

Directors and Officers Insurance - Do you need it?

Expert knowledge means success



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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

In recent years, directors and officers liability insurance has become a core element of business insurance. In the US, as many as 95% of Fortune 500 companies maintain directors and officers (“D&O”) liability insurance. In the UK, the directors and officers of more than 60% of UK companies are now covered by D&O insurance.

The obligations and responsibilities of directors and officers are increasing. In the UK, many directors are obliged to follow the guidance of the Combined Code on Corporate Governance, as well as responsibilities in the area of Internal Controls. Today, directors can also be held liable for corporate manslaughter. All of this means that directors and officers are now held responsible, at unprecedented levels, for the management decisions they make. As UK society moves nearer to that of the litigious US, claims brought against directors and officers for “wrongful acts” can put their personal wealth at risk. Indeed, they can put the company's own financial viability at risk if the company decides to reimburse the director or officer being sued without suitable insurance cover.

If an employee is injured at work, your employers liability insurance will pay up. If a visitor slips and injures himself on a wet floor and sues your business, the chances are that your general liability insurance will meet the claim against you. But if your company is hit by less tangible claims - such as employee sexual harassment or fraud – then D&O insurance can cover your legal costs.

Directors have many responsibilities. At all times, they must show requisite care and skill. Care is defined as “*the care that one would take if one were acting on one's own behalf and the skill commensurate to that which another competent person (director) would show*”. Directors have fiduciary duties, both positive and negative - the first to act honestly and promote the company in the best light at all times, and the second to put the company's interests first should they conflict with his/her own.

Background

Ever-increasing Directives from Brussels, as well as a multitude of UK statutory offences, impose increasing liabilities on directors and officers. The situation is even more complicated when the organisation (and that includes both companies trading for profit as well as organisations in the not-for-profit sector) has assets, representation or operations overseas.

The Companies Act 2006 lists countless offences. There are more responsibilities in other legislation such as the Financial Services Act 1986, the Health & Safety at Work Act 1974, the Fair Trading Act 1973, The Perjury Act 1911 and the Bribery Act 2010 to name but a few.

Directors and officers can be held liable:

- For the consequences of their acts, errors and omissions.
- Conflicts of interest.
- Imprudent investment decisions.
- For acts of company employees and other business activities in which they did not necessarily participate.
- Making unauthorised payments (even if innocently made).
- Negligent supervision of delegated responsibility.
- Negligent misstatements especially with regard to the company's future profitability.
- For legal fees and other expenses incurred in defending claims made against them.

Mistakes can happen in the course of running the business that adversely affect shareholders, employees, creditors and other interested parties of the company. Such parties won't hesitate to sue – they're all potential sources of legal action and can bring an action against employees who hold a position of responsibility where it is alleged that they have acted negligently or outside their authority. There could also be alleged breach of trust or duty.

The Growing Popularity of D&O Insurance

Claims for personal liability are increasing all the time as disgruntled shareholders, regulators, auditors, creditors and others are suing directors and other company officers. The cost of defending these claims, apart from the eventual damages award, is often beyond the pocket of everyone except for the very wealthy. That's why D&O insurance has become so popular.

History

In the 1930s, following the depression, Lloyd's of London introduced insurance cover for directors and officers of companies. At that time, companies weren't allowed by law to indemnify their directors and officers. But, since directors and officers didn't see themselves to be exposed to great risk, the insurance didn't catch on. Even by the 1960s, the market for D&O coverage was negligible. Then, during the 1960s, changes in the interpretation of the securities laws created the realistic possibility that directors and officers themselves, and not only companies, could face significant liability. Insurers responded with a policy of insurance known as “directors and officers” or D&O for short.

The D&O industry matured and evolved during the 1970s through the 1990s and continues to do so today. From its modest beginnings in the 1930s, D&O insurance has now become of age. Starting with basic D&O coverage, the industry has spawned a large number of new and related products. The original focus on “personal financial protection” has changed and D&O insurance is often coupled with insurance cover designed to protect the company from various liabilities.

Increased legislation, both in the United Kingdom and worldwide, has escalated the possibility of legal action against directors and officers. The increase in successful litigation against directors and officers has led to an increased need for insurance protection against the background of tighter UK and European regulation in the areas of health and safety, environment, employment and corporate governance.

Claims against directors and officers can be brought by an ever-widening group of people, including:

- Employees
- Customers
- Suppliers
- Creditors
- Bankers
- Regulators
- Shareholders

Issues leading to litigation are widespread:

- Wrongful termination
- Discrimination
- Harassment
- Dishonesty
- Emotional distress
- Fraud
- Financial reporting
- Environmental matters
- Health and safety at work.

The Advantages of D&O

The Company Perspective

If your directors and officers are unfortunate enough to be sued, they can be confident that they will not have to finance their own defence as the cost of defending the claim will be paid by insurers on an ongoing basis as the case proceeds.

The insurance policy covers more than just the directors and officers of the company:

- Others within a company can make mistakes that affect the whole company, so managers and supervisors are also covered. Managers who are responsible for company policy or implementing employment and health and safety procedures are covered, if they find themselves being sued personally for failing to prevent incidents of discrimination, harassment, safety violations etc.

- The policy provides protection for directors and officers who make public statements on behalf of the company or who are involved in a merger or acquisition by covering the defence costs and exemplary damages arising from libel or slander actions.
- Directors are covered for defence costs when there is an environmental claim alleged to be their fault that causes damage to third parties or affects the value of the company.

An additional benefit to having D&O insurance is the company's ability to attract outside directors, particularly non-executives. Appointment to an executive or non-executive position brings not only personal prestige but may also bring potential personal liability for a negligent act, or an act outside the appointee's authority or which is in breach of duty or trust.

Today's shareholders, employees, regulatory authorities, customers and creditors expect more from directors and officers and their companies than ever before. Their conduct and integrity is scrutinised with new vigour. Directors or officers can be held responsible for actual or alleged wrongful acts, errors or omissions, including negligent advice, misstatement or improper disclosure. The recent trend in mergers, take-overs and acquisitions poses even more harrowing minefields for company executives, as the slightest error or oversight could cost dearly and leave them exposed to legal actions from a variety of sources.

The Officers' Perspective

Unlike a company's liability, which is usually limited, the liability of directors and officers may be unlimited when sued in their personal capacity whilst acting on behalf of the company. In such circumstances, their defence may have to be funded personally. Without insurance, directors and officers could face the possibility of personal bankruptcy.

Wrongful acts include breaches of trust, negligent acts or omissions, misstatements, wrongful trading under the Insolvency Act or any other claim made against the director or officer whilst acting in that capacity.

Directors Indemnities – New Regulations

From 6 April 2005, the Companies Act was revised to permit companies to indemnify their directors in relation to non-criminal liabilities to third parties and to fund director's defense costs incurred in civil and criminal proceedings (subject to refund if judgment is given against the director or the director is convicted). Indemnities against directors' defense costs will be possible where the action is taken by the company itself but is settled out of court or ends in favour of the director.

Unfortunately, these provisions will not automatically apply and in most cases it will be necessary to amend the company's Articles of Association to take advantage of them. The drafting of the indemnity is crucial, as an indemnity that goes beyond the scope of the new legislation is void in its entirety.

Examples of Cover

The main benefit arising from having D&O insurance is that the directors' and officers' personal assets are protected in the event of a claim for wrongful acts.

Libel & Slander

A director might contribute an article to a trade magazine in which he makes various allegations regarding the efficiency of a competitor product. The director is then open to action by the competitor company.

Employment Practice Liability

A director is removed from the board and the remaining directors are sued for wrongful dismissal and breach of contract. Even if the claim is settled out of court, significant legal costs might be incurred prior to the settlement.

Breach of Contract

A supplier of raw materials becomes involved in a dispute with one of its customers and stops supplying goods to the customer. The supplier also puts pressure on other suppliers to take similar action. One of the directors of the supplier company is sued for breach of contract.

Questions and Answers

What is Directors' & Officers' Liability Insurance?

The policy is a personal liability cover for the senior management of a company and its subsidiaries. It covers claims for losses arising out of an alleged or actual wrongful act committed in the capacity as a director or officer of the company. This includes legal costs, expenses, damages, judgements or settlements.

As a private company without any public shareholders, why do I need D&O insurance?

Shareholder liability is only one of the many exposures that face directors and officers. As a director or officer of a private company, you have an exposure to legal actions if you or your company:

- Employs one individual or more
- Deals with customers, clients, competitors, the government, other third parties

- Plans a flotation or other fundraising offering of debt or equity in the next 24-36 months.

Doesn't my company assume all the liability in a D&O liability legal action?

No. The company is empowered to indemnify its directors and officers against personal liabilities that arise from activities carried out on behalf of the company. But individual directors and officers of a company can be held personally liable as a result of their acts or failure to act with respect to the company's business interests.

Apart from actions brought by shareholders, who else might sue directors and officers?

Most lawsuits against directors and officers are not brought by shareholders. Most claimants have nothing to do with the ownership of the business. And private companies face just as much exposure as public companies in this arena.

Does it really apply to me - I'm not a proper director?

It certainly does. The law allows actions against Executive Directors, Non-Executive Directors, Shadow Directors and indeed any employee who holds a managerial or supervisory role.

When do claims usually arise?

Legal proceedings against directors and officers usually arise following certain events:

- Change of control of a company, perhaps following the death of a major shareholder.
- The publication of an official report on the company's affairs.
- Dishonesty of a director or officer.
- Dramatic change in share value.
- A public offering of shares.
- Appointment of a receiver.
- Acquisitions or mergers.
- Issue of a prospectus.
- Boardroom disputes.
- Poor trading results.

What's excluded from cover?

The main exceptions from D&O cover include fraud and dishonesty, acting illegally for profit and advantage, and pollution. In addition, if another director sues you from your own company, the legal costs in defending the claim are not usually covered.



What's the Cost?

Premiums will depend on the industry or business sector in which your company operates, its turnover and other financial data, staff numbers, the number of directors, the level of cover you wish to buy and other factors. For a formal quotation for D&O insurance, your brokers will need to be provided with:

- The last 2 years' annual reports and accounts of your company.
- Any interim reports.
- Details of financial activities and any change in financial status.
- A completed proposal form.

Whilst depending on the factors mentioned above and the level of cover required (usually between £20,000 and £10m) and the options required, the premium cost starts at about £750 a year. This is a tax-deductible expense to the company.



Further Information

Books on this subject, obtainable from good bookshops and at Internet bookshops such as Waterstones and Amazon include:

- **Directors' and Officers' Liability Insurance**, by Graham Buck, published by FT Finance, a division of Pearson Professional Limited, ISBN: 1853348473.
- **Directors' & Officers' Liability Insurance: A guide to international practice**, by Ian Youngman, published by Woodhead Publishing Limited, ISBN: 1855734370.
- **The D&O Book: A Comparison Guide To Directors & Officers Liability Insurance Policies**, by Gary W., ARM Griffin, published by Griffin Communications Inc, ISBN: 0941360210.
- **Directors and Officers Liability Insurance Deskbook**, by David E. Bordon, Michael R. Davisson and others, published by American Bar Association, ISBN: 1570733406.

If you are thinking about D&O insurance you should consider the wordings on offer very carefully and check that they cover the sort of claims you might face. Speak to your broker and test their ability to understand your needs in this sector.

This guide is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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