

Director's Liability Insurance: A shield?

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The increased professionalism required of executive and particularly non-executive directors means that there is a higher standard expected of directors in general. The non-executive directors are now given a greater role in making the Board accountable, matters are not simply left up to the shareholders to decide at the annual general meeting. They are there to act as the eyes and ears of the shareholders. The non-executive directors are also exposed to potential liabilities even though they are perceived to strengthen the corporate governance framework and act as some form of check and balance on the executive directors.

A great deal of significance has been attached to the activities of directors and officers. There has been a remarkable increase in interest in directors' and officers' liability insurance cover over the past few years. The number of claims increase as the directors fail to meet the higher standard expected of them. The increase in compliance and regulatory requirements make it all the more important than before for directors and officers to consider whether they have necessary coverage that may respond to the regulatory enquires and disciplinary proceedings.¹ It is usually debated that a company's directors and officers who commit breaches of duty escape accountability because they are able to rely on a provision in the company's articles which exempt them from all

¹ The recent case of Crescent Standard Investment Bank ("CSIBL") was the largest investment bank quoted on all stock exchanges of Pakistan. The market was taken by surprise when it declared a huge loss of Rs. 2.1 billion for the year end 2005. Since the main shareholders were individuals or companies of the well known business group, the Crescent Group, there was enormous interest in the affairs by financial and political circles as well. The case, describes the various types of entities that were merged to form CSIBL principally to protect the stakeholders by creating an entity with a large capitalization. The bank reported in its annual reports that all internal control mechanisms for good governance stipulated by the SECP were in place, and the same was reported by the auditors as satisfactory. After having been subjected to investigation, it was revealed that the internal management was involved in a variety of acts of misrepresentation and concealment. This is a classic case highlighting some of the weaknesses in the structure of corporate governance regimes in Pakistan.

liability apart from willfully caused losses. Problem arises where without a mechanism to limit the liability of officers and directors for claims brought against them, it becomes almost impossible for corporations to find anyone willing to serve as officers or directors.

In contrast to the above, an insurance policy can cover matters that cannot simply be indemnified; (such as where the company does not have the resources to pay for indemnification or where there is negligence, default, breach of duty or breach of trust involved of which the officer / director is alleged). This is discussed in detail below.

Pakistan Company law, provides for limited indemnification of officers and directors, which simply means that a company has to reimburse them for expenses incurred and amounts paid in defending the claims brought against them [for actions taken on behalf of the corporation]. Section 194 of the Companies Ordinance, 1984 declares void any provision, whether contained in a company's articles or in any contract with the company or otherwise, for exempting any director or officer of the company or....from, or indemnifying him against, any liability which by virtue of any law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he/she may be guilty in relation to the company. Section 194 is reproduced below for your convenience:

s. 194.- Liabilities, etc., of directors and officers. - Save as provided in this section, any provision, whether contained in the articles of a company or in any contract with a company or otherwise, for exempting any director, chief executive or officer of the company or any person, whether an officer of the company or not, employed by the company as auditor, from, or indemnifying him against, any liability which by virtue of any law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company, shall be void:

Provided that, notwithstanding anything contained in this section, a company may, in pursuance of any such provision as aforesaid, indemnify any such director, chief executive, officer, or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal, in which Judgment is given in his favour or in which he is acquitted, or in connection with any application under section 488 in which relief is granted to him.

Section 194 of the Companies Ordinance, 1984 clearly provides an indemnity cover to all directors, chief executive, officer or auditor of the company to the extent of any liability incurred in defending proceedings in which judgment is given in his favour or in which he is acquitted to the extent of covering the legal costs.

Apart from the indemnity cover to the extent stated above, there is no express provision in the Pakistan Companies Ordinance for insurance of directors. Having said that there is no provision at the moment that prevents a company from purchasing insurance for directors to cover matters resulting from acts done by them. This seems logical given the increasing accountability of company directors and since the issue of insurance has become a major concern for most of the officers taking up the position of directors. Additionally directors themselves want to be aware of the protection that is extended to them via the insurance cover. We see a noticeable shift in the trend with more and more companies now looking to provide insurance for their directors.

In order to draw a comparative analogy, we had the opportunity to review the UK legislation in this respect. The UK Companies Act, 1985 section 310, bears a great deal of similarity to section 194 of the Companies Ordinance, 1984.

Previously, section 310 of the Companies Act, 1985 with limited exceptions, prevented a company from exempting any officer or indemnifying him or her against any liability for negligence, default, breach of duty or breach of trust of which (s)he may be guilty in relation to the company, as follows:

S.310 Provisions exempting officers and auditors from liability.

- (1) This section applies to any provision, whether contained in a company's articles or in any contract with the company or otherwise, for exempting any officer of the company or any person (whether an officer or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default,*

breach of duty or breach of trust of which he may be guilty in relation to the company.

- (2) Except as provided by the following subsection, any such provision is void.*

- (3) A company, may in pursuance of such a provision, indemnify any such officer or auditor against any liability incurred by him in defending any proceedings (whether civil or criminal) in which judgment is given in his favour or he is acquitted, or in connection with any application under section 144(3) or (4) (acquisition of shares by innocent nominee) or section 727 (director in default, but not honest or reasonable), in which relief is granted to him by the court.*

The above section 310, Companies Act 1985 attracted a lot of debate on the issue. It was argued that where a company effected a directors insurance policy and paid the premiums the contract would be void as a "contract with the company" for indemnifying [officers] against..... liability.

Obviously, a policy that could not be enforced in the event of a dispute offers little or no security at all.

These gaps were later addressed by section 137 of the Companies Act 1989, which amended section 310 so as to establish beyond doubt that the latter does not invalidate insurance effected by a company for its directors and officers. The amended section 310 Companies Act read as follows (the added subsection 3 is highlighted):

S.310 Provisions exempting officers and auditors from liability.

- (1) This section applies to any provision, whether contained in a company's articles or in any contract with the company or otherwise, for exempting any officer of the company or any person (whether an officer or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company.*

- (2) Except as provided by the following subsection, any such provision is void.*

- (3) This section does not prevent a company:*

**(a) from purchasing and maintaining for any such officer or auditor insurance against any such liability, or
(b) from indemnifying any such officer or auditor against any liability incurred by him:
(i) in defending any proceedings (whether civil or criminal) in which judgment is given in his favour or he is acquitted, or
(ii) in connection with any application under section 144(3) or (4) (acquisition of shares by innocent nominee) or section 727 (general power to grant relief in case of honest and reasonable conduct) in which relief is granted to him by the court.**

Now the reason for discussing the Companies Act, 1985 is simply because as you see there has been a very obvious shift in the thinking of UK legislation, allowing companies to purchase on its own insurance for officers and directors. The Companies Act, 1985 was later on repealed by the Companies Act, 2006 except for certain provisions that are irrelevant in the context of our discussion.

Under the new legislation, the Companies Act, 2006 a separate section for the provision of insurance is set out under section 233. This illustrates the growing significance of the topic in recent times, so much so that it was thought necessary to set out a separate provision in order to recognize the importance as well as to acknowledge the same.

The relevant provisions are reproduced below:

232. Provisions protecting directors from liability²

S.232- 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.

(2) Any provision by which a company directly or indirectly provides an indemnity (to any extent) for a director of the company, or of an associated company, against any liability attaching to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he is a director is void, except as permitted by—

(a) section 233 (provision of insurance),

²Under section 310 of the Companies Act, 1985 the provision exempted officers such as directors, auditors and other positions such as company secretary or manager. Later on, the 2006 Act made consequential changes in section 310 whereby auditors were excluded from the applicability of the provisions of section 232 and applies only to directors this means that holders of other positions such as company secretary or manager, are no longer covered by this exemption..

(b) section 234 (qualifying third party indemnity provision), or

(c) section 235 (qualifying pension scheme indemnity provision).

(3) This section applies to any provision, whether contained in a company's articles or in any contract with the company or otherwise.

(4) Nothing in this section prevents a company's articles from making such provision as has previously been lawful for dealing with conflicts of interest.

233 Provision of insurance

Section 232(2) (voidness of provisions for indemnifying directors) does not prevent a company from purchasing and maintaining for a director of the company, or of an associated company, insurance against any such liability as is mentioned in that subsection.

The above stated section 233 provides that, a company may purchase and maintain insurance for its directors against any liability attaching to them in connection with any negligence, default, breach of duty or breach of trust by them in relation to the company of which they are a director.

Having looked at the statutory position in relation to the indemnification and insurance of directors in Pakistan, we conclude that the two are separate issues altogether. For indemnification there exists provision under the law, whereas for insurance there is none, *as yet*.

Under common law principles a director owes a fiduciary duty to his company not to put himself in a position where his duty to the company may conflict with his personal interests. The true picture is that *if* a director puts himself in a position like this then, unless he can rely on a provision entitling him to do so in the Articles of Association, the customary sanctions of voidability of the transaction will follow. Although the Articles of a particular company can, however, exclude or modify the application of this principle and if they do so, they are not exempting the director from the consequences of a breach of duty owed to the company this is simply stating a director must comply with the requirements (i.e. as to disclosure) if the self-interest dealing transaction is to be valid. Accordingly, no Articles of Association can release a director from his overall duty to act in the best interests of the company.

However, this leaves us to further consider the question of the rules governing the director’s conduct. It would indeed be a bit absurd to think that a director’s duty to use reasonable care and skill is capable of modification. It is argued that in order to ensure that directors’ powers are to be used for proper purposes, one needs to have a closer look at the corporate constitution for its content.

Nevertheless, there is a need under Pakistan law for recognizing the provision of appropriate insurance for directors. Although it is quite clear that the law does not prohibit any provision for indemnification and if company’s articles provide so, as long as the acts done do not constitute negligence, default, breach of duty and breach of trust, this would be valid. However, in case of insurance the issue that lies in the fore front is of premium and it is usually debated that who should actually be obtaining the insurance cover, should it be the company or directors individually.

Directors’ duties, no-conflict rules as well as the rules for appropriate disclosure all are very complex and require careful analysis. Some might argue that the provision of insurance to directors could be a beginning of other problems for regulators to ponder. However, on a corporate level this is a liability protection tool which should be considered more seriously than before. On a separate note, the Taskforce³ for reviewing the Code of Corporate Governance, 2002 has also recommended addition of a provision in relation to insurance of directors.

BIBLIOGRAPHY

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³The Taskforce group consisting of 11 members was set up by **Pakistan Institute of Corporate Governance (“PICG”)** so as to review the Code of Corporate Governance, 2002 in the light of various available surveys and feedback and to propose requisite amendments to it. The review has since come to a conclusion with the proposed recommendations being placed on PICG’s website for public comment. These shall subsequently be submitted to the SECP at the end of May 2010.