

CORPORATE GOVERNANCE, DIRECTORS, PLEASE INSURE

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Happy New Year, corporate India, says SEBI. Come January 1, 2006 and all listed companies in India are expected to be compliant of clause 49 of the listing agreement. What is the worry, then? Nothing, if things go right. But a lot, if things do not go right.

Post accounting scandals that hit the corporates, these are trying times for Directors and Officers. They are operating in an extremely difficult and complex business environment. Corporate scandals have forced judiciary and regulator to make stringent norms for observing the conduct of Directors and Officers while discharging their duties.

It is no more a celebration to become a Director as the current law has a major impact on the liability of Directors and Officers. Although as more and more legislations attempt to protect shareholders and are expected to improve corporate governance, they also bears the risk of increasing the number of litigations – against the Company as well as the Directors and Officers.

Increased awareness and organized attempt to legalize the provision of corporate governance around the globe, including the Sarbanes Oxley Act in the USA, has had significant impact on companies. Compliance under Sarbanes Oxley is required not only by the Companies located in the US and listed on a US stock exchange but also in some cases by the companies based outside the U.S. but working with US Companies. It is therefore not unusual for the Directors to conduct a thorough due diligence on the Company before accepting the Directorship of the Company. Before accepting their offices, it is the right of Directors and Officers to ask for the indemnification from the Company to the extent possible under the law.

Most of the private equity deals and VC deals, where the investor's nominee accepts the Board seat, they

would invariably require the Company to indemnify them to the extent possible under the law as well as take D&O policy.

All these factors have led to the need and development of Directors' & Officers' Liability Insurance (D&O). India has also started to witness Investor activism. Not only the costs involved in legally defending Directors and Officers are substantial, but the penalties that can be personally incurred by Directors could be severe.

D&O offers individual Directors and Officers the protection they need from personal liability and financial loss arising out of wrongful acts committed or allegedly committed in their capacity as Officers and/or Directors by transferring this risk to the insurance market. D&O covers have gradually broadened over the years. However, Directors and Officers need to know which risks can be passed on to the Insurance Company and where the D&O insurance cover is not available, leaving Directors exposed to personal risk.

While a company is legally permitted to cover the personal liability costs resulting from activities performed on behalf of the company, this ability, called indemnification, may not apply in every situation. In some cases, the financial burden of the liability is the sole responsibility of the Director or Officer or other insured. The primary purpose of D&O insurance is to fill in these gaps, protecting the personal assets of the individual Director or Officer. Even in cases where indemnification is available, most policies contain a second feature, corporate reimbursement, which advance on behalf of the company, or repay expenses or losses incurred by Directors and Officers while discharging their functions, of course with certain exclusions.

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What does D&O insurance policy cover?

D&O insurance protects Directors and Officers from liability arising from actions related to their official positions. Due to expanded size of the business, market pressures and the industry's responses to the development of case law, D&O insurance has grown beyond its original and basic coverage. Thus, a single policy now may provide multiple and varied options by standard form or endorsement.

The individual coverage typically is subject to distinct terms, conditions and deductibles, and even may be subject to distinct policy limits or in some cases sub-limits. However, there is some similarity in coverage offered in a D&O policy. For example, D&O insuring agreements generally specify that coverage is limited to claims first made during the policy period. In addition, the insurer typically does not have a duty to defend but is required to cover the costs of the insured's defense.

Insuring Agreement A (D&O)

Although each policy has its own wordings, Insuring Agreement A, often referred to as "A-Side Coverage," typically provides coverage directly to the Directors and Officers for loss (including defense costs) resulting from claims made against them for their wrongful acts.

A-Side Coverage applies where the Company does not indemnify its Directors and Officers. A Company may not indemnify its Directors and/or Officers because it either:

- (i) is prohibited by law from doing so,
- (ii) is permitted to do so by law and the company's bylaws but chooses not to do so, or
- (iii) is financially incapable of doing so, due to bankruptcy, liquidation, or lack of funds.

Insuring Agreement A may additionally specify that coverage is limited to those claims connected to an insured's capacity as an insured Director or Officer of the company. The issue of capacity as the Director and Officer recurs throughout D&O coverage analysis. The limiting language may appear in the insuring clause, in the definitions of "wrongful act" or "insured" found elsewhere in the policy, or in all three clauses.

Although a claim sometimes implicates an insured in a single and clear capacity, a claim may well arise out of an individual's multiple capacities. For example,

an individual may be sued as a Director and also as a shareholder of a company (perhaps as a purchaser or seller of company securities).

Insuring Agreement B (Corporate Reimbursement)

A typical Insuring Agreement B, or "B-side coverage," reimburses a Company for its loss where the Company indemnifies its Directors and Officers for claims against them. B-side coverage does not provide coverage to the company for its own liability. The language and conditions of Insuring Agreement B is typically the same as Insuring Agreement A.

Entity Securities Coverage

Many D&O policies offer an optional coverage to protect the Company against securities claims. Such coverage provides protection for the Company for its own liability. Currently, many policies provide such coverage to the Company whether or not its Directors and Officers are also sued. However, other policies provide such coverage only where the Company is a co-defendant with its Directors and Officers. Entity coverage may be part of the policy form as "Insuring Agreement C" or may be added as an endorsement.

EPL Coverage

Employment Practices Liability ("EPL") coverage also has become a common addition to Company coverage – often by endorsement to the D&O policy or as a stand-alone policy issued to the company. This coverage typically protects Directors, Officers, employees and/or the company against employment-related claims brought by employees and, in certain circumstances, specified third-parties. For example, it provides coverage for wrongful dismissals or failures to promote, sexual harassment, and other violations of federal, state or local employment and discrimination laws brought by the company's employees. EPL claims have also seen a dramatic increase in frequency and severity over the past decade.

Exclusions

It is extremely important to understand the exclusions from the coverage of the D&O policy.

Dishonesty Exclusion

Any claims made in connection with an insured's dishonesty, fraud, or willful violation of laws or statutes are not covered under D&O policy. The

dishonesty exclusion also may be coupled with personal profit exclusion, barring coverage in connection with an insured's illicit gain.

Insured v. Insured Exclusion

As the term implies, an insured versus insured ("IvI") exclusion bars coverage for claims made by an insured (e.g., a Director, Officer or insured Company) against another insured. In addition, the exclusion may bar coverage for claims brought,

- (i) by anyone directly or indirectly affiliated with an insured,
- (ii) by a shareholder unless the shareholder is acting independently and without input from any insured, or
- (iii) at the behest of an insured.

The exclusion essentially prevents a company from suing or orchestrating a suit against its Directors and Officers in order to collect insurance proceeds.

Professional Liability Exclusion

As a general rule, D&O policies do not provide coverage for liability associated with the provision of professional services. Thus, where a bank officer is liable for acts as a banker rather than an officer of the bank, a D&O policy with professional liability exclusion would not provide coverage.

Prior Acts Exclusion

Prior acts exclusions bar coverage for claims arising out of an insured's wrongful acts prior to a specified date. The date may coincide with the termination of coverage under a previous policy.

Prior and Pending Litigation Exclusion

Prior and pending litigation exclusions generally exclude coverage for (1) claims pending prior to the inception of the policy, or another agreed upon date, and (2) subsequent claims based on the same facts or circumstances.

Conclusion

There is no denying of the fact that the time for D&O policy has arrived. If the Directors and Officers wish to avoid personal liabilities for potential litigation, for illustration for the followings acts, then there is no substitute for D&O policy:

- Failure of supervision.
- Mergers, takeovers and divestment.
- liquidation
- Inaccuracy in statements of financial accounts.
- Lack of judgement and good faith.
- Mis-management of funds.
- Mis-statements in prospectus.
- Allotment of shares.
- Changes in control of shareholding.
- Shareholder claims.
- Misdeeds of co-directors
- Unauthorised loans or investments.
- Failure to obtain competitive bids.
- Imprudent expansion resulting in a loss.
- Using inside information.
- Unwarranted dividend payment, salaries or compensation.
- Misleading statements filed with the stock exchange.
- Wrongful dismissal of an employee.
- Trustee accountability and responsibility.
- Customs and excise allegations.
- Administrative liabilities.
- Disposal of old firm/entry of new owners.
- Miscellaneous litigation.

Thus most Companies, both public and private, can benefit from D&O insurance policies when taken after proper study and understanding.