

A Bird's Eye view of Directors and officers liability insurance

Abstract

With the advent of globalization, business environment in the country is changing rapidly. Shareholders, employees, regulatory bodies and consumers are becoming aggressively assertive of their perceived rights to influence corporate decisions and business strategies. Thus, being a Director or Officer of a company these days brings with it, not only the stress and strain of making business decisions; but also exposure to enormous potential legal liability.

Directors and Officers (D&O) Insurance covers personal liability of the Director or officer, in the event of a claim against them, alleging a wrongful act in their day to day activities in a managerial or supervisory role in the organization. The D&O policy normally covers all past, present and future Directors and Officers of the Company and its subsidiaries.

Key words: Insurance, Corporate Governance, Directors and Officers, legal liability

A Bird's Eye view of Directors and officers liability insurance

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Introduction

Corporate governance is the talk of the day, thanks to growing stakeholder pressure, rising regulatory scrutiny and supervision, increasing customer awareness and mounting judicial activism on the role of directors and officers of an enterprise in managing its affairs.

With the economy getting globalize in terms of footprint revenues and financing, passage of laws such as the Public Company Accounting Reform and Investor Protection Act laws in the US, better known as the Sarbanes-Oxley (SOX) law, and the imminent implementation of Clause 49 of the Listing Agreement in the Indian context, it is becoming necessary to formalize and implement good corporate government practices.

Corporate governance has been attracting public attention across the world. The quality of governance is also essential to shaping the growth and the future of any capital market and economy.

A company does not make decisions. It appoints a board of directors, officers and managers to make decisions on its behalf. In making these decisions, the directors and officers not only place the company at risk from actions by an aggrieved party; they also place themselves personally at risk.

Directors are jointly and severally liable. It is they who manage the assets and control the company's day-to-day affairs and are liable personally to pay losses suffered by the

company following an act which is wrong, negligent, outside the company's authority, beyond their powers, or which evidences insufficient skill and care in managing the company's affairs.

Directors and officers are bound by duty to the company itself, shareholders, employees, creditors, customers, competitors, members of the public, government and other regulatory bodies. Any breach or non-performance in duties can result in claims against the companies and/or its directors of the company by reason of any wrongful act in their respective capacity.

What is D & O Liability Insurance

The directors and officers, while discharging their functions and defending the companies against the cases filed by third parties, may also incur some expenses and put to loss. The companies are bound to indemnify the directors and officers for the losses they suffer. Under these circumstances, the directors and officers liability insurance policies issued by various insurance companies will be handy in saving the companies from financial collapses.

Directors and Officers Liability Insurance provides financial protection for the directors and officers of the company in the event they are sued in conjunction with the performance of their duties as they relate to the company.

Directors and officers liability insurance (D&O insurance) protects against legal claims for wrongful acts performed by corporate directors or officers in performing their corporate duties. Wrongful acts include omissions, errors, misstatements, misleading statements, neglect or breach of duty.

Directors and officers can be personally sued by shareholders, creditors, employees, suppliers, customers, competitors or regulators. Suits can be brought for various reasons. Shareholders might sue for insider trading. Creditors might sue for misrepresenting the financial health of the company. Competitors might sue for anti-trust or unfair trade practices.

Need for D&O Liability Insurance

With the advent of globalization, business environment in the country is changing rapidly. Shareholders, employees, regulatory bodies and consumers are becoming aggressively assertive of their perceived rights to influence corporate decisions and business strategies. Thus, being a Director or Officer of a company these days brings with it, not only the stress and strain of making business decisions; but also exposure to enormous potential legal liability.

Along with modernization of the Indian economy and integration of the Indian market with global markets, there is a new threat looming large for big Indian companies and their top management.

The directors and other top management team can be sued personally for their official functions by their own employees, bankers and creditors, shareholders, customers and competitors, regulators and government for their acts of commissions and omissions.

Reports on Corporate Governance like the Kumaramangalam Birla Report 1999, the Narayana Murthy Report 2003 and Clause 49 of the listing agreement with stock exchanges, etc. set out the breadth and scope of board level responsibilities more clearly than ever before. These statutes set the standards for directorial behaviour and at the same time increase the potential for actions against directors who fall short of these

standards. Defence costs and damages in such actions can vary from thousands to millions of rupees and the length of time taken to settle cases can extend from several months to several years.

Adhering to strict corporate governance standards and tighter disclosure standards would certainly make the Indian corporate sector more transparent. However, it will not necessarily guarantee protection against litigation by shareholders, employees and consumers and environmental activists, in view of the increasingly complex set of laws that govern the business environment in India and the world over. 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 to every situation.

The regulatory environment facing the directors of today's companies is more rigorous, and their responsibilities more onerous than before. The next few years will see even tighter legislation and increasing globalization of business, thus subjecting directors and officers to closer scrutiny from shareholders, customers, employees, suppliers and regulators not just in the global market place but also in their domestic environment.

From the directors' point of view the need for Directors & Officers Insurance is important because claims from stockholders, employees, and clients will be made against the company, and against the directors of the company. Since a director can be held personally responsible for acts of the company, most of the directors and officers will demand to be protected rather than put their personal assets at stake.

Secondly, the companies need Directors and Officers Insurance because investors and members of board of directors will not be willing to risk their personal assets to serve as a corporate director or officer, no matter how heartfelt their belief in the company.

Lastly, employment practices suits constitute the single largest area of claim activity under D&O policies. Over 50% of D&O claims are employment practices related.

A D&O liability insurance policy is not a replacement for sound management and corporate governance. But a good policy helps in as much as it reduces the apprehensions and addresses the concerns of the directors and officers so that they can concentrate on their work to take the company on the growth path, quarter-to-quarter, to the satisfaction of all stakeholders and society.

Scope of D&O liability Insurance

Some of the specific exposures that make D&O insurance necessary for the Directors and Officers are:

- Vulnerability to shareholder/stakeholder claims
- Sexual harassment, discrimination allegations and other employment practice violations
- Regulatory investigations
- Accounting irregularities
- Exposures relating to mergers and acquisitions
- Corporate Governance requirements
- Compliance with various legal statutes

Who can bring an action against Directors and Officers?

- Employees
- Suppliers
- Competitors
- Regulators
- Customers
- Shareholders
- Other stakeholders

Compensation Offered

The extent of indemnity being severely restricted by the Companies' Act will reimburse the extent of legal costs expended only if the Director/ Officer successfully defend the act taken against him/her.

Also, coverage is available on a 'claims made' basis and applies only to claims made against the Board of Directors during the policy period, irrespective of when the wrongful act occurred.

D&O policies cover claims made during the policy period. It doesn't matter when the wrongful acts occurred. A claim arising from a lawsuit filed this year for a wrongful act committed last year is covered by this year's policy.

Directors and Officers Liability Policies are usually "Manuscript Policies" in the insurance business. That means that they are not standardized, and each company tends to make a lot of variations even within their own issued policies.

The cover applies to:

Liabilities arising from any claim made against Directors and/ or Officers of the company by reason of any wrongful act in their respective capacity.

Liabilities against the company where it is required to indemnify the Directors/ Officers pursuant to common or statutory law provisions or Memorandum and Articles of Association.

The company and its subsidiaries that are under the common control of the Directors / Officers.

General Exclusions

- Prior and pending litigation and claims submitted under previous policies.
- Bodily injury, sickness, disease, emotional distress, death, damage or destruction of tangible property including loss.
- Insured v/s Insured. viz. Directors suing each other.
- Illegal personal profit and remuneration.
- Deliberate, dishonest or fraudulent acts.
- Pollution and/ or contamination.
- Insider trading.

Recent Trends

In recent years, directors and officers liability insurance has become a core component of corporate insurance. As many as 95% of Fortune 500 companies maintain directors and officers (“D&O”) liability insurance today. Publicly held companies have two to three times as many claims made against their directors and officers than privately or

closely held companies. Indian corporates may be far behind their US counterparts in buying directors and officers (D&O) liability cover from the general insurance agencies as a means of safeguarding themselves. But the trend is picking up. The buzzword in the insurance business today is D&O insurance, against the severity and size of litigation and settlement values.

In India, D&O liability insurance is mainly purchased by companies that are listed overseas especially in exchanges such as NASDAQ.

Most buyers in India are from the IT sector, followed by pharmaceutical and auto companies.

Against nearly 100 per cent D&O insurance penetration in the US and about 70 per cent in Europe, in India much less than 10 per cent of the corporates have so far opted for financial liabilities cover.

Of them, nearly 70 per cent are companies listed in the US, information technology and business process outsourcing companies having contracts with US companies and a pharma companies.

Oil and Natural Gas Corporation (ONGC) has picked up a Rs 100-crore cover for its directors and officers (D&O). The company fears a “manifold” increase in litigation risk, especially from the United States. This is the biggest personal insurance policy purchased by an Indian public sector company. Satyam Computers have a \$75 million D&O Liability insurance.

A trend seen in the country in recent times is that large government ownership or family owned (two of the most common ownership traits) are opening up. These are signs of changing times which directors are forced to reckon with.

D&O insurance has been criticized for undermining corporate governance by eliminating a strong disincentive for illegal or unethical behavior. Insurance companies understand that, by writing a D&O policy, they facilitate the sorts of wrongful acts they are insuring against. Accordingly, they tend to scrutinize a corporation's corporate governance safeguards as a part of the underwriting process.

Conclusion

Corporate governance, which used to be given only lip service earlier, is now given importance; publicly-listed companies are required to have in place independent directors and audit committee. Consequently, a number of companies in India are inclined to improve their corporate governance practices especially since the media, rating agencies and institutional investors score companies on this aspect.

The perception in India that this will “not happen to us” has changed to “this could happen to us.” This is a reflection of increased awareness of the exposures.

As India becomes more global and Indian entrepreneurs move up the value chain in the supply of goods and services, there will be demand for liability insurance. “

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