

Executive negligence: Consequences and covers

P. UMESH

CORPORATE governance is the hot-topic these days, 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 globalised 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 formalise 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. A director's personal liability is unlimited. All his assets are at risk. Unlike the company, he cannot hide behind limited liability.

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.

Who can bring an action against the directors and officers?

- The company — for actions which are in breach of the director's and officer's duty to the company. If the company fails to take action, then a shareholder may enforce the company's rights by an action on behalf of himself and all other shareholders. This is known as a derivative action.

- Shareholders — they may bring an action in their own names if their rights have been injured and suffer losses.

- Employees — for wrongful employment practices such as discrimination, harassment and wrongful termination.

- Governmental or regulatory authorities — for breach of laws and regulations.

- Official receiver/liquidator — in all

types of winding up actions, he may apply for permission to examine the conduct of directors and officers, both past and present, and pursue litigation against them.

- Creditors — in the event of a company going into liquidation and/or failing to pay its creditors, they may bring an action against any or all of the directors, both past and present.

- Others — anyone suffering a loss as a result of a breach of warranty of authority to contract on the company's behalf.

It is interesting to note that in the global claimant distribution, it is the shareholders who contribute as high as about 42 per cent of the claims, whereas in India/Asia-Pacific, regulatory agencies contribute the maximum number of the claims, in the region of 40 per cent.

Then, how to avoid trouble?

First is the realisation that the fundamental responsibility of directors and officers is to represent prudently the interests of the shareholders as a group and other corporate constituencies in directing the business of the company within the law. They are serving to protect the stockholders and other stakeholders, not to protect management.

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.

In some cases, the financial burden of the liability is the sole responsibility of the director or officer or other insured person. Attention is invited to Section 201 of the Companies Act, 1956 which reads as "Avoidance of provisions relieving liability of officers and auditors of company: Save as provided in this section, any provision, whether contained in the articles of a company or in an agreement with a company or in any other instrument, for exempting any officer of the company or any person 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, misfeasance, breach of duty or breach of trust of which he may be guilty in relation to the company, shall be void."

"Provided that a company may, in pursuance of any such provision as aforesaid, 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 in which he is acquitted or discharged or in connection with any application under section 633 in which relief is granted to him by the Court."

This is where the Director and Officer liability policy may come in handy. The primary purpose of the D&O liability insurance cover is to endeavour to fill in these

gaps, protecting the personal assets of the individual director or officer.

Protection under D&O liability policy

The policy protects the directors and officers against:

- Legal costs in defending allegations brought against them alleging wrongful acts.

- Any damage awarded to the claimants against the directors and officers.

A policy is normally arranged in the name of the parent/holding company and provides protection to the directors and officers of that company and also the directors and officers of all subsidiary companies. The policy may also be extended (optional) to provide what is termed as 'Outside Board' protection. This extension protects the directors and officers of the parent company, or of any subsidiary, while appointed to act as directors of a company outside the main group, so long as the appointment is at the request of a group company. Dependent upon the profile and needs of the company, various types of coverage are available in the market.

As in the case of other liability insurances, criminal, intentional and malicious acts are outside the scope of the policy.

A good D&O liability insurance cover helps to:

- Improve the company's ability to recruit qualified directors and officers. Directors designated are beginning to insist on a good D&O policy before assuming duties. With the sweeping changes in the profile and the responsibilities of the directors, it is becoming increasingly necessary for the persons intending to become directors to seek protection in some form or the other. It would not be a surprise if people insist on adequate insurance protection as a prerequisite to taking over as directors.

- Avoid time-consuming, distracting and potentially embarrassing claims and litigation.

- Enhance the defence of claims and reduce the potential recovery by a claimant.

- Improve the company's ability to obtain favourable D&O insurance coverage at reasonable costs.

Globalisation has also resulted in Indian companies, particularly from the knowledge-based sectors, increasingly accessing the global markets for capital as well as acquiring and setting up companies in other countries. The directors' and officers' liability policy assumes greater importance if an Indian company is planning to access the US or other foreign markets for capital or to acquire or set up a subsidiary to consolidate its operations overseas.

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.

(The author is Regional Head, South, Howden India, Bangalore. He can be reached at p.umesh@howdenindia.com. The views are personal.)