Corporate Briefing

Directors' indemnities – the new rules

From 6 April 2005, companies may provide wider indemnities to their officers (directors and the company secretary) to protect them from liabilities incurred in carrying out their duties. These new provisions form part of the Government's response to an earlier consultation on the overhaul of directors' and auditors' liabilities. The new legislation is intended to address directors' concerns about the increasing risk of them incurring personal liability which cannot be indemnified by the company. These issues are of particular relevance in the current climate of high profile claims against directors, such as Equitable Life and Enron.

Old Law

Prior to 6 April 2005, it was **unlawful** for a company to:

- exempt its officers (i.e. directors and secretary) against liabilities incurred due to their negligence, default, breach of duty or breach of trust; or
- indemnify any of its officers against such a liability except for one incurred by him in defending civil or criminal proceedings in which judgment was given in his favour, he was acquitted or relief was granted to him on the basis that his conduct was honest and reasonable; or
- lend an officer funds to meet his defence costs as they were incurred.

Therefore, the indemnity was limited to defence costs provided the director's defence was successful or relief was granted and was only available once the outcome of the court proceedings was known.

New Law

The new provisions still contain a general prohibition on officers being exempted from certain liabilities. However, an indemnity may now be given to a director if it is a "qualifying third party indemnity provision" (a "**Qualifying Indemnity**").

Key recommendations

- **Check Articles of Association - amend if necessary.**
- **Review Directors' and Officers' Insurance policy - update if necessary.**
- **Consider level of indemnities which should be offered to officers (is shareholder approval required?).**
- **How will the indemnities be enforced? Consider reviewing Service Agreements or implementing a Deed Poll in favour of all present/future directors.**

A Qualifying Indemnity is a provision whereby a company directly or indirectly provides an indemnity against a liability to a director of the company or group company provided that the indemnity does not cover a liability:

a) owed to the company or any group company;

b) to pay a fine imposed in criminal proceedings or a penalty imposed by a regulatory body;

c) in defending criminal proceedings in which he is convicted;

d) in defending civil proceedings brought by the company, or a group company, in which judgment is given against him; or

e) incurred in connection with any application for relief which is refused by the Court.

The areas of significance include the following.

- Directors can be indemnified in civil proceedings brought by third parties for the cost of fighting the case and liabilities incurred, even if they are on the losing side.
- Directors can be indemnified for costs in regulatory proceedings even if they are on the losing side.
- If a claim is brought by the company, a director's defence costs can be paid for by the company, but they may have to be repaid if he loses.
- Associated companies may not indemnify a director where such indemnification by the company is not permitted.
- Companies may not agree to limit directors' liability to the company in any way.
- The existing prohibitions on indemnities and exempting officers from liability still apply to auditors.
- The rules relating to directors' loans have been relaxed to allow for the payment of directors' defence costs, which must be repaid in most circumstances (unless the proceedings are successfully defended, they are incurred in defending a third party civil claim and are covered by a Qualifying Indemnity).

The future of Directors' and Officers' insurance ("D&O Insurance")

The new legislation specifically allows companies to maintain D&O Insurance and such insurance will continue to provide indemnity cover over and beyond that which a company is permitted to provide by law. It would be sensible for D&O Insurance to cover liabilities for which the company cannot indemnify its directors in addition to, of course, providing protection of directors in the event of insolvency of the company.

If the company is proposing to indemnify its officers then it is essential that any D&O policy be reviewed to check how the new indemnity provisions tie in with the insurance cover.

Is D&O Insurance required in light of the new legislation?

For most companies, the answer will be yes.

There are exclusions in all insurance policies. Some typical D&O exclusions relate to pollution and pension issues. It is also difficult to obtain D&O cover against certain actions e.g. those brought by US entities.

Also, the majority of D&O policies contain "presumptive indemnification" clauses, which stipulate that the company is deemed to have indemnified directors *"to the fullest extent permitted by law"*. This can cause problems, e.g. if there is no corporate reimbursement cover or if different insurers provide the two elements of cover. In those circumstances, the directors may find themselves caught between the company and the D&O insurers.

Is shareholder approval required?

This issue was raised during the DTI's consultation on the new rules. Although shareholder approval was favoured by a number of respondents, it is not included within the new legislation.

However, shareholder approval may be required if there is no cap on the liability or where there are loans to directors. In any event, companies will need to check their Articles of Association (the "**Articles**") to see if they permit the range of indemnities proposed to be granted.

Where should the indemnities be contained?

Indemnities are often contained within the Articles, although it may prove difficult for a director to enforce an indemnity only contained within the Articles. Instead, once agreed, the indemnities should be contained in either the director's service agreement or letter of appointment, or alternatively within a deed applicable to all directors.

If the same indemnities were to be provided to all directors of the company/group of companies, the easiest way of implementing a consistent policy would be for a Deed Poll to be entered into by the company in favour of all present and future directors.

General considerations

The board should carefully consider whether extending any indemnity or granting new ones is in the best interest of the company. To do so would clearly protect the directors' personal positions, but may place them in a conflict of interest position. Also, in years to come, if the company is faced with a crippling claim the board may question why such an extensive uncapped indemnity was given. In addition, the fact that an indemnity has been provided may mean that settling a case becomes more difficult. Some boards may wish to limit the cover to defence costs.

What level of indemnity should be given?

To allow continued flexibility, a company could allow indemnities to the fullest extent permitted by law, subject to such exclusions as the board may from time to time decide.

Once an indemnity has been granted, the current board will need to exercise the power to amend the exclusions reasonably. A failure to do so could lead to potential breach of contract claims by individual directors who are adversely affected by any such changes to the scope of an indemnity.

Another area for consideration is the extent to which indemnities continue to apply after the termination of the director's appointment. This may be a matter for commercial negotiation at the time the director is appointed. One solution for the company may be to provide that any indemnity will cease to apply altogether in the event that the director's employment is terminated in accordance with specified summary termination provisions in his service contract or letter of employment (sometimes referred to as "bad leaver" provisions).

Exclusions and limits which may be considered

A board may consider the following exclusions.

- Cover only for defence costs and for appeals, subject to consent of the shareholders.
- A cap on liability, either a specified amount or a percentage of profits.
- Exclusion for fraud.
- Exclusion for funding of legal costs where the claim is brought by the company.
- Exclusion for the payment of legal costs where a regulatory body has brought a successful claim.
- Exclusion where a director is a "bad leaver".
- Exclusions for claims by third parties where a director does not successfully defend the claim.
- Different exclusions for executives and non-executive directors.
- Exclusions for any directors who have left the board prior to the implementation of the new indemnity provisions.

In addition, the company should consider any other relevant circumstances e.g. its ability to recover costs where the director is obliged to repay those to the company.

Disclosure requirements

All indemnities must be disclosed in the annual report of the company in each year that the indemnity is in force. A copy of the indemnity, or a summary of its terms, must also be available for inspection by shareholders.

Action which should be taken

The provisions may be implemented at any time. However, it is important that the Articles are reviewed immediately to see if any amendments are required to put in place the framework that allows the provisions of the new law to be adopted.

Although some companies may prefer to delay introducing the provisions to see how the market develops, it would make sense to deal with the matter promptly. It is likely that as directors become aware of the new regime new recruits will expect a board to have formulated a policy prior to their appointment. As discussed above, there are methods whereby the regime may be implemented whilst allowing the board flexibility to review the position.

The standard indemnity provision in most companies' Articles will only reflect the old law. To take advantage of the new law, the board will either have to amend the Articles or put in place a separate contractual indemnity. Careful thought will have to be given to the drafting of the indemnity, as it will be invalid if it goes beyond the scope of the new legislation.

To discuss how Berg Legal can assist you with these issues, please contact Stephen Foster, Head of our Corporate and Commercial Department at stephenf@berg.co.uk. Alternatively you can call Stephen on 0161 833 9211.

berg legal 35 peter street manchester m2 5bg
t. 0161 833 9211 f. 0161 834 5566 e. help@berg.co.uk
dx 14379 manchester 1 **www.berg.co.uk** Regulated by the Law Society

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