sup>

Case law has established certain types of breach of duty which are incapable of ratification by an ordinary resolution of members and for which only the unanimous consent of the members will suffice to ratify the conduct. A fraud on the company's creditors cannot be ratified at all.

## **B.7 D&O Insurance**

Section 233 provides that the Section 232(2) general prohibition on companies indemnifying their directors does not prevent a company from purchasing and maintaining for a director of the company, or of an associated company, insurance against any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company.

While such insurance is not mandatory under the Companies Act, listed companies which are subject to the Combined Code are generally expected to take out D&O cover. Paragraph A.1.5 of the Combined Code states that the company "should arrange appropriate insurance cover in respect of legal action against its directors". No further guidance is provided by the Combined Code as to what "appropriate insurance cover" implies. However, for a general discussion of this topic the Guidance Note on D&O insurance produced by The Institute of Chartered Secretaries & Administrators (ICSA)<sup>14</sup> may be referred to, keeping in mind though that several developments have had an impact on directors' liabilities (e.g. the Companies Act) and corresponding need for insurance since the last edition of that guidance note in 2005.

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<sup>13</sup> Since this new restriction does not apply to the voting of director-members on authorization in advance of an act which would otherwise be in breach of a duty, prior authorization can be preferable over subsequent ratification.

<sup>14</sup> ICSA Guidance Note ref no 030925, available at [www.icsa.org.uk](http://www.icsa.org.uk). That paper aims to provide a check-list of some of the major issues that prospective directors should consider, both to help them understand D&O insurance and also to evaluate the cover provided by companies they are considering joining; and is a useful aide memoire for existing directors and for organisations when considering their own requirements for such cover.

## **B.8 Restrictions on scope of indemnities and D&O insurance**

Sections 232(2) and 234 together prohibit companies from providing indemnities to their directors for liabilities incurred to the company itself<sup>15</sup>, liabilities to pay criminal fines or regulatory penalties, and/or liabilities incurred in *unsuccessfully* defending criminal proceedings, civil proceedings brought by the company, or an application for relief in which the court refuses to grant relief. The rationale is public policy (as such indemnities would defeat the object of imposing civil or criminal duties on directors) and would therefore also be an incorrect use of a company's resources.

Section 233 does not contain similar restrictions in relation to D&O insurance cover. However, for public policy reasons, insurance cannot be obtained in relation to criminal penalties incurred as a result of wilful conduct such as fraud. Also, the FSA prohibits firms which it authorises from entering into, arranging, claiming on or making a payment under a contract of insurance that is intended to have, or has or would have, the effect of indemnifying any person against all or part of a financial penalty. It explains that the purpose of this prohibition is to ensure that financial penalties are paid by the person on whom they are imposed.<sup>16</sup>

## **B.9 Requirement for disclosure of indemnities, but not D&O insurance**

Section 236 requires a company to disclose qualifying indemnities in its directors' report and to keep copies of indemnity provisions available for inspection by any shareholder. These disclosure obligations might be seen as the quid pro quo for Section 234 allowing boards to approve QTPIPs, without the need for shareholder approval.<sup>17</sup>

However, the Companies Act does not require companies to disclose the D&O insurance cover which they obtain for their directors, despite the fact that such insurance can cover the directors for a broader range of risks than indemnities. The Listing Rules require companies to which the Combined Code applies to include a corporate governance statement in their annual financial report, and if a company has not taken out D&O insurance cover as recommended by Paragraph A.1.5 of the Combined Code, it will have to explain why. The Listing Rules, however, do not require the disclosure of details of the insurance cover. While some companies merely state in their report that such insurance is in place without giving any details, other companies disclose details such as the premium paid or even the main terms of the policy.

## **B.10 Freedom to indemnify officers other than directors and other non-directors, and to provide them D&O cover**

Section 232(2) only applies to directors. Accordingly, the Companies Act does not restrict companies from exempting or indemnifying officers, such as the company secretary and other members of senior management even against successful claims by the company itself. Nor are there any restrictions on indemnifying *former* directors.

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<sup>15</sup> Unless the company is the trustee of an occupational pension scheme: see the summary of Section 235 above.

<sup>16</sup> See FSA Handbook GEN 6.1.3G and 6.1.5R.

<sup>17</sup> While for listed companies LR 11 requires shareholder approval of related party transactions, there is an exception to that requirement in relation to an indemnity if the terms of the indemnity are in accordance with those specifically permitted to be given to a director under the Act.

The Companies Act does not restrict companies from buying D&O insurance for non-directors and does not require disclosure of any such cover.

However, the directors' duties should deter them from providing to non-directors excessive or otherwise inappropriate indemnities or insurance cover.

### **B.11 Interaction between indemnities and D&O insurance**

Indemnities and D&O insurance typically are not alternatives but complement each other.

With an indemnity:

- the loss covered is usually wider than the scope of loss typically covered by an insurance policy (which usually contains several exclusions) but must not provide cover for directors in respect of claims by the company for breach of duty;
- there are generally no deductibles or monetary limits (but it is possible to include such limits);
- an indemnity may cover a director for liabilities incurred prior to the grant of the indemnity; and
- an indemnity is less open to termination for omissions than a D&O insurance policy.

However, D&O insurance:

- may provide cover for directors in respect of claims (including successful claims) by the company for breach of duty;
- generally does not require advanced defence costs to be repaid even if a director is found liable to the company for breach of duty<sup>18</sup>; and
- should be available to meet claims even if the company becomes insolvent (assuming prior payment of premiums).

Note that some D&O insurance policies contain a term to the effect that the company will be deemed to have provided its directors with the fullest indemnity permitted by law and that the insurer's liability is qualified accordingly.

### **B.12 The directors' duties when deciding on indemnities and D&O insurance**

The directors must comply with their duties when deciding what indemnities and insurance the company should provide, when negotiating the terms of the indemnities and insurance, and subsequently when the company has to handle claims under the indemnities or to make claims under the insurance. They should take particular care to comply with their statutory duties to act within powers (Section 171), and to avoid conflicts of interest (Section 175). If necessary, the

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<sup>18</sup> For example, while insurance against financial penalties is prohibited (FSA GEN 6.1.5, see above), this does not prevent an insurance for the costs of defending FSA enforcement action or any costs to be paid to the FSA (GEN 6.1.7). Accordingly, a policy is not required to provide for repayment of costs advanced if the FSA finds against the insured.

company's insurance broker can be requested to benchmark such matters across a peer group to help the board assess what is appropriate.

The articles of association need to be checked to ensure compliance with any provisions the articles may contain with respect to providing indemnities and purchasing of insurance. For example, some articles expressly address the potential conflict of interest in directors deciding to grant indemnities to, or to purchase insurance for, themselves or a fellow director. Some companies have amended their articles to the effect that the prohibition for directors to vote on any resolution of the board in respect of a contract in which the director has an interest does not apply where that interest arises from the giving to the director of any indemnity (provided that all other directors are also being offered indemnities on substantially the same terms) or from any contract for the purchase of insurance for the benefit of the director.

## **C. Indemnities - other corporate governance issues to consider**

### **C.1 Form of the indemnity**

The Companies (Model Articles) Regulations 2008 contain model articles (the “Model Articles”) for both private and public companies providing that the company may indemnify its directors and former directors in accordance with the Companies Acts.<sup>19</sup>

In practice, two main forms of indemnities are used:

- Deed of indemnity: The company and each beneficiary can enter into an individual agreement providing for the indemnity. This provides the company with greater flexibility to negotiate different terms with each beneficiary, or to terminate the indemnity with respect to an individual beneficiary.
- Deed poll: The company can issue a deed poll, granting an indemnity to a defined group of beneficiaries. This has the practical advantage of enabling the company to issue a single deed poll, which will stay in place despite turnover in the beneficiaries. It also has the great advantage, in terms of corporate governance, of treating all of the defined group equally.

There is a third way which some companies have pursued, namely to alter the articles to provide (as opposed to merely permit) the indemnity. This is unsatisfactory so far as the director is concerned, and we do not recommend it. The articles of association of a company are not automatically binding as between a company and its officers as such and an individual director may struggle to establish that the provision was incorporated into his contract.<sup>20</sup>

### **C.2 Persons to be covered**

We think it would normally be reasonable for the indemnity to cover at least each of the persons mentioned in the Model Articles – i.e. the company’s directors and former directors.

Unlike the final Model Articles, the March 2008 draft for such articles also expressly provided that the company may indemnify officers other than directors. Though the draft articles did not define the term “officer”, in the light of Section 1173(1) this would have been to be interpreted as including (at least) a director, manager or secretary, however leaving room for a broader interpretation since the definition in Section 1173(1) is not exhaustive.

The exclusion of officers other than directors from the relevant provisions in the final Model Articles does not mean they may not be indemnified. As pointed out above, the Companies Act only restricts indemnities granted for the benefit of directors while officers other than directors are not subject to these restrictions. The Model Articles reflect this position.

A company may therefore also consider extending the indemnity to other officers. A key issue for in-house lawyers is whether the term “officer” would apply to them when acting in that capacity or

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<sup>19</sup> SI 2008/3229, coming into force on 1 October 2009. See Articles 52 (for private limited companies), 38 (for companies limited by guarantee), and 85 (for PLCs) of the Model Articles.

<sup>20</sup> See *Globalink Telecommunications Ltd v Wilbury Ltd* [2002] EWHC 1988 (QB).

as, say, the compliance officer. Others who might well wish to be included are the heads of risk and internal audit. There may be good grounds for such officers also to be covered by the indemnity and they should be specified as intended beneficiaries of the indemnity so as to avoid any uncertainty as to whether they are included in the term “officer”. On the other hand, the company’s external auditors would not be included in the term “officer” for this purpose, as an indemnity to an auditor of the company is void (with limited exceptions only) under Section 532 of the Companies Act.

### **C.3 Scope of the indemnity**

For directors, the indemnity will often be as comprehensive as permitted by law: i.e. it will extend to any liability suffered or incurred by any beneficiary in respect of his acts or omissions in the course of his employment while he is also a director, as well as in his capacity as a director or officer, respectively, arising in connection with any claim, proceeding, investigation or action brought against the beneficiary, but excluding indemnity for liabilities incurred to the company itself, liabilities to pay criminal fines or regulatory penalties, or legal costs incurred in *unsuccessfully* defending criminal proceedings, civil proceedings brought by the company, or an application for relief in which the court refuses to grant him relief.

For non-directors, Section 234 is not applicable, and it would therefore be open to the company to indemnify them against a wider range of liabilities than directors, subject only to general principles of contract law (e.g. not to permit an indemnity against the consequences of the beneficiary’s own fraud). We believe that in practice non-directors are usually *not* granted wider indemnities than directors, perhaps because the restrictions in relation to directors are considered to be reasonable in relation to other officers as well.

Deeds of indemnity often include provisions on the funding by the company of expenditure incurred by a beneficiary in defending any civil, criminal or regulatory proceedings or actions against him in connection with alleged wrongdoings by the beneficiary in his capacity as director or officer. In addition to reflecting the restrictions provided for by the Companies Act, the company will usually only agree in the deed of indemnity to provide a loan which it considers appropriate and under the terms it deems appropriate in the relevant situation. This is understandable, as the company will want to retain discretion whether to provide a loan for a director’s or officer’s defence costs where, for example, the company itself has brought the claim against that person, or it is concerned about that person’s ability to repay the loan if judgment is given against him/her. However, the company’s exercise of that discretion should be impartial, as discussed below.

### **C.4 Conduct of claims**

An indemnity gives each beneficiary a direct claim against the company. The indemnity should impose an obligation on each beneficiary to notify the company of any claim or circumstance that could give rise to a claim potentially covered by the indemnity and an obligation to keep the company informed of the progress of the claim. This will enable the company to carry out its own investigation of the circumstances of the claim, and to notify its D&O insurers if it has D&O insurance cover for payments it makes under the indemnity (see Section D below).

In order to protect the company’s reputation (as well as to control legal costs), the indemnity may enable the company to instruct the beneficiary how to defend or settle a claim, and to take sole conduct of the claim, including the right to settle the claim at its discretion.

Companies should handle claims under the indemnity, and exercise rights which the indemnity provides the company (e.g. discretion whether to provide a loan for a director's or officer's defence costs, or to defend or settle a claim), in the company's best interests. However, this may be difficult when the circumstances of the claim raise potential conflicts of interest for individual directors and officers. Conflicts may arise, for example, when:

- a director is himself defending a claim by a third party, a criminal proceeding or a regulatory investigation,
- when a number of directors and officers are defending such claims etc and there is at the same time a potential dispute between the various directors and officers (perhaps because some are blaming others for the problem), or
- a third party claim shows that the company may have a claim against the director.

In these situations, the board (in particular, the independent NEDs, if any) should ensure that there is an independent investigation of the circumstances of the claim and, if the investigation reveals that a director or officer has performed badly or is guilty of some wrongdoing, should take appropriate action against that person. The board should also oversee such investigation and the process of handling the claims, with the assistance of the company secretary and/or the head of legal (or specialist head of compliance, if the company has one).

## D. D&O insurance - other corporate governance issues to consider

### D.1 Types of policy

As mentioned in Section B, there is no restriction under the Companies Act on a company's power to provide D&O cover for their directors and other officers.

The Model Articles expressly permit the directors to purchase and maintain D&O insurance, at the expense of the company, for the benefit of any relevant director in respect of any relevant loss. They define a "relevant director" as any director or former director of the company or an associated company, and "relevant loss" as any loss or liability which has been or may be incurred by a relevant director in connection with that relevant director's duties or powers in relation to the company, any associated company or any pension fund or employees' share scheme of the company or an associated company.<sup>21</sup>

In practice, D&O insurances are normally taken out covering one or a combination of the following components<sup>22</sup>:

- "Side A" provides individual directors and officers cover for non-indemnifiable losses, i.e. losses that the company cannot pay for.
- "Side B" provides for reimbursement of the company for payments it is due to make to individual directors and officers under an indemnity in relation to the costs of claims, settlements and legal defence. Side B is often known as "Company Reimbursement Cover".
- "Side C" covers losses suffered by the company from securities claims made against the company itself. Companies may also be able to buy broader entity cover to include employment practices liability and costs in defending corporate manslaughter claims. Side C is often known as "Entity Cover".

D&O insurances are generally 'claims made' contracts. Professor Parsons comments as follows:

*D&O policies, like Professional Indemnity insurance, but unlike Employers' Liability, Public Liability etc., are 'claims made' contracts – meaning that the insurer which pays is the one on risk when the third party makes a claim against the insured (in effect the current insurer) rather than the insurer that was on risk at the date of the negligent act which led to the claimant's loss, or the date of the loss itself. D&O insurers are liable for claims notified in the period of insurance but, of course, the insured also has to notify potential claims ('circumstances which may give rise to a claim'). If the insured does notify such potential claims then they are deemed to have occurred in the period of insurance if they subsequently become actual claims, even if the policy been cancelled or another insurer has taken over the risk. Conversely, if the insured fails to notify potential claims in a timely way they will be refuted if they subsequently crystallise into actual claims and the policy could be avoided ab initio if it has been renewed in the meantime. In my*

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<sup>21</sup> See Articles 53 (for private limited companies), 39 (for companies limited by guarantee), and 86 (for PLCs) of the Model Articles.

<sup>22</sup> For more detail on the contents of D&O policies, see the ICSA Guidance Note referred to in the Foreword.

*experience failure to notify properly is the most common ground on which insurers seek to avoid liability under claims made policies, so it may be worth emphasising how important all this is.*<sup>23</sup>

## **D.2 Scope of Side A insurance and persons to be covered by it**

For the reasons mentioned in Sections B.8 and B.11 above, Side A insurance is capable of filling some (but not all) of the gaps in the indemnities that the company is allowed to provide to its directors in order to mitigate their legal and regulatory burden. In practice a distinction is drawn between liabilities which are considered acceptable to protect against, and those which are considered unacceptable. It is generally considered acceptable to provide D&O cover to a director against: claims by the company itself or an associated company against a director for breach of duty, even if the company is successful; and legal costs incurred by a director in civil proceedings brought by the company in which judgment is given against him, in regulatory investigations and proceedings relating to the affairs of the company, or in connection with an application for relief in which the court refuses to grant him relief. On the other hand, for the reasons mentioned in Section B.8 above, D&O policies generally do not extend to fines and penalties levied by regulators or criminal courts, and legal costs incurred unsuccessfully in relation to fraud or dishonesty findings (the director being required to repay those amounts if he is found guilty, regardless whether he can still appeal)<sup>24</sup>.

As with indemnities (see Section C.2 above), we think it would normally be reasonable for Side A insurance to cover at least each of the persons mentioned in the Model Articles – i.e. the company’s directors and former directors. In addition, companies may wish to consider buying appropriate insurance for other officers (other than the external auditors).

## **D.3 Monetary limits**

There is no right answer as to the level of D&O cover which a company should purchase. Much will depend on the size of the company, the nature of its business, the quality of its self-risk assessment, and where its shares are traded (e.g. a US-listed company may want to purchase higher limits than a UK-listed company or a private company). There were reports that Equitable Life’s former directors had only £5 million in cover, when they were sued for £1.7 billion for alleged negligence, and had to face a lengthy and complex trial. Since then, it has become quite common for FTSE 100 companies to buy in excess of £150 million of cover, especially when they have US SEC exposure.<sup>25</sup> Reports on other European companies such as Siemens AG suggest similar amounts.<sup>26</sup> Companies usually consult with their insurance brokers as to what is a reasonable level of cover for their directors and other officers, given the nature of their business, the comparables in the market and the costs.

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<sup>23</sup> Professor Parsons provided this comment in response to a previous draft of this report. He discusses this topic in greater detail in the article referred to in footnote 5 above, at pp 10-11.

<sup>24</sup> Other common restrictions and/or exclusions are listed in the ICSA Guidance Note. Buyers of D&O cover may request the inclusion of “final adjudication” wording that provides defence on appeals and where repayment of legal costs is only required if all appeals are exhausted or an appeal is not sought.

<sup>25</sup> Guy Carpenter, Casualty Specialty Update September 2003, p.12 (<http://www.guycarp.com/portal/extranet/insights/reports.html>).

<sup>26</sup> In April 2008, Financial Times Deutschland reported Siemens AG preparing to sue former members of the management board for damages in connection with its alleged bribery scandal, seeking also €250m from insurers based on D&O insurances.

Another potential issue to be considered is that successful claims exceed the available coverage. Often the coverage will be available on a first come, first served basis with respect to the relevant period. However, companies and individual directors may wish to consider alternative concepts such as looking to policies that provide separate limits for the NEDs, or that NEDs may even be covered under separate policies, so that they are not affected by claims made by the executive directors.

#### **D.4 Deductibles**

Being obliged to pay one's own deductible obviously provides an incentive to act carefully, and so might help to mitigate the hazard point referred to in Section A.2 above.<sup>27</sup> However, the market practice is to have deductibles only on Sides B and C cover (i.e. cover for the entity, not the individuals).

A company may be able to lower costs of D&O by opting for higher deductibles. This shows an underwriter that a company is taking a risk and the higher the deductible the more confident they are about being a good risk. There are different deductibles for different types of loss. It is common to have one deductible in US dollars for US claims and a lower deductible in local currency for 'rest of world' claims. Also, for listed entities there are usually higher deductibles for US securities claims.

If deductibles are included, the directors need to understand when and how they apply. For example, the difference between a single event and a series of events can become crucial where the deductible applies per single event.

#### **D.5 Disclosure to the insurer**

When a company first takes out a D&O policy, and whenever it renews it, the insurer will require information to assess the risk it will take under the insurance. The scope and breadth of the investigation conducted by the insurer (including a due diligence process, if appropriate) will depend on the circumstances of each case, in particular on the size of the company and the nature of its business, as well as the current conditions of the insurance market.

Material misrepresentation may enable the insurer to avoid any liability under the insurance policy. In addition, some proposal forms for D&O policies may include a "basis of contract" clause to the effect that every statement in the proposal form is given the status of a warranty. As a result, any error in the proposal form, even if trivial, can be used by the insurer to reject claims made under the policy. Combined with the absence of a proper severability clause, an error by one director in completing the proposal form could result in the policy for the benefit of the company and all the directors being avoided. Consequently, companies normally seek to have the "basis of contract" clause removed.<sup>28</sup>

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<sup>27</sup> For example, the Section 3.8 of the German Corporate Governance Code recommends that if the company takes out a D&O insurance policy for the executive board and supervisory board, a suitable deductible should be agreed. However, that provision of the German Corporate Governance Code is itself subject to debate. Some German companies do not comply, arguing that because they have group policies covering different groups of individuals it would not be fair to have the same deductible for all despite differences in salaries etc.

<sup>28</sup> Critics of this clause are now also supported by the provisional proposals of the English and the Scottish Law Commissions, which in July 2007 published their joint consultation paper on insurance contract law. For business contracts, the commissions argue that

Some standard D&O policies anticipate these arguments by not only excluding the “basis of the contract” clause but also including general provisions to the effect that (a) no statements made, nor any information or knowledge possessed by any insured person, nor any acts, errors or omissions of any insured person, shall be imputed to any other insured person, and (b) the insurer irrevocably waives any right it may have to rescind or avoid the policy, or any part of it, on the grounds of innocent or negligent non-disclosure or innocent or negligent misrepresentation by any insured. The aim is to make it very difficult for the insurer to avoid the policy for misrepresentation by the company, in the absence of fraud, or any individual insured. Professor Parsons comments that a D&O policy is likely to be construed as a composite insurance policy (effectively a bundle of contracts covering each director separately), but companies normally request the inclusion of a “severability” clause to put the matter beyond doubt.<sup>29</sup>

## **D.6 Conduct of claims**

In relation to the handling of claims under a D&O policy, issues similar to those discussed above in respect of claims under indemnities arise (see Section C.4). In particular, the insurance cover should be treated as an asset of the company, with claims being made and managed as carefully as if the company’s own assets were being drawn on.

## **D.7 Non-executive directors**

The ICSA Guidance Note points out that it is good practice for summary details of the D&O cover to be given to non-executive directors on their appointment. Being outside the day-to-day operations of the company, non-executives may want assurance (e.g. from the company secretary) that the company has actually paid the premium. They may be concerned about the quality of the disclosures that the executives have made to the insurer when taking out the cover. They may also be concerned about having to compete with other directors if they all have to claim under the policy. Finally, they may be concerned about claims made after they cease to be directors, and the availability of “run-off” insurance. For all these reasons, some non-executive directors are working with brokers to develop “portable” cover, which they will buy for themselves and which will cover each of their directorships.<sup>30</sup>

## **D.8 Run-off Cover**

Some D&O policies provide “run-off” cover for retired directors, which covers them for claims made against them after they retire, triggered only if the company no longer buys D&O cover for them.

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insurers should not be able to use a “basis of the contract” clause on a proposal form to convert all the answers given into warranties. Instead the commissions provisionally propose that a warranty of past or present fact must be set out in a specific term of the policy or an accompanying document. The Law Commission Consultation Paper No 182 and The Scottish Law Commission Discussion Paper No 134, Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured, para. 5.116, available at <http://www.lawcom.gov.uk/docs/cp182.pdf>.

<sup>29</sup> Professor Parsons provided this comment in response to a previous draft of this report.

<sup>30</sup> We are indebted to Graham Durgan of Emile Woolf International Training Professionals for many of the thoughts in Section D.7.

## **E. The role of in-house lawyers**

### **E.1 Advising the board on the corporate governance issues**

As discussed above, there are many corporate governance issues for the board to consider when deciding what indemnities and/or D&O cover the company should provide to its directors and officers. The company secretary (who may also be the senior in-house lawyer) should normally advise the board on these issues. The company's risk manager and head of HR may also have views.

The directors and officers need guidance on the indemnities and D&O cover, so that they understand what is in place, what risks are or are not covered, and what their personal obligations are. This guidance might be coordinated with any training on directors' duties (including updates on new developments), so that the directors are aware of all the issues in context.

As mentioned in Sections C.4 and D.6 above, conflicts of interest may arise when claims are made under indemnities and/or D&O cover. The company secretary and/or the senior in-house lawyer should assist the board to oversee such claims.

### **E.2 Arranging indemnities**

The company secretary and/or the senior in-house lawyer should be involved in drafting the indemnities, and should ensure that they reflect the board's stance on the corporate governance issues discussed above. It would be prudent to take external legal advice on these documents, and once they are in place to review them regularly, so as to ensure that they take account of the latest market practice and are enforceable in accordance with their terms (subject to the usual exceptions). They should liaise with the company's risk manager and head of HR, in case they have comments and to keep them informed.

### **E.3 Arranging and renewing the D&O cover**

The company secretary and/or the senior in-house lawyer should be involved in discussing the scope of insurance with the company's risk manager and its insurance broker and should ensure that the terms and cost reflect the board's stance on the above corporate governance issues. They should also ensure that the D&O insurance dovetails with the indemnities and that any necessary disclosures are made to the insurers. This may include providing a copy of the company's risk assessment review.

They should review the insurance annually, together with the company's internal risk manager and its insurance broker, to ensure that the cover remains appropriate, and that any necessary disclosures are made to the insurers. Items that may need to be disclosed include: any changes in the nature of the company's business or of the jurisdictions in which it operates; acquisitions of companies (especially if they operate in the USA); and issues of new securities over a certain threshold. The effect of a change of control of the company also needs to be considered as it may well mean the insurance moves to a run-off basis and is not open to new claims

#### **E.4 Notifying claims to the D&O insurers**

Policies generally require that the insurer is promptly notified of any claim raised and normally the insurer will need to be notified of circumstances which may give rise to a claim. The company's senior management should allocate responsibility to a particular individual for notifying claims. If you are allocated this responsibility, make sure that you have a reliable means of learning about any potential claims and circumstances which may give rise to a claim; keep a good record of any notifications you receive internally and notifications that you make externally. It is very important to have good lines of communication with the HR department, as they may often learn of potential claims or circumstances before the senior in-house lawyer.

#### **E.5 Management of claims under the indemnities and/or the D&O cover**

The in-house lawyers' role in relation to the management of claims will usually include:

- advising the company how to comply with the terms of the indemnities and/or the D&O policy: for example, whether the insurer's consent is necessary with respect to the choice of legal counsel, the incurrance of defence costs and/or the settlement of a claim; or whether the company should inform the insurer about any material events and circumstances in relation to the claim and proceedings;
- advising on identifying and managing any potential conflicts of interest on the part of the directors and officers claiming under the indemnities and/or D&O policy;
- escalating issues (such as disputes between individual directors and officers) to the board where appropriate;
- ensuring that claims under D&O cover are notified properly and in due time, and that the claims process is properly documented; and
- taking care to preserve legal privilege where appropriate.

#### **E.6 The in-house lawyer's own position**

In-house lawyers may play a variety of roles in a company, such as legal advisor, compliance officer, director or company secretary.

When acting purely in their capacity as legal advisors, in-house lawyers are not likely to be covered by the company's standard indemnities and D&O insurance (unless the terms are wide enough). Nor is there likely to be a compulsory professional indemnity insurance cover in place since under the Solicitors' Code of Conduct 2007 this is only required where the solicitor acts for a client other than his or her employer in relation pro bono work; commercial telephone legal advice services; as a lawyer employed by a law centre, charity or other non-commercial advise services; or as a solicitor employed by lawyers of other jurisdictions. The Code of Conduct expressly provides that, in all other cases, the employed solicitor must consider whether his or her employer has appropriate indemnity insurance or funds to meet any award made as a result of a claim in professional negligence against the solicitor, for which the employer might be vicariously liable.<sup>31</sup> Accordingly, as

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<sup>31</sup> Solicitors' Code of Conduct 2007, Rule 13.01.

being named as an insured under D&O insurance is not currently common, the in-house lawyers should discuss with their senior management whether the company should obtain professional indemnity insurance to protect them from claims, in the same way as external lawyers are routinely protected. If the company will not provide such insurance, the in-house lawyers will have to consider taking out their own insurance. In addition to insurance, in-house lawyers may wish to consider whether they should ask to be covered by indemnities granted to officers, bearing in mind that such indemnities would not normally cover a successful negligence claim by the company itself against the in-house lawyer.

If and when acting in the capacity of director or company secretary, in-house lawyers should be covered by the company's standard indemnities and D&O cover. If and when acting in the capacity of compliance officer, their position may be uncertain, and they should check whether in such capacity they are expressly covered by the company's indemnities and D&O cover (or have a separate indemnity and cover).

If they have no other cover, in-house lawyers may find it useful to take up the option of legal expenses cover under their home insurance. This may cover the legal expenses incurred in bringing or defending legal proceedings (such as a claim for damages, specific performance or an injunction) in connection with a contract of employment, subject to a limit of say £50,000 or £100,000. This may be useful if a legal action has started or is imminent, but may not cover disciplinary proceedings as a pre-cursor to legal action. It is worth checking what cover you already have, and whether you should increase it – but remember to do this before an issue arises!

## **Disclaimer**

The information contained in this document is given in good faith with the intention of furthering the understanding of its subject matter. Whilst the Corporate Governance Committee of the Commerce & Industry Group (“Committee”) believes that it is accurate and up-to-date as at the date on which it was approved for publication (16<sup>th</sup> April 2009), none of the Committee, the Commerce & Industry Group, the Law Society of England and Wales, or any of their respective members or employees accept any liability:

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## **Acknowledgments**

The C&I Group Corporate Governance Committee would like to thank Andre Basile of AIG UK Limited, Graham Durgan of Emile Woolf International Training Professionals, Clive Edrupt of CBI Company Affairs, and Professor Christopher Parsons of Sir John Cass Business School for their comments on earlier drafts of these guidelines. The Committee of course retains responsibility for the final version.

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