

Directors' and Officers' Insurance in the UK

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Abstract

This paper examines the significance of the directors' and officers' (D&O) insurance policies in the UK. It argues that the significance of D&O policies lies in D&O policies being commercial than legal tools for directors. As a legal tool, where third parties sue the director, unless a director assumes personal responsibility (where this assumption is an element of the civil wrong), English law does not impose personal liability against the director, and a D&O policy may not respond. Moreover, as a legal tool, it may not be necessary, as defence costs can be provided to directors under company indemnity. As commercial tools, D&O policies provide directors with defence and investigation costs, and in criminal cases defence costs until the final judgment or admission of dishonest conduct. Moreover, as a commercial tool, unlike under company indemnity where directors would repay defence costs if unsuccessful, defence costs will usually be covered off by a D&O policy in the event of a negative judgment.

1. Introduction

It was way back in 1985 that Reuben Hasson lamented the lack of critical attention in Commonwealth countries given to the law of insurance in general.¹ Ten years later, in 1995, Colin Baxter lamented the dearth of attention in academic journals given to the subject of directors' and officers' liability insurance (D&O policy) in particular.² Fifteen years later, in 2010, Rob Merkin lamented the scarcity of academic writing on insurance in general.³ With the burgeoning market in D&O insurance backed by a provision in the Companies Act 2006 that allow companies to procure D&O insurance for their directors, company lawyers may no longer afford to leave D&O insurance to operate in its closet if they should comprehensively discuss directors' duties and liabilities. In opening, with doctrinal keys, the D&O insurance closet, the twin objectives of this paper are: first, to assess the limits of a D&O policy as a legal tool in the context of English company law and, second, to examine the significance of D&O policies as commercial tools in an increasingly tougher regulatory landscape in the UK.

D&O policies are a type of liability insurance designed to provide cover for company executives. The origin of D&O policies is debatable. Its introduction in the UK is said to have its origin in the US, so that D&O is effectively an American export.⁴ D&O liability insurance is a product of American legal and business developments rather than that of the traditional common law rooted in English law.⁵ In the US, D&O insurance was introduced in

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¹ R Hasson, *Subrogation in Insurance Law: A Critical Evaluation* 5 OJLS 416 (1985).

² C Baxter, *Demystifying D&O Insurance* 15 OJLS 537 (1995).

³ R Merkin, *Tort and Insurance: Some Insurance Law Perspectives* PN 194 (2010).

⁴ C Baxter, *Demystifying D&O Insurance* 15 OJLS 537, 538 (1995).

⁵ MR Pasban, C Campbell and J Birds, *The Protection of Corporate Directors in England and the US* 26 Anglo-Am L R 461, 491 (1997).

the aftermath of the stock market crash and the enactment of the federal securities laws of the 1930s, in order to protect directors against liability from shareholder suits, when statutory indemnification rights were less express or expansive.⁶ Merkin and Steele observe that, in the UK, liability policies did not emerge outside the marine context until the second half of the nineteenth century.⁷ Regardless of the origin of D&O policies, the UK offers the largest European market for D&O policies. D&O policies are lawful under the Companies Act 2006.⁸

The overarching view taken in this paper is that the significance of D&O policies lies in D&O policies being commercial tools rather than legal tools for directors. The legal and commercial distinction turns on whether a D&O policy would indemnify a director against: (a) a pecuniary award made against him, and (b) the costs in defending a claim against him. Where, for example, a D&O policy will pay the cost for defending criminal conduct, but will not pay pecuniary award by way of criminal fines, it is herein argued that the D&O policy would be reduced from a legal to a commercial tool. In a third party claim for negligent misstatement, for example, where a director has not assumed personal responsibility, liability does not arise and a D&O policy need not respond as a matter of law – as such, a D&O policy stripped of defence costs cover, just like an oral contract, is not worth the paper that it is written on.⁹ As legal tools, 'D&O policies will not indemnify a director against: (i) liability arising by reason of the director's dishonest, fraudulent or criminal conduct; or, (ii) criminal fines or regulatory penalties.' As commercial tools, 'D&O policies will cover defence costs (including civil, regulatory and criminal proceedings), with no repayment risk unless the director is found to have acted dishonestly or fraudulently.'¹⁰

Way before the financial crisis, high-profile cases against directors such as the *Equitable Life Assurance Society v. Bowley*,¹¹ caused the realisation that directors are under significant risk of litigation and therefore need D&O policies. The global financial crisis has increased the realisation that directors need D&O policy cover in order to be protected against likely claims from third parties. This realisation has led to the conclusion that, it would be a brave director who would choose not to have such cover, given the current and likely future climate in which directors will operate.¹² The force of that conclusion is examined herein by discussing the significance of D&O policies both as legal and commercial tools for directors.

Whilst there are risks and D&O policies are significant, it is arguable that in the UK, the significance of D&O policies in essence lies in respect of defence costs rather than in substantive coverage. Arguably, in regards to lawsuits by third parties, English company law is unlikely to find a director, acting in his or her capacity as a director, liable to third parties, unless the director assumes personal responsibility. Moreover, if D&O policies are desired for their provision of defence costs, these defence costs could be provided to directors under company indemnity. In this reasoning, less significance would be attached to D&O policies as legal tools. But this is just half of the story. D&O policies provide directors with defence costs during litigation, and regulatory and other investigation costs outside litigation. In cases of alleged crimes, D&O policies provide directors with defence costs until the final judgment is made against the director or until the director admits dishonest conduct. Furthermore, while defence costs will usually be covered off by a D&O policy in the event of a negative

⁶ R Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?* 14 Del J Corp L 1, 4 (1989).

⁷ R Merkin and J Steele, *Insurance and the Law of Obligations*, 64 (Oxford, Oxford University Press 2013).

⁸ CA 2006, s 233 allows a company to procure insurance for a director against any liability that would attach to or her in connection with any negligence, default, breach of duty or breach of trust in relation to the company.

⁹ R Merkin, *Directors and Officers Insurance and the Global Financial Crisis* 118 BILA J 1, 6 (2009).

¹⁰ J Page and F Kean, *Directors' Liability, D&O: The Changing Face of Personal Exposure*, 21 (London, Allen & Overy LLP and Willis Towers Watson, May 2016).

¹¹ [2003] EWHC 2263 (Comm); [2003] BCC 829.

¹² J Hill and C Henley, *Directors' and Officers' Liability Insurance: Problems and Pitfalls* 172 IHL 37 (2009).

judgment, if a director is found guilty in circumstances where defence costs were met under the company indemnity, the director will typically then have to repay those defence costs as well as paying any fines imposed.¹³ In this latter reasoning, even as commercial tools, in the increasingly tougher regulatory landscape, much significance is attached to D&O policies.

This paper proceeds as follows. Part 2 provides an overview of the frequency and effectiveness of D&O claims. Part 3 discusses three broad categories of potential liabilities for directors: claims for breach of directors' duties; insolvency claims; and criminal and regulatory investigations. In each category, it discusses the value of D&O policies as either legal tools or commercial tools, and the rating of significance (less/much) of D&O policies. Part 4 assesses the likelihood of finding directors personally liable in claims brought against them by third parties. It argues that the law is unlikely to impose personal liability on directors, which most demonstrates the limitation of a D&O policy as a legal tool. Part 5 examines the provisions in the Companies Act 2006 ('CA 2006'), which provide for company indemnity and court's relief to directors. It observes that the protection for directors under company indemnity is outmatched by better terms of defence costs under D&O policies rendering D&O policies indispensable. Part 6 highlights typical exclusions and limitations in D&O policies. The final part provides some concluding remarks.

2. Overview on Frequency and Effectiveness of D&O Claims

Assessing the frequency of D&O claims in the UK is negated by the fact that D&O claims are invariably settled out of court and without publicity. The limited available data suggests that D&O claims in the UK have been rising. According to Marsh, a global insurance broker, it recorded an increasing trend of its UK clients' D&O claim notifications between 2005 and 2015; from 200-300 in 2005 to 1,300 in 2015 of D&O claim notifications annually.¹⁴ The reason for this rising trend in D&O claims is because UK and EU regulators, particularly in the financial sector, have become more active since the global financial crisis, and cross-border co-operation between regulators adds to the complexity of regulatory activities.

The effectiveness of D&O policies lie in their being commercial tools than legal tools. In dealing with D&O claims, insurers, unconcerned themselves with legal niceties that the law may not attach personal liability to directors, are willing to indemnify under D&O policies. In treating D&O policies as commercial tools, insurers still concede to the law in limiting the effectiveness of D&O policies. In a survey conducted by Allen & Overy and Willis Towers Watson in 2016, two things are noted about the practical use of D&O policies. First, D&O policies will cover defence costs (including civil, regulatory and criminal proceedings), with no repayment risk unless the director is found to have acted dishonestly or fraudulently. Second, D&O policies will not indemnify a director against: (i) liability arising by reason of the director's dishonest, fraudulent or criminal conduct; or, (ii) criminal fines or regulatory penalties.¹⁵ In effect, even as a commercial tool, a D&O policy is a defence costs insurance.

3. Trend of Claims and Potential Liabilities

¹³ A Barton and F Kean, *Directors' Liability Survey: Directors in Peril – Insurance and Indemnity in Risky Times*, 6 (London, Allen & Overy LLP, December 2011/January 2012); A Barton and T Webster, *D&O Liability Insurance* 34 CSR 63 (2010).

¹⁴ I Martin, *Professional and Management Liability Insurance Claims: Common Pitfalls for Unwary Policyholders*, 4-5 (London, Marsh Report 2016).

¹⁵ J Page and F Kean, *Directors' Liability, D&O: The Changing Face of Personal Exposure*, 21 (London, Allen & Overy LLP and Willis Towers Watson, May 2016).

In a survey undertaken by Herbert Smith (a leading law firm) in 2006, participants were asked whether they ‘believe that exposure to potential claims is acting as a deterrent to those considering becoming a director,’ and 56% of respondents believed it was ‘acting as a deterrent to some extent.’ This survey concluded that: ‘there is a perception, particularly amongst smaller companies, that directors’ overall potential exposure to claims has increased since *Equitable Life* and *Enron*. Whether this viewpoint accurately reflects the reality of the situation is debatable.’¹⁶ This realisation of the potential risk of litigation has long rendered those considering becoming directors to be reluctant to take up jobs without a D&O policy in place. In that regard, it has been suggested that, ‘company-funded D&O insurance may prove highly instrumental in encouraging talented persons to serve as directors.’¹⁷ The significance of D&O policies in the UK is brought to view when one compares the provision of defence costs under D&O policies with those provided under company indemnity. But first, an overview of the frequency and effectiveness of D&O claims, followed by a discussion of three broad potential liabilities that highlights both the limitation of D&O policies as legal tools and the significance of D&O policies as commercial tools.

3.1. *Claims for Breach of Directors’ Duties*

As a legal tool, much as D&O policies are preferable than company indemnity for defence costs, in cases where directors are sued for breach of their duties codified in the CA 2006,¹⁸ the rarity of such litigation arguably renders D&O policies less significant. As these directors’ duties are owed to the company,¹⁹ the proper claimant is the company, not shareholders,²⁰ although in rare cases shareholders may sue derivatively. That the company alone can sue is nothing more than a statement of the legally obvious: only the right-holder can enforce its rights.²¹ For breach of directors’ duties, for companies with Model Article, it is for the board of directors to sue the defaulting director – (a) either as part of ‘the management of the company’s business, for which purpose they may exercise all the powers of the company’, (b) or as directed by special resolution of the shareholders, for which ‘no such special resolution invalidates anything which the directors have done before the passing of the resolution.’²² The board may choose not to sue, applying s 239(6)(b) of the CA 2006.²³ The decision to sue is in effect a matter for the board, but boards rarely sue their fellow directors unless after a takeover with a new board and where a majority of the directors on the new board are willing to sue directors of the old board as was the case in *Regal (Hastings) Ltd v. Gulliver*.²⁴ On the one hand, if the board does not sue their fellow directors, defence costs are not triggered and a D&O policy is unnecessary. On the other

¹⁶ M Bakes, *Insurance and Reinsurance Litigation: 2006 Review* 106-109 (London, Herbert Smith, February 2007), available at <http://sites.herbertsmithfreehills.vutrevx.com/20/2615/landing-pages/2006insuranceannualreview.pdf> (last accessed 16 January 2016).

¹⁷ V Finch, *Personal Accountability and Corporate Control: The Role of Directors’ and Officers’ Liability Insurance* 57 MLR 880, 890 (1994).

¹⁸ CA 2006, ss 171 to 177.

¹⁹ CA 2006, s 171; *Percival v. Wright* [1902] Ch 421.

²⁰ *Foss v Harbottle* (1843) 67 ER 189; (1843) 2 Hare 461.

²¹ D Kershaw, *Company Law in Context*, 589 (2nd edn, Oxford, Oxford University Press 2012).

²² The Companies (Model Articles) Regulations 2008, regulations 3 and 4.

²³ This section needs to be read carefully. It deals with the power of company members to ratify breaches of directors’ duties etc, which is made clear in subsection 2 that the ‘decision of the company to ratify such conduct must be made by resolution of the members of the company.’ But subsection 6 confirms the power of directors when it states: ‘Nothing in this section affects – (b) any power of the directors to agree not to sue, or to settle or release a claim made by them on behalf of the company.’

²⁴ [1967] 2 AC 134; [1942] 1 All ER 378.

hand, if the board sues their fellow directors, defence costs are triggered; a D&O policy is necessary, but arguably less significant given the rarity of this kind of litigation in the UK.

Much or less significance may be attached to D&O policies in respect of the alternative of derivative claims. Whilst shareholders may sue derivatively, the ‘independent shareholders’ or the ‘majority inside a minority’ may choose not to bring a claim against a director for breach of duty.²⁵ Members may ratify breaches of a director under section 239 of the CA 2006.²⁶ In seeking ratification, section 239(4) precludes the counting of the vote of the offending director (in his capacity as a member) and the vote of any member connected with him (as defined by sections 252 and 254 of the CA 2006).²⁷ Shareholders may sue in a derivative claim, if they overcome the two-stage criteria to obtain permission. First, under the three mandatory bars in s 263(2), the court must refuse permission if: (a) the conduct was authorised by members before it occurred; (b) the conduct was ratified by members after it occurred; and (c) a person acting in accordance with s 172 (duty to promote the success of the company) would not seek to continue the claim; – courts should refuse permission on this mandatory ground only if ‘no reasonable director’ would continue the claim.²⁸ Second, under the discretionary factors in s 263(3), the court must consider: (a) whether the member is acting in good faith; (b) whether a director acting for the benefit of the company would attach importance to continuing the action;²⁹ (c) the likelihood of prior approval/ratification; (d) the likelihood of subsequent ratification; (e) whether the company has decided not to pursue the claim; and (f) whether a shareholder could instead bring a personal action. These criteria illustrate how procedurally and substantively English law has developed to provide disincentives to prospective claimants; – the average bona fide shareholder, who genuinely contemplates taking an action, reading through this non-exhaustive list and faced with these complexities, will often give up in despair at this stage.³⁰ On the one hand, less significance is attached to D&O policies given the likelihood that shareholders may either choose not to sue or give up suing in despair without attempting to sue. On the other, where shareholders attempt to sue, though they may fail to surmount the stages for permission to sue, the cost for directors to defend themselves in the pre-litigation stages would render attaching much significance to D&O policies.

While shareholders may sue in a derivative claim, English law has traditionally provided a disincentive for derivative claims, and statutory provisions in ss 260-264 are unlikely to produce US-style derivative litigation. Arad Reisberg argues that a US-style derivative litigation is probably quite far off the mark in the UK.³¹ Reisberg observes that courts continue to retain a wider discretion over whether a derivative claim is to proceed or be refused, and litigants must still face up to the traditional suspicion of English courts towards such claims. In addition, the practicalities of financing shareholder litigation will remain a major obstacle. With the amendment of the Courts and Legal Services Act 1990 to allow contingency fees in civil litigation,³² David Kershaw has suggested that, if contingency fees

²⁵ *Smith v. Croft* [1988] Ch 114; [1987] 3 WLR 405.

²⁶ Whether fraudulent wrongs can be ratified, is still governed by common law (see section 180(4)(a) and section 239(7) of the CA 2006) – for our purpose, it suffice to note that a D&O policy would not respond to fraud (see further discussion under section 3.2 below).

²⁷ See *Franbar Holdings Ltd v. Patel* [2008] BCC 885, 896.

²⁸ *Iesini v. Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420 (Lewison J).

²⁹ See the business considerations to be taken into account in *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch); [2012] BCC 676.

³⁰ J Lowry and A Reisberg, *Pettet's Company Law: Company Law & Corporate Finance*, 262 (4th edn, London, Pearson Education Limited 2012).

³¹ A Reisberg, *Derivative Actions and Corporate Governance*, 166 (Oxford, Oxford University Press 2007).

³² Section 58, as amended by the Legal Aid, Sentencing and Punishment of Offenders Act 2012.

are available in derivative litigation one can expect a significant increase in claims.³³ Time will tell whether contingency fees will usher in a US-style derivative litigation to render the need to attach much significance to D&O policies. Instead of derivative claims, shareholders are more likely to make use of broad unfair prejudicial jurisdiction under CA 2006, s 994, though the purpose there usually is to force the majority shareholders to buy out the minority rather than to seek recovery for the company in respect of any breach of directors' duties.³⁴

Liquidators may sue directors for breach of their duties to the company. As the cause of action for breach of directors' duties accrues to the company,³⁵ yet directors who are in control will not normally allow the company to sue them, then liquidators can only sue when control has passed from directors in liquidation. It is in such cases, when directors lose control and a liquidator is appointed, D&O policies could be of much help. 'Such circumstances sometimes provide rare examples of litigation by the company itself against directors.'³⁶ The risk of litigation is likely to be reduced by the 'difficulties which liquidators face in trying to bring cases against directors and also because of a lack of funding to pursue these matters.'³⁷ Even if the company is insolvent, investors may still leave the directors out of the picture – the UK's loser pays rules provide one incentive for plaintiffs to forgo bringing directors to court, this being to avoid the risk of paying the directors' legal costs if the action fails.³⁸ Overall, on the foregoing, one may attach less significance to D&O policies for litigation by liquidators.

3.2. Insolvency Claims

The second broad category of potential liabilities for directors is liability for insolvency transactions under the Insolvency Act 1986. One of these liabilities applies to fraudulent trading. Any shield that may have been accorded to directors for breach of their company duties is lifted in cases where fraud is involved. To this extent, the law imposes criminal and civil liabilities on directors for committing a fraud whilst in office. It is a criminal offence for a director to carry on the business of a company for fraudulent purpose or with intent to defraud creditors or any other person.³⁹ Where the company is in the course of winding up, the law imposes a civil liability, with the same test as for criminal liability, upon the director.⁴⁰

However, general liability insurance always precludes indemnifying the insured in cases of moral culpability such as fraud or dishonesty. For example, s 55(2)(a) of the Marine Insurance Act 1906 provides that an insurer is not liable for any loss attributable to the wilful misconduct of the insured. As such, a director liable for fraudulent trading under s 213 of the Insolvency Act 1986 will not recover under a D&O policy. But the significance of a D&O policy is not lost, as insurers are likely to pay for defence costs until a final decision finding fraud or dishonesty, or until the director admits dishonest conduct, and then seek to recover costs from fraudulent or dishonest directors. This illustrates the core function of a D&O policy: essentially, to provide (lawfully) defence costs – a D&O is a defence costs insurance.

Although a company is liable for actions carried out by a director, in cases of fraud, a director can face personal liability. An example is the case of *Standard Chartered Bank v.*

³³ D Kershaw, *Company Law in Context*, 638 (2nd edition, Oxford, Oxford University Press 2012).

³⁴ B Hannigan, *Company Law*, 274 (3rd edn, Oxford, Oxford University Press 2012).

³⁵ CA 2006, s 170; *Percival v. Wright* [1902] 2 Ch 421.

³⁶ J Lowry and A Reisberg, *Pettet's Company Law: Company Law & Corporate Finance*, 237(4th edn, London, Pearson Education Limited 2012).

³⁷ B Hannigan, *Company Law*, 647 (3rd edn, Oxford, Oxford University Press 2012).

³⁸ BR Cheffins and BS Black, *Outside Director Liability across Countries* 84 Tex L Rev 1385, 1413 (2006).

³⁹ CA 2006, s 993.

⁴⁰ Insolvency Act 1986, s 213.

Pakistan National Shipping Corporation (No 2),⁴¹ where a director knowingly and deliberately made false claims to obtain payment on a letter of credit, and was not allowed by the court to be shielded by the corporate veil. However, in such cases of fraud, a D&O policy does not respond. Once the director admits or is found guilty of fraud, if defence costs had been met by a D&O policy, the director will have to repay those defence costs to the insurer.

The bar for D&O policy to respond in fraud cases is due to the *ex turpi causa* – ‘a principle that prevents a claimant from using the court to obtain benefits from his own illegal conduct.’⁴² In such cases, a D&O policy does not respond, for ‘an assured cannot recover if he has to rely upon his own illegality or if he is seeking to make a profit from his own illegality.’⁴³ It was said by the House of Lords in *Tinsley v. Milligan* that ‘a party to an illegality can recover by virtue of a legal or equitable property interest if, but only if, he can establish his title without relying on his own illegality.’⁴⁴ Equally, where, as was the case in *Safeway Stores Ltd v. Twigger*,⁴⁵ the company itself is found to have infringed the law, public policy and *ex turpi causa* would prevent the company passing on liability to its directors’ insurer. As such, where the director has infringed the law and seeks to rely on his illegality to be indemnified of the liability, a D&O policy would not respond, as the D&O policy cannot respond to illegality.⁴⁶ This bar is not exclusive of D&O policies; it applies to all types of insurance. In fraudulent cases, no significance need be attached to D&O policies.

Besides fraudulent trading, a director may also be liable for wrongful trading.⁴⁷ This liability is imposed if a director causes the company to incur debts when he or she knows or ought to have known at the time that the company had no prospect of avoiding insolvency. Normally, the company, through the liquidator, sues the director for wrongful trading. But commenting on wrongful trading, Davies and Worthington observed that litigation under s 214 seems to have been sparse and, certainly, there are few reported cases. Davies and Worthington also observed that, the initiation of litigation is vested in the liquidator, who does not have access to public funds to commence litigation, and so the liquidator is likely to be unwilling to risk the company’s already inadequate assets on litigation unless there is a very strong chance of success.⁴⁸ Of course, the limited number of reported cases does not tell us how many actions are brought or threatened, which result in the directors making an out-of-court contribution to the company.⁴⁹ Arguably, liquidators are likely to be unwilling to risk the company’s already inadequate assets on litigation, for cases are unlikely to succeed where directors have behaved responsibly.⁵⁰ In 2014, the UK Government observed that ‘since 1986 there have only been around 30 reported wrongful trading cases, about 50 preference claims and about 80 reported cases arising from undervalue transactions’ – after identifying that lack of funding was one of the problems, it proposed ‘allowing liquidators to sell or assign the cause of action.’⁵¹ Following the 2015 reforms, the liquidator may assign a

⁴¹ [2002] UKHL 43; [2003] 1 AC 959.

⁴² *Stone & Rolls Ltd v. Moore Stephens* [2009] UKHL 39; [2009] 1 AC 1391, 1452 (Lord Phillips).

⁴³ R Merkin, *Directors and Officers Insurance and the Global Financial Crisis* 118 BILA J 1, 7 (2009).

⁴⁴ [1994] 1 AC 340, 375 (Lord Browne-Wilkinson); [1993] 3 WLR 126.

⁴⁵ [2010] EWCA Civ 1472; [2011] 2 All ER 841.

⁴⁶ See *Gray v. Thames Trains* [2009] UKHL 33; [2009] 1 AC 1339; and *KR v. Royal & Sun Alliance Plc* [2006] EWCA Civ 1454; [2007] 1 All ER (Comm) 161.

⁴⁷ Insolvency Act 1986, s 214.

⁴⁸ P Davies and S Worthington, *Gower & Davies Principles of Modern Company Law*, 236 (9th edn, London, Sweet & Maxwell 2012).

⁴⁹ D Kershaw, *Company Law in Context*, 806 (2nd edn, Oxford, Oxford University Press 2012).

⁵⁰ See *Re Continental Assurance Co of London Plc* [2007] 2 BCLC 287; [2001] BPIR 733 where the level of knowledge required to trigger liability for wrongful trading was discussed and the threshold clearly set in favour of directors.

⁵¹ BIS, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business: Government Response* (2014) paras 260 and 262, available at:

right of action.⁵² The high litigation cost may still deter creditors and insolvency litigation firms buying assigned rights of action. Nonetheless, where the liquidator attempts litigation for wrongful trading, D&O policies would provide cover for defence costs, and in that respect, some level of significance ought to be attached to D&O policies.

In assessing how much significance to attach to D&O policies, much as directors may be concerned about being out of pocket to fund defence costs when the company is insolvent, whether this risk warrants attaching much significance to D&O policies, should be assessed against the funding difficulties faced by liquidators in bringing claims against directors. The power of liquidators to bring proceedings against directors,⁵³ require the sanction of the court or liquidation committee or creditors.⁵⁴ If sanctioned, proceedings costs are liquidation expenses payable from insolvent company assets,⁵⁵ subject to creditors' consent for litigation costs in excess of £5,000.⁵⁶ As already notes, a liquidator is likely to be unwilling to risk the company's already inadequate assets on litigation unless there is a very strong chance of success.⁵⁷ A director who has acted honestly and reasonably and therefore ought fairly to be excused, who is concerned about the risk of being sued by liquidators, may find comfort in seeking relief from the courts under s 1157 CA 2006. Especially in small or owner-managed companies, which find insurance premiums prohibitive, s 1157 may valuably fill the absence of D&O policy.⁵⁸

3.3. Criminal and Regulatory Investigations

The third broad category of potential liabilities lies in criminal and regulatory investigations that directors are increasingly facing, especially in the wake of the global financial crisis. In the UK, directors of publicly traded companies may potentially be sued for providing misleading disclosure in financial services and may face a claim for compensating investors under s 90 of the Financial Services and Markets Act 2000. This s 90 claim is analogous to a US claim under s 11 of Securities Act of 1933 – but lawsuits of this sort are, however, virtually unknown in the UK.⁵⁹ At the time of writing this paper, there is one case, *Greenwood v. Goodwin and the Royal Bank of Scotland (RBS)*,⁶⁰ lingering in the courts, where claimants seek to invoke statutory remedies against RBS or against key RBS directors under s 90 of the Financial Services and Markets Act 2000. Regardless of the outcome of this case (*Greenwood v. Goodwin*, which may take time, being the first lawsuit of this sort), the very fact this rare lawsuit has occurred, triggers the need for directors to have defence cover, and the high costs involved appeal to attaching much significance to D&O policies.

In a D&O insurance survey undertaken by Allen & Overy LLP jointly with Willis in 2011, 'regulatory investigations and enquiries were identified by 84% of [the] respondents as the

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/304297/bis-14-672-transparency-and-trust-consultation-response.pdf (last accessed 7 May 2017).

⁵² Insolvency Act 1986, s 246ZD (inserted by Small Business, Enterprise and Employment Act 2015, s 118).

⁵³ Power to bring legal proceedings under ss 213, 214, 238, 239, 242, 243 or 423, Insolvency Act 1986.

⁵⁴ See IA 1986, Sch 4, Pt I, para 3A; and Sch 4, Pt II, para 4 (if winding by court).

⁵⁵ See Insolvency Rules 1986, r 4.218(3)(a)(ii).

⁵⁶ See Insolvency Rules 1986, r 4.218A(1)(d).

⁵⁷ P Davies and S Worthington, *Gower & Davies Principles of Modern Company Law*, 236 (9th edn, London, Sweet & Maxwell 2012).

⁵⁸ R Edmunds and J Lowry, *The Continuing Value of Relief for Directors' Breach of Duty* 66 MLR 195, 216 (2003).

⁵⁹ BR Cheffins and BS Black, *Outside Director Liability across Countries* 84 Tex L Rev 1385, 1411 (2006).

⁶⁰ [2014] EWHC 609 (Ch) (07 Mar 2014); previous hearings: [2014] EWHC 227 (Ch) (12 Feb 2014); [2013] EWHC 2785 (Ch) (30 Jul 2013) – these hearings were at management stage, determining how claimants would share legal costs against the defendants and what costs, with the RSB so far taking an advantageous position.

risk that posed the greatest concern to their directors.’⁶¹ This risk comes in the wake of the global financial crisis, where, to ensure that companies comply, regulators are increasingly targeting directors for corporate wrongdoing. Directors operating in this increasingly tougher regulatory landscape are at risk of being investigated and liable to pay high regulatory fines and penalties. The traditional company law principle that directors are an embodiment of the company so that they are not liable for their acts as agents is no longer robust enough to protect directors in this regulatory landscape. The insurance market has long provided D&O policies, which are proving more robust than company indemnity in protecting directors. It is for this risk, above all risk categories, that much significance is attached to D&O policies.

In the survey by Allen & Overy LLP and Willis, Barton and Kean state that ‘evidence suggests regulatory investigations and enquiries are on the increase, and media coverage of scrutiny surrounding phone hacking cases, dawn raids conducted by the Financial Services Authority (FSA), and Office of Fair Trading (OFT) enquiries into price fixing, only serve to worry directors even more.’ This regulatory landscape is increasingly tougher, as UK, EU and US regulators are increasingly cooperating to deal with cross-border investigations on the wrongdoing of multinational companies. Should companies pay for D&O policies to protect directors? Yes, and this is why: as companies cannot exist without persons – ‘the company itself cannot act in its own person, for it has no person; it can only act through directors’⁶² – the company’s purchase of D&O policies to protect directors is essentially a protection of the company’s own existence. Arguably, regulators are not per se ramping up directors, but the companies managed by directors. To the extent that the protection in D&O policies is lawful, it is in the interest of the company to pay for D&O policies to protect its human embodiment.

4. Certain Third Party Claims

Whilst third party claims against director may arise in various ways, we are here concerned with only claims arising out of their transactions with the company. In respect of third parties who sue directors in relation to their transaction with the company, directors are unlikely to be found liable for breaches of their duties. This unlikelihood of finding a director liable renders D&O policies less significant.⁶³ Moreover, ‘even where liability is established, it is most unlikely to be covered by a D&O policy so the substantive coverage of a D&O policy is in most cases going to prove illusory.’⁶⁴ Moreover, the problem with D&O policies is that these are often ‘drafted in a manner which pays no regard to the liabilities that directors may actually face – careful scrutiny of a D&O policy shows that it covers phantom liabilities and does not respond to actual liabilities.’⁶⁵ Taking the view that the majority of third parties dealings with companies are contractual, it is likely that majority of claims would be in contract. Unless a director has given personal guarantees to third parties or contracted as an individual, director’s liability is unlikely and the cause of action against directors may not be made out at all for a D&O policy to respond. On the premise that directors are not under significant risk of being sued by third parties, with a D&O policy unlikely to respond if directors are sued, less significance is here attached.

In this respect of third parties who sue out of their transaction with the company, from the perspective that company law may not attach personal liability to directors, the name ‘D&O

⁶¹ A Barton and F Kean, *Directors’ Liability Survey: Directors in Peril – Insurance and Indemnity in Risky Times*, 4 (London, Allen & Overy LLP, December 2011/January 2012).

⁶² *Ferguson v. Wilson* (1866-67) LR 2 Ch App 77, 89-90 (Cairns LJ).

⁶³ See below in this section discussion of the case *Williams v. Natural Life Health Foods Ltd* [1998] 1 WLR 830; [1998] 2 All ER 577.

⁶⁴ R Merkin, *Directors and Officers Insurance and the Global Financial Crisis* 118 BILA J 1, 1 (2009).

⁶⁵ R Merkin, *Tort and Insurance: Some Insurance Law Perspectives* PN 194, 197 (2010).

liability policy' is misleading. The need for a D&O policy implies personal liability on the part of a director, yet in respect of third parties, liability is on the company. As 'the company itself cannot act in its own person, for it has no person; it can only act through directors,'⁶⁶ then directors are agents of the company, and if agents, unless agents assume personal liability, third parties' recourse is to the company as the principal. As such, company law places the resultant liability for such acts on the corporate entity. As a matter of law, directors are not liable for the acts of the company.⁶⁷ However, 'if a company is formed for the express purpose of doing a wrongful act or if, when formed, those in control expressly direct that a wrongful thing be done, the individuals as well as the company are responsible for the consequences.'⁶⁸ As an embodiment of the company the director incurs no liability unless and until he assumes personal responsibility.⁶⁹ This notwithstanding, perhaps due to directors having a perceived fear of personal liability, insurers moved in to create a D&O policy to allay their fears. Whilst a D&O policy is significant for defence costs cover in third party claims, directors' liability implied in D&O policies ignores the principle of corporate personality, which principle, if understood, renders the name 'D&O policy' misleading.

The principles of company law are such that acts of the director are counted for the company. It is then difficult, where a director acts in his or her director capacity, unless the existence of the company is denied, to find liability on the director in a company law context. The position in law was stated that, 'a corporation is an abstraction, it has no mind of its own any more that it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very *alter ego* and centre of the personality of the corporation.'⁷⁰ In other words, 'if the guilty man was in law identifiable with the company then whether his offence was serious or venial his act was the act of the company.'⁷¹ As such, in respect of third parties and for substantive coverage, a D&O policy is not significant, for it is not directors who are liable for the acts they render for the company, but rather the company itself. If third parties sue directors, as a commercial tool, a D&O policy is, despite the law, significant for providing directors with defence costs.

Considering that 'the majority of allegations against directors are settled before they reach court,'⁷² insurers may commercially indemnify on settlement without a finding of liability first. In cases where third party claims do go to court, if the director is found to have assumed personal liability, arguably a D&O policy should not respond; for then the director acted outside the capacity of a director to be covered by a D&O policy when s/he assumed personal liability. On the other hand, if the court exonerates the director, applying principles of company law and agency, arguably the proper defendant was the company and the director may not have needed a D&O policy. A careful analysis of the situations in third party claims show that whether or not a director assumes personal liability a D&O policy may need not respond as a matter of law – as such, a D&O policy stripped of defence costs cover, just like

⁶⁶ *Ferguson v. Wilson* (1866-67) LR 2 Ch App 77, 89-90 (Cairns LJ).

⁶⁷ This stems first from *privity of contract* rule, and second from the *doctrine of agency* – only a party to the contract can sue and be sued, and the common law exception of agency allows the company to sue and be sued when directors as agents of the company contract or transact with third parties.

⁶⁸ *Rainham Chemical Works Ltd v. Belvedere Fish Guano Co Ltd* [1921] 2 AC 465, 476.

⁶⁹ R Grantham and C Rickett, *Directors' "Tortuous" Liability: Contract, Tort or Company Law?* 62 MLR 133 (1999); see *Williams v. Natural Life Health Foods Ltd* [1998] 1 WLR 830, 835-837 (Lord Steyn); [1998] 2 All ER 577.

⁷⁰ *Lennard's Carrying Co* [1915] AC 705 at 713.

⁷¹ *Tesco Supermarkets Ltd v. Natrass* [1972] AC 153, 173; [1971] 2 WLR 1166.

⁷² A Felsted, 'The danger of being an executive in the UK' *Financial Times* (17 October 2006).

an oral contract, is not worth the paper that it is written on.⁷³ As such, less significance should be attached to D&O policies.

Whether D&O policies as legal tools would respond to liability claims is partly answered by the case of *Williams v. Natural Life Health Foods Ltd.*⁷⁴ The *Williams* case concerned claimants who had sustained losses having bought a business opportunity which later failed, and the claimants unsuccessfully brought a tortious claim against the director of the selling company for negligent misstatement. In this case, the selling company had become insolvent and the claimants sought to attach liability to the director. The claimants failed to prove that the director had assumed personal responsibility to them in selling, and the director was held not liable in tort. As a legal tool, for a D&O policy to respond in such claims, liability of the insured must first be established.⁷⁵ The decision in *Williams* demonstrates that D&O insurers are unlikely to face many third party claims or/and that D&O policies are unlikely to respond.

Unless the director has assumed personal responsibility, in cases where this is a necessary element of the civil wrong against the director, *Williams* demonstrate that English law does not attach liability to a director who acts in his capacity as a director. In such third party claims, without an assumption of personal liability, and further shielded by company law principles, ordinarily, the director has no need for a D&O policy. D&O policies only respond where a director incurs liability in his or her capacity as a director. 'Accordingly, if *Williams* is taken at face value, then, absent special words of extension, in the exceptional circumstances where liability is incurred by a director to a third party, it will not be protected by D&O cover.'⁷⁶ Where the director assumes personal responsibility, arguably the director would be acting outside his or her capacity of a director and a D&O policy would still not respond.⁷⁷ In strict legal terms, incurring liability outside a director capacity renders a D&O policy inapplicable, but treating a D&O merely as a commercial tool, nothing in law hinders D&O insurers from providing directors with third party indemnity by way of defence costs.

The decision in *Williams* represents a limit to directors' liability. The assumption of personal responsibility must be evidenced by an act which transgresses the director's corporate authority, to the extent that any accountability for the tortious act becomes, in reality, the director's and his or hers alone.⁷⁸ However, in deciding tortious liability of corporate agents, as the issue 'is not peculiar to companies',⁷⁹ it is not a question of company law, but rather 'an application of the law of principal and agent to the requirement of assumption of responsibility under the *Hedley Byrne* principle.'⁸⁰ Where assumption of responsibility is an element of a civil wrong, there is no need to resort to company law to decide the liability of corporate agents. In other words, 'when the civil liability of a corporate agent is called into question, the only relevant enquiry is whether the elements of the civil wrong are proved against the agent.'⁸¹ Where, for example, in deciding liability for

⁷³ R Merkin, *Directors and Officers Insurance and the Global Financial Crisis* 118 BILA J 1, 7 (2009).

⁷⁴ [1998] 1 WLR 830; [1998] 2 All ER 577.

⁷⁵ *Post Office v. Norwich Union Fire Insurance Society Ltd* [1967] 2 QB 363; [1967] 2 WLR 709.

⁷⁶ R Merkin, *Directors and Officers Insurance and the Global Financial Crisis* 118 BILA J 1, 6 (2009).

⁷⁷ It requires the director or officer to have acted in that *capacity* – D&O policies define 'director or officer' as any natural person presently or previously appointed/elected by the company as a director or officer during the period of insurance and acting in such *capacity* on behalf of the company – for example, see Zurich D&O policy wording, available at <https://www.zurich.com/NR/rdonlyres/1FFFFBFE-CE7B-4422-B6D8-173E1D9EF4EF/0/NZDOPolicywording.pdf> (last accessed 16 January 2016).

⁷⁸ S Griffin, *Company Director's Personal Liability in Tort*, LQR 36, 40 (1999).

⁷⁹ *Williams v. Natural Life Health Foods Ltd* [1998] 1 WLR 830, 835-837 (Lord Steyn).

⁸⁰ *Standard Chartered Bank v. Pakistan National Shipping Corp (No.2)* [2003] 1 AC 959, 969 (Lord Hoffmann).

⁸¹ N Campbell and J Armour, *Demystifying the Corporate Liability of Civil Agents* 62 CLJ 290, 300 (2003).

deceit,⁸² where assumption of responsibility is not an element of the tort, a director cannot hide behind the company to avoid such liability.

‘Consequently, if personal liability does not arise in the first place, the insurer’s substantive duty to indemnify does not arise either,’⁸³ and so a D&O policy is not triggered to respond. For substantive cover, unless claims under a D&O policy are settled out of court without the need to establish liability against the assured director, strictly, unless a director is liable, a D&O policy does not respond and a director need not be insured for a company’s liability. Moreover, as a typical D&O policy wording require a director or officer to have acted in that capacity for a D&O policy to respond,⁸⁴ it is here argued that if assumption of personal liability is proven, a D&O policy is unlikely to respond, as the director will not have acted in a director capacity for the policy to respond. What then is left of D&O policies in respect of third parties who sue directors in relation to their transaction with the company is provision of defence costs, which a D&O policy provides as a commercial tool.

5. Company Indemnities and Statutory Relief

Having discussed potential liabilities that a director may face, the next step is to discuss the extent to which directors may manage those potential liabilities, and in particular, assess whether directors may afford to rely on company indemnities instead of having a D&O policy. This leads to ways in which companies may indemnify directors under provisions set out in the CA 2006. The Act prohibits a company from exempting a director from liability in relation to the company or associated company for which the person is a director. But the Act allows a company to provide indemnity insurance for its directors, and exemption is allowed in regard to qualifying third party indemnity and qualifying pension scheme indemnity. In addition, the Act allows a director to seek relief from the court without the need for insurance. The relevant provisions of the Act are outlined and discussed below.

5.1. Provision of Defence Costs in Proceedings and Investigations

Section 205 allows a company to fund a director’s defence costs in defending any criminal or civil proceedings in connection with any alleged negligence, default, breach of duty or breach of trust by him in relation to the company or an associated company. This mirrors the defence costs under a D&O policy and may seem to render a D&O policy unnecessary.

Section 206 allows a company to provide a director with funds to meet expenditure incurred or to be incurred by him in defending himself in an investigation by a regulatory authority or defending against action by a regulatory authority. Proceedings against directors tend to involve not only cases that may give rise to damages, but also administrative investigations by Financial Conduct Authority or Prudential Regulation Authority. As the main benefit of having a D&O policy is in providing defence costs, this section may seem to render a D&O policy unnecessary.

In relying on ss 205 and 206, ‘interestingly, in neither case is shareholder approval required for the provision of this funding.’⁸⁵ While it could be said that the function of a

⁸² *Standard Chartered Bank v. Pakistan National Shipping Corp (No.2)* [2003] 1 AC 959 (HL).

⁸³ A Paolini, *Lending Sub-Prime and Advising on Financial Investments from a D&O Insurance Perspective*, JBL 432, 443 (2012).

⁸⁴ For example, Zurich Insurance plc, Part C – directors and officers liability, covers claims against the ‘insured person whilst acting in this capacity on behalf of the company.’ Available at <http://www.camberfordlaw.com/files/wordings/ZurichSecurityLiabilityPolicyWording.pdf> (last accessed 8 May 2017).

⁸⁵ B Hannigan, *Company Law*, 294 (3rd edn, Oxford, Oxford University Press 2009).

D&O policy is to provide defence costs arising from civil/criminal proceedings or regulatory investigations and actions, it is cost-effective and serves the interests of the company better to engage ss 205 and 206 as and when actual lawsuits or investigations ensue, instead of paying the high D&O premiums. If it is in the best interest of the company, it should not be difficult for a board of directors to approve provision of defence costs to defend a lawsuit or investigation brought against one of their fellow directors. The question then is why a board of directors would prefer to cause a company to pay D&O policy premiums instead of obtaining defence costs from the company as and when litigation or investigation ensues.

The answer lie in the limitations the law places on company indemnity as a legal tool and the liberality insurers places on D&O policy as a commercial tool. Section 205(2) provides that the funds advanced to the director for defence costs are to be repaid in the event of the director being convicted in the proceedings or judgment being given against him in the proceedings. In respect of such limitation in regard to regulatory investigations, s 206 is silent; however, s 234(3) precludes a company from indemnifying a director against liability to pay a sum payable to a regulatory authority by way of a penalty in respect of non-compliance with any requirement of a regulatory nature (however arising).⁸⁶ As a commercial tool, nothing in law hinders a D&O policy from providing a liberal cover than ss 205 and 206, as long as the cover is not illegal or against public policy. Indeed, insurers guard against illegality by inserting into D&O policies standard wording to the effect that, in civil/criminal proceedings or regulatory investigations, the policy will indemnify for defence costs, 'although if the assured at any point is found guilty of, or admits to, fraud, the funding ceases automatically and the insurers may seek to recover their costs payments from the assured.'⁸⁷ The liberality insurers place on D&O policy as a commercial tool is that a D&O policy will provide 'defence costs cover (civil, regulatory and criminal proceedings), with no repayment risk in the event of the director being found to have acted wrongfully unless they are found to have acted dishonestly or fraudulently.'⁸⁸ Thus, much significance would be attached to a commercial tool than to a legal tool that leave a director out of pocket.

In addition, two scenarios here illustrate the risk to directors of relying on ss 205 and 206 instead of purchasing D&O policies. First, directors may leave the company, new directors join, old directors are investigated or sued, and new directors refuse to indemnify. This scenario is not frequent in the UK, nonetheless a risk that may be concerning enough for directors to have a rational fear of potential liability so as to attach much significance on D&O policies. Second, the company becomes insolvent and unable to indemnify. In the situation involving insolvent companies that no longer have assets, where proceedings are brought against directors, D&O policies provide for the needed defence costs. Crucially, a D&O policy could help here. How much significance should be attached to D&O policies depends on the funding capacity a liquidator has to bring such proceedings against directors.

5.2. Restrictions on Provisions for Protecting Directors

Section 232(1) prohibits, by way of making void any provision that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him or her in connection with any negligence, default, breach of duty or breach of trust in relation to the company. This section puts to an end a reoccurrence of the outcome in *Re City Equitable*

⁸⁶ CA 2006, s 234(3)(a)(ii).

⁸⁷ R Merkin and J Steele, *Insurance and the Law of Obligations*, 395 (Oxford, Oxford University Press 2013).

⁸⁸ A Barton and F Kean, *Directors' Liability Survey: Directors in Peril – Insurance and Indemnity in Risky Times*, 9 (London, Allen & Overy LLP, December 2011/January 2012); Barton and Webster, *D&O Liability Insurance* 34 CSR 63 (2010).

Fire Insurance Co Ltd,⁸⁹ where the action against directors failed due to a provision in the articles exempting them from liability unless the loss had been caused by their own willful neglect or default. Section 232(2) provides that 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 or her in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he or she is a director is void, except as permitted by (a) s 233 (provision of insurance), or (b) s 234 (qualifying third party indemnity provision), or (c) s 235 (qualifying pension scheme indemnity provision). Section 232(2) provides exceptions to what s 232(1) prohibits. Arguably the prohibition in s 232(1) prevents abuse of power by the controlling director who could use company's money to indemnify himself for wrongdoings.

The relationship between a D&O policy and the prohibition in s 232 is very odd, for in effect, what s 232(1) prohibits the company to do directly, s 232(2) allows the company to do indirectly by means of a D&O policy. A director owes his or her duties to the company,⁹⁰ and it will be the company that has the right to enforce those duties against the director.⁹¹ Hence, s 232(1) prohibits any provision (in the Articles or in any service contract) that exempts the director from liability to the company. Section 232(2) then confirms that a D&O policy and/or a third party indemnity is permitted without breaching s 232(1), which s 233 and s 234 also confirm. Arguably, s 232(2) provides the board with the opportunity to consider insurance costs in the light of the interests of the company as a whole rather than as they would be considered for the indemnity which s 232(1) prohibits. In other words, 'the need to buy insurance will bring the cost of the protection home to the board which is arranging for it, whilst an indemnity, which carries no immediate costs for the company, might be too easy a provision to slip into the articles.'⁹²

5.3. *Provision of Insurance for Directors*

Section 233 allows a company to procure insurance for a director against any liability that would attach to him or her in connection with any negligence, default, breach of duty or breach of trust in relation to the company. Davies and Worthington have argued that, whilst 'at first sight, this is very odd,' as by paying for say a D&O policy 'the company ends up paying for the directors' breaches of duty' and making it seem 'to deprive the directors' duties rule of any deterrent effect,' the deterrent effects of the duties are not lost when s 233 is assessed subject to insurance market qualifications.⁹³ First, Davies and Worthington argue that the insurance market is unlikely to provide cover for fraud or wilful default or liability to account for profit made, and hence liability remains with the director. Second, Davies and Worthington argue that insurers will adjust premiums as incentives or refuse to insure those with bad records. Finally, Davies and Worthington argue that as qualified persons may not take on board positions without insurance, it may be more effective for the company to provide insurance. Directors may not feel safe without a D&O policy. Indeed, when a statutory provision permitting directors' insurance was first introduced,⁹⁴ one of the advantages provided in parliamentary debates was that it should be especially beneficial to

⁸⁹ [1925] Ch 407; [1924] All ER Rep 485.

⁹⁰ CA 2006, s 171; *Percival v. Wright* [1902] Ch 421.

⁹¹ *Foss v. Harbottle* (1843) 67 ER 189; (1843) 2 Hare 461.

⁹² P Davies and S Worthington, *Gower & Davies Principles of Modern Company Law*, 633 (9 edn, London, Sweet & Maxwell 2012).

⁹³ P Davies and S Worthington, *Gower & Davies Principles of Modern Company Law*, 631 (9 edn, London, Sweet & Maxwell 2012).

⁹⁴ Companies Act 1989, s 137, amending Companies Act 1985, s 310, now contained in CA 2006, s 233.

non-executive directors, particularly those in small companies who are paid only relatively small sums for their services but who are, nonetheless, potentially liable in law with their executive colleagues for substantial sums.⁹⁵ This renders D&O policies much significant.

It is argued that one reason why directors would prefer engaging s 233 and cause the company to pay for annual D&O policy premiums instead of relying on company indemnity is because directors are risk averse due to the fear of investigation or litigation. Directors' risk aversion may be allayed in two ways: either by company indemnity at the point when the director is actually investigated or sued, or by annual D&O policy premiums regardless of whether the director is investigated or sued. Given that it is directors as a board who decide whether to rely on company indemnity or pay for a D&O policy, to ensure that their decision to pay for a D&O policy is cost-effective and in the best interest of the company, the law ought to subject the board to an inquiry: whether an intelligent and honest man or woman in the position of director could have in all the circumstances reasonably believed that the transaction was for the benefit of the company.⁹⁶ In theory, a director complies with the duty to act in the best interest of the company if the director actually believes the action is in the company's interests; in practice, based on relevant evidence, the courts tend to look at what a director could plausibly believed.⁹⁷ Depending on the assessment of perceived risk, all factors remaining constant, if less significance is attached to D&O policies, a board mindful of this inquiry is likely to rely on company indemnity and not pay for D&O policy premiums.

Arguably, company directors will generally rely for their protection and for payment of their defence costs on some combination of (a) the permitted indemnities usually contained in the company's articles, (b) D&O policy to pay defence costs incurred by the director and any civil penalties incurred, and (c) qualifying third party indemnities. One of the reasons why a D&O policy is likely to be preferred to company indemnity is that the restrictions on company indemnity are wider than those in many D&O policies. For example, the company is precluded from indemnifying a director for fines and penalties,⁹⁸ but the 'loss' recoverable under a D&O policy, 'depending on the wording and facts, may include civil fines and penalties but will not include matters uninsurable.'⁹⁹ The issue of D&O policies paying fines for directors remains arguable. There is no public policy reason why an insured cannot claim under an insurance policy in respect of a fine where the fine is imposed against an individual through no fault of their own, for example in the case of a strict liability offence where there is no argument that the director is personally culpable.¹⁰⁰ With D&O policies providing better terms than the law allows in company indemnity, boards will continue to engage s 233.

Less significance could, arguably, be attached to D&O policies where the principle that English courts will not allow litigation to interfere with the management of companies is still considered robust enough to protect directors. The reluctance of English courts to interfere in directors' commercial decisions is well settled. In 1812, Lord Eldon stated that: 'This Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom.'¹⁰¹ In 1902, Lord Davey stated that: 'it is an elementary

⁹⁵ HC Deb 26 October 1989 vol 158 cc1174-6 'Insurance effected for officers or auditors;' HL Deb 09 November 1989 vol 512 cc1008-10 'Motion moved on consideration of Commons amendment.'

⁹⁶ See *Neptune (Vehicle Washing Equipment) Ltd v. Fitzgerald (No 2)* [1995] BCC 1000, 1017; *Regentcrest Plc v. Cohen* [2001] BCC 494; [2001] 2 BCLC 80, 105; *Sintel Communications Ltd v. Rebak* [2006] EWHC 572 (QB) [2006] 2 BCLC 571, 596; *Primlake v. Matthews Associates* [2006] EWHC 1227 (Ch); [2007] 1 BCLC 666, 731.

⁹⁷ D Kershaw, *Company Law in Context*, 345 (2nd edn, Oxford, Oxford University Press 2012).

⁹⁸ See CA 2006, s 234(3).

⁹⁹ J Hill and C Henley, *Directors' and Officers' Liability Insurance: Problems and Pitfalls* 172 IHL 37 (2009).

¹⁰⁰ A Barton and F Kean, *Directors' Liability Survey: Directors in Peril – Insurance and Indemnity in Risky Times*, 6 (London, Allen & Overy LLP, December 2011/January 2012).

¹⁰¹ *Carlen v. Drury* (1812) 1 Versey & Beames 154, 158; 35 ER 61, 62 (Lord Chancellor Eldon).

principle of the law relating to joint stock companies that the Court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so.¹⁰² In 1927, Lord Scrutton stated that: ‘it is not the business of the Court to manage the affairs of the company.’¹⁰³ In 1966, Buckley J was of the opinion that as long as the majority acted within their constitutional rights and directors acted within their powers, ‘the court should not investigate the rival merits of the views or policies of the parties.’¹⁰⁴ In 1974, Lord Wilberforce stated that: ‘there is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.’¹⁰⁵ The principle that English courts will not allow litigation to interfere with the management of companies is, in the modern increasingly tougher regulatory landscape in which directors operate, not robust enough. The regulatory landscape, seeking to hold companies accountable, seeking to find scapegoats for the global financial crisis, treats directors with much suspicion than protection.

One of the implications for corporate governance arising from D&O policies is the need for directors to avoid being tainted with the moral hazard problem. Baker and Griffith presented the moral hazard problem as an economic analysis militating against D&O policies.¹⁰⁶ Moral hazard is the tendency of insurance to increase loss by reducing an insured person’s incentive to take care to avoid loss. Baker and Griffith argue that the economic analysis of insurance teaches that insurance increases loss whenever the following six conditions are met: (1) money compensates for loss, (2) the decision makers are rational loss minimizers, (3) taking care requires effort, (4) taking care is effective, (5) the beneficiaries of the insurance have control over the care-taking activity, and (6) insurance payments are not conditioned on a given level of care. Baker and Griffith assert that D&O policies meet all six of these conditions. Moreover, in a derivative claim, Baker and Griffith observe that D&O policies are ‘completely circular wealth transfer’ and ‘pocket shifting in the extreme.’¹⁰⁷

In derivative claims money travels in a circle – from the director to the company (in settlement of the derivative claim), then back from the company to the director (in fulfilment of the company’s obligation under the terms of a D&O policy). If a D&O insurer indemnifies a director against liability he was forced to meet under the derivative claim, the company indirectly pays by way of prior premium contributions and by way of likely future higher premium contributions following the claim. It is also cyclical as both the director and the company seem to benefit – the director who would not have had funds to pay damages to his company is indemnified by the insurer, and the company recovers from the insurer what it could not recover from the director without insurance. To avoid being tainted with the moral hazard problem, directors should subject their decision to pay for a D&O policy to a self-inquiry: would an intelligent and honest person in the position of directors in all the circumstances reasonably believe that the transaction is for the benefit of the company?

The purchase of D&O policies not only creates a moral hazard but also a legal dilemma. In company law, directors are agents of the company. The risks and liabilities of running the business should fall on the company (principal) and should not be shifted to directors (agents). In other words, ‘it is the corporation alone – not the agent, director or officer who is acting in furtherance of the corporation’s business – that should bear the liability or risk of

¹⁰² *Burland v. Earle* [1902] AC 83, 93 (Lord Davey).

¹⁰³ *Shuttleworth v. Cox* [1927] 2 KB 9, 23 (Scrutton LJ).

¹⁰⁴ *Hogg v. Cramphorn Ltd* [1967] Ch 254, 268 (Buckley J); [1966] 3 WLR 995.

¹⁰⁵ *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821; [1974] 2 WLR 689; [1974] 1 ALL ER 1126, 1131 (Lord Wilberforce).

¹⁰⁶ T Baker and SJ Griffith, *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation*, 60 (Chicago, University of Chicago Press 2010).

¹⁰⁷ T Baker and SJ Griffith, *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation*, 43 (Chicago, University of Chicago Press 2010).

doing business.’¹⁰⁸ In the company principal-agent situation, this creates a legal dilemma. The principal-agent relationship here is that the company (principal), as a legal person, can only act through the directors (agents), as natural persons; the principal’s power to decide on whether to purchase a D&O policy is exercised exclusively by the agents; if the agents take inappropriate risks in running the business, and yet exercise the principal’s power to purchase D&O policies, it creates a moral hazard as well as a legal dilemma.

Shareholders cannot resolve this legal dilemma, for in company law, other than in limited cases if shareholders direct directors by way of special resolution,¹⁰⁹ directors have exclusive rights to manage the company and cannot be ordered by the shareholders.¹¹⁰ The solution is not to resort to economic arguments that shareholders are principals and the related agency costs theories.¹¹¹ The law needs to respond to this legal dilemma. A good example of a law’s response is found in Germany. In dealing with directors’ inappropriate risks, the German Stock Corporation Act provides: ‘If the company takes out an insurance covering the risks of a member of the managing board arising from his work for the company, such insurance should provide for a deductible of no less than 10 per cent of the damage up to at least an amount equal to 1.5 times the fixed annual compensation of the managing board member.’¹¹² The German approach is to deal with risk taking as part of the remuneration for directors – requiring that the ‘remuneration systems must be designed so as to avoid incentives to enter into harmful, disproportionately high-risk positions.’¹¹³ The UK could follow the German example and insert a similar clause under s 233 of the Companies Act. However, like other company law provisions, enforcement of such a clause by derivative claims may remain problematic given the disincentive for derivative claims discussed above.

Directors may also wish to avoid being seen as putting their self-interest before the interest of the company. The decision to purchase a D&O policy should be to ‘promote the success of the company for the benefit of its members as a whole,’ having regard to ‘the need to act fairly as between members of the company.’¹¹⁴ The problem is that directors tend to ‘buy D&O coverage for self-serving reasons and the coverage itself, because it does not control moral hazard, reduces the extent to which shareholder litigation aligns managers’ and shareholders’ incentives.’¹¹⁵ To avoid self-interest, directors may take extra safeguards by subjecting their decision to purchase D&O policies to the scrutiny of shareholders in a general meeting. Rather than wait to bring derivative claims, shareholders should be willing to question in general meetings the decision to purchase D&O policies, for shareholders do not benefit from wealth transfer represented in derivative claims settlements. What shareholders gain for the company in derivative claims from liable directors either was lost *ab initio* in D&O policy premiums paid by the company or is lost as a result of the company

¹⁰⁸ M Petrin, *The Curious Case of Directors’ and Officers’ Liability for Supervision and Management: Exploring The Intersection of Corporate and Tort Law* 59 American University Law Review 1661 (2010).

¹⁰⁹ The Companies (Model Articles) Regulations 2008, regulation 4.

¹¹⁰ *Automatic Self-Cleansing Filter Syndicate Co Ltd v. Cunningham* [1906] 2 Ch 34.

¹¹¹ For examples of these economic theories of corporate governance, see: MC Jensen and WH Meckling, *The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure* 3 Journal of Financial Economics 305 (1976); R Hessen, *A New Concept of Corporations: A Contractual and Private Property Model* 30 Hastings Law Journal 1327 (1979); E Fama, *Agency Problems and the Theory of the Firm* 88 Journal of Political Economy 228 (1980); E Fama and M Jensen, *Separation of Ownership and Control* 26 Journal of Law and Economics 301 (1983).

¹¹² Section 93(2) para 2 of the German Stock Corporation Act.

¹¹³ Y Hausemann and E Bechtold-Orth, *Changing Remuneration Systems in Europe and the United States: A Legal Analysis of Recent Developments in the Wake of the Financial Crisis* 11(2) EBOR 195, 216 (2011).

¹¹⁴ CA 2006, s 172(1)(f).

¹¹⁵ T Baker and SJ Griffith, *The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer* 95 Geo L J 1795 (2007).

indirectly reimbursing directors through the provision of D&O policy. The board would be freed of the self-interest implications if shareholders supported the purchase of D&O policy.

5.4. Provision for Qualifying Third Party Indemnity

Section 234 deals with qualifying third party indemnity provisions, which is one of the exceptions to s 232. This allows a company to indemnify a director against liability incurred by him or her to a person other than the company or group of companies. Although s 234(3) qualifies the indemnity with a number of restrictions, a director would still have the benefit of defence costs. Section 234(3) prohibits third party indemnity for a director in criminal proceedings in which he or she is convicted, or in civil proceedings brought by the company in which judgment is given against him or her, or in connection with an application for relief in which the court refuses to grant the director relief. These prohibitions, as s 234(4) makes it clear, are to the final decision in the proceedings, which means defence costs can be paid until the final decision is made.

Arguably, s 234 is wider than it seems and should be read as permitting whatever it does not prohibit. In the case of a civil action brought by a third party the indemnity provision may cover both the liability of the director and the costs of defending the action, whether successfully or unsuccessfully.¹¹⁶ With this wide reading, a board seeking cost-effective means of protection, taking into account the interest of the company, may rely on s 234 than cause the company to pay D&O policy premiums.

5.5. Provision for Qualifying Pension Scheme Indemnity

Section 235 deals with qualifying pension scheme indemnity provisions, which is another of the exceptions to s 232. This allows a company to indemnify a director who is a trustee of an occupational pension scheme against liability incurred in connection with the company's activities as trustee of the scheme. Unlike s 234, which restricts indemnity to lawsuits brought by third parties, s 235 allows indemnity in civil proceedings brought by the company as well. 'In other words, as far as the director's activities on behalf of the company as trustee are concerned, a complete indemnity arrangement is permissible in relation to civil liability.'¹¹⁷ A trustee director need not have his or her company pay D&O policy premiums, but simply rely on s 235. Although s 235(3) prohibits indemnity for liability incurred by a director in defending criminal proceedings in which he or she is convicted, s 235(4) makes it clear that this conviction is to the final decision in the proceedings, which leaves defence costs payable until the final decision is made.

5.6. Provision for Relief by the Courts

Section 1157 provides a director with an alternative to a D&O policy, in that, at the discretion of the court, a director may obtain relief from liability, without the need for insurance. If relief is granted, this attaches to liability for negligence, default, breach of duty or breach of trust. In exercising discretion, the court may relieve wholly or in part a director who acted honestly and reasonably and therefore ought fairly to be excused. This relief could apply to liability to account for profits and for liability to pay damages to the company.¹¹⁸ A partial

¹¹⁶ P Davies and S Worthington, *Gower & Davies Principles of Modern Company Law*, 634 (9 edn, London, Sweet & Maxwell 2012).

¹¹⁷ P Davies and S Worthington, *Gower & Davies Principles of Modern Company Law*, 635 (9 edn, London, Sweet & Maxwell 2012).

¹¹⁸ *Coleman Taymar Ltd v. Oakes* [2001] 2 BCLC 749; (2001) 98(35) LSG 32.

relief was granted to a negligent director in *Re D'Jan of London Ltd*,¹¹⁹ but relief was denied in a number of other cases.¹²⁰ However, where relief is sought for liability for wrongful trading under s 214 of the Insolvency Act 1986, it is unlikely that the court will grant relief.¹²¹ Section 1157 relief, if granted, is in relation to liability to the company.¹²² Even then, as it was illustrated in the case of *Philip Towers v. Premier Waste Management Ltd*,¹²³ courts will not grant relief under s 1157 where a director is in breach of his or her duties to the company with no mitigating factors or where there is no evidence of injustice which might be relevant to granting relief in his or her favour. With the uncertainty involved in invoking s 1157, directors may prefer to have the backup of a D&O policy in place.

5.7. Should UK Directors Forego D&O and Rely on Company Indemnity?

It was back in 1995 when Collin Baxter argued that, ‘an unhappy feature of a D&O policy is that any case which does qualify for D&O protection will almost always be one which could readily be dealt with by other means.’¹²⁴ But since 1995, to the onset and the aftermath of the 2008 global financial, the corporate governance landscape has changed. Assessing in 2017 those ‘other means,’ the company and statutory indemnity provisions, reveals that D&O policies provide better terms for defence costs than those ‘other means.’ Yes, as a legal tool, D&O policies may not have to respond, but D&O policies operate as commercial tools. As commercial tools, D&O policies are often not scrutinised by courts, as most claims are settled out of court with insurers willing to pay in circumstances they would legally not be obliged to pay. It was observed in 1994 that, ‘the process for settling D&O claims in England is not marked by a propensity to litigate, it is extremely rare for claims to go to court,’¹²⁵ and up to 2017 there was still no evidence of D&O litigation increasing and out of court settlement may still keep D&O policies useful as commercial tools. Commercial justifications recognised back in 1994, are still relevant at the time of writing this paper in 2017, which are: encourages persons to act as non-executive directors; allows directors to take commercially justifiable risks free from the fear of potential personal ruin; and makes available a more substantial pool of funds for compensating victims of wrongdoing than would otherwise be the case.¹²⁶

To be fair on Collin Baxter’s 1995 statement above, Warren Buffett’s 2011 statement on the undesirability of D&O policies should not go unnoticed. Recalling that D&O policies are said to have originated in the US, there were still in 2011 US companies like Berkshire Hathaway Inc that had shelved D&O policies as an unnecessary expense. Warren Buffett of Berkshire Hathaway Inc believed that corporate culture matters, and that if directors make mistakes, they must bear the consequences, without insurance protection. Buffett explained: ‘we do not provide them directors and officers liability insurance, a given at almost every other large public company. If they mess up with your money, they will lose their money as well. Our directors, therefore, monitor Berkshire’s actions and results with keen interest and

¹¹⁹ [1994] 1 BCLC 561.

¹²⁰ *Dorchester Finance Co Ltd v. Stebbing* [1989] BCLC 498; *Guinness Plc v. Saunders* [1990] 2 AC 663; [1990] 2 WLR 324; *Clark v. Cutland* [2003] EWCA Civ 810; [2004] 1 WLR 783.

¹²¹ *Re Produce Marketing Consortium Ltd* [1989] 1 WLR 745; [1989] 3 All ER 1.

¹²² *Customs and Exercise Commissioners v Hedon Alpha Ltd* [1981] QB 818; [1981] 2 WLR 791.

¹²³ [2011] EWCA Civ 923; [2012] BCC 72.

¹²⁴ C Baxter, *Demystifying D&O Insurance* 15 OJLS 537, 557 (1995).

¹²⁵ V Finch, *Personal Accountability and Corporate Control: The Role of Directors’ and Officers’ Liability Insurance* 57 MLR 880, 901 (1994).

¹²⁶ V Finch, *Personal Accountability and Corporate Control: The Role of Directors’ and Officers’ Liability Insurance* 57 MLR 880, 892 (1994).

an owner's eye.'¹²⁷ That would be a hard act to follow, and Buffett is unlikely to have many friends in UK boardrooms! With UK law permitting D&O policies, D&O policies offering better defence costs than company indemnity, and directors operating in an increasingly tougher regulatory landscape, it would be a brave director who would forego a D&O policy.

6. Exclusions and Limitations Clauses

If by now the discussion is tilting towards attaching much significance to D&O policies, before anyone in the UK boardroom gets too excited, one has to take note of D&O policy exclusions. A legal practitioner specialising in insurance warned: 'A D&O policy wording is one of the most complex and intricate on the market – policy wordings are complex and the smallest error could result in a large gap in coverage.'¹²⁸ Below are few exclusion highlights.

Despite any doubts that might be cast on the significance of D&O policies, their market is sure, and the UK is the largest European market for D&O policies. With increasing D&O market, also come exclusions lest the insurers pay too much. Typically, a D&O policy gives cover for 'losses' arising from culpable acts committed by the assured in his capacity as a director. Culpable acts will generally be defined to mirror the wording of s 232 of the CA 2006 constituting negligence, default, breach of duty or breach of trust. Losses will generally be defined to include the sums a director pays as damages that are paid under a settlement or after a trial and legal costs that are incurred defending claims.¹²⁹ The CA 2006 and English company law in general do not attempt to deal with the contractual terms of a D&O policy. Instead, lawmakers have been content to let market forces govern the terms on which this insurance is available.¹³⁰

The terms of D&O policies tend to follow and build upon the norms developed in the general insurance market. Although there are currently no specific statutory terms attached to D&O insurance, D&O policies follow general insurance terms and inevitably exclude coverage for dishonest or fraudulent conduct and for the obtaining of a private benefit or profit. In *West Wake Price & Co v. Ching*,¹³¹ although the plaintiffs did not plead fraud, the claim seemed to be based on dishonesty and could not be sustained against the underwriters. English courts will also decline to enforce terms of D&O policies that contravene the interests of public policy, which may well mean that, regardless of how D&O insurance is structured, knowing or intentional director's misconduct is uninsurable.¹³² In summary, 'public policy prevents D&O Insurance policies and corporate indemnities from providing a director with indemnity protection against liability arising by reason of the director's dishonest, fraudulent or criminal conduct or with indemnity for criminal fines.'¹³³ It is still a matter of debate as to what extent public policy precludes D&O policies from indemnifying for regulatory fines and penalties. Arguably, to the extent the fine does not result from the director's dishonest or intentional misconduct, it should be lawful for insurers to indemnify under a D&O policy. For example, strict liability fines and penalties, attaching no fault of a director due to dishonest or intentional misconduct, should not be against public policy. But while this area remains uncertain, some D&O policies exclude regulatory fines and penalties.

¹²⁷ P Tom, *No to D&O Insurance Journal* (4 April 2011).

¹²⁸ J Hill and C Henley, *Directors' and Officers' Liability Insurance: Problems and Pitfalls* 172 IHL 37 (2009).

¹²⁹ BR Cheffins and BS Black, *Outside Director Liability across Countries* 84 Tex L Rev 1385, 1415-1416 (2006).

¹³⁰ B Black (ed), *Comparative Analysis on Legal Regulation of the Liability of Members of the Management Organs of Companies*, 219 (Law Working Paper 103/2008, European Corporate Governance Institute 2006).

¹³¹ [1957] 1 WLR 45; [1956] 3 All ER 821.

¹³² B Black (ed), *Comparative Analysis on Legal Regulation of the Liability of Members of the Management Organs of Companies*, 219 (Law Working Paper 103/2008, European Corporate Governance Institute 2006).

¹³³ A Barton and T Webster, *D&O Liability Insurance* 34 CSR 63 (2010).

One limitation to note is that of failing to show legal liability. Insurers may not reimburse on a D&O policy in cases where the policyholder fails to show that it was liable for the loss. In *Beazley Underwriting Ltd v. Travelers Companies Inc.*,¹³⁴ a policyholder could not claim an indemnity under its professional indemnity insurance where it had settled a third party's claim in circumstances where it was not liable for the third party's losses.

7. Conclusion

The global financial crisis has increased the realisation that it would be a brave director who would forego a D&O policy. This paper has examined the significance of D&O policies both as legal and commercial tools for directors. While D&O policies as legal tools may give an illusory cover, they are indispensable as commercial tools due to their defence costs cover.

In the wake of the global financial crisis, to ensure that companies comply, regulators are increasingly targeting directors for corporate wrongdoing. Directors are at risk of being investigated and liable to pay regulatory fines and penalties. The company law principle that directors are an embodiment of the company so that they are not liable for their acts as agents is no longer robust to protect them in this regulatory landscape. Insurers are not indifferent bystanders; they have long created D&O policies to protect directors. Directors being risk averse, with company indemnity inadequate for needed defence costs, may not work without a D&O policy. Company law in turn permits companies to purchase D&O policies.

The effectiveness of D&O policies lie in their covering defence costs (including civil, regulatory and criminal proceedings), with no repayment risk unless the director is found to have acted dishonestly or fraudulently. In dealing with D&O claims, insurers, unconcerned themselves with legal niceties that the law may not attach personal liability to directors, are willing to indemnify under D&O policies. Notwithstanding that D&O policies are commercial tools, their effectiveness is limited by law and will not cover (a) liability arising by reason of the director's dishonest, fraudulent or criminal conduct; or/and (b) criminal fines or regulatory penalties. Even as a commercial tool, a D&O policy is a defence costs cover.

Given that it is the board of directors who decide to protect directors by paying for a D&O policy, their decision could be tainted with self-interest. To avoid this implication, two suggestions have been advanced: first, directors should subject their decision to pay for a D&O policy to a self-inquiry: would an intelligent and honest person in the position of directors in all the circumstances reasonably believe that the transaction is for the benefit of the company? Second, directors may take extra safeguards by subjecting their decision to purchase D&O policies to the scrutiny of shareholders in a general meeting. There remains uncertainty as to what extent public policy precludes D&O policies from indemnifying for regulatory fines. It has been herein suggested that fines and penalties that are not a result of the director's dishonest or intentional misconduct, should be lawful under D&O policies.

¹³⁴ [2011] EWHC 1520 (Comm); [2012] 1 All ER (Comm) 1241.