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## **D&O LIABILITY INSURANCE: AN ESSENTIAL COMPONENT OF AN ORGANISATION'S RISK-MITIGATION TOOLBOX**

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Directors and officers of all organisations are facing an increased risk of personal exposure. Their roles and responsibilities have become progressively more onerous in recent years, mainly as a result of new legislation and regulatory requirements, stakeholder pressure and increased governance and social responsibilities, as well as the complexity of trans-continental and macro-economic trading conditions.

In South Africa, the Companies Act 71 of 2008 ('Companies Act') contains strict provisions in respect of the conduct and duties of directors and officers, as well as specific provisions relating to liability for the breach of their duties. As such, directors and officers of all organisations are required to undergo the necessary training to understand and be able to act on all of the components of their organisation's \*Corporate Governance Framework®, in order to ultimately mitigate all potential risks to the board, management and the organisation itself.

*"We know that directors are embracing opportunities in IT investment, product innovation or emerging markets, but we've also seen that they're facing unprecedented regulatory and political scrutiny, mounting shareholder activism, a recessionary environment, intense competition for business and talent, and an irresistible rise in claims."*

**Source: AIG Insurance Organisation**

The law compels directors and officers to fulfil various fiduciary duties, including that they must act with a duty of care and skill, whilst placing the organisation's interests at the forefront of their efforts. Furthermore, the duties of directors and officers extend well beyond the common law and legislation.

The organisation's Memorandum of Incorporation (MOI), including the director or officer's letter of appointment, job description, board charters, delegations of authority as well as the organisation's policies give rise to many more potential areas in which directors and company officers ('officers') may be held to account if they do not fulfil their duties. The chances of wrongdoing, especially for newly appointed or inexperienced people in these positions are exponentially increased.

In addition, the King IV Report on Corporate Governance for South Africa, 2016™ (King IV™) contains recommendations that increase the accountability of directors and officers to conduct the affairs of an organisation in a manner that respects and promotes the interests of all stakeholders.

Occupying any boardroom, or senior management position -- by its very nature -- is a function which inherently involves risk and risk taking. It is therefore not surprising that increasingly, organisations are providing people in these positions with protection against claims for any breaches of their fiduciary and other duties towards the organisation. Indeed, by not providing D&O Liability Insurance ('D&O') to its directors and officers, an organisation runs the risk of actively disincentivising enlightened individuals

from joining the organisation in the first place, let alone expecting them to take risks-for-reward, no matter how calculated, when their personal reputations and assets are at stake.

While an organisation's compliance with the provisions of the King reports, the Companies Act and other relevant legislation may satisfy various governance requirements -- as well as provide a level of assurance to stakeholders -- such compliance may not necessarily alleviate the costs or risks involved when a claim is brought against a director for their breach of duty. Directors and officers themselves generally require additional levels of protection against allegations of poor governance; hence the critical importance of D&O.

### What is D&O Liability Insurance?

In recent years, D&O has become a core component of corporate insurance. Essentially, it offers protection to directors and officers against legal claims for "wrongful" acts performed by them whilst performing their corporate duties, and protects their personal assets, as well as the assets of the organisation itself.

In this context, "wrongful" acts includes omissions, errors, misstatements, misleading statements, neglect or breach of duty by the director or officer, who may be personally sued by any number of complainants, including: *shareholders* (for insider trading and/or reckless behaviour); *creditors* (for misrepresentation of an organisation's financial health); *competitors* (for unfair trade practices); *regulators* where legal obligations have been breached, as well as employees, suppliers and customers.

*"Apart from pressures from the public, shareholders and political stakeholders, liability insurers and auditors are putting pressure on boards to better manage corporate governance issues . . . With accreditation and regular performance appraisals, insurers would be able to assess the risk of individual directors and reduce premiums for 'well managed' directors."*

**Professor Bob Garratt**

Whilst D&O is conceptually fairly simple, in practice these policies may be extremely complex. The cover is highly specialised and contains various exclusions and extensions, which may be negotiated between the organisation and the underwriter.

Generally, D&O policies would cover legal costs and expenses incurred in defending an action brought against a director or officer of an organisation and would include reimbursement for civil damages, defense costs and costs awarded against a director, settlements and fines and penalties, where such matters are insurable by law.

### D&O Liability Insurance and corporate governance

D&O and corporate governance are inextricably linked, since they affect, and are affected, by each other in various ways. For example, an analysis of an organisation's corporate governance forms part of the due diligence undertaken by D&O underwriters. On the other hand, increased legislation, regulation and

focus on corporate governance around the world have led to the need for -- and development of -- more sophisticated D&O.

Whilst D&O offers a safeguard for directors and officers against claims for breach of their duties, it has also been criticised for potentially undermining corporate governance insofar as it may minimise the personal impact of shareholder litigation for the director or officer involved, and in so doing, diminish the effectiveness of one of the tools of management control. It may also be seen to eliminate a strong disincentive for illegal or unethical behaviour and even to facilitate the wrongful acts which are being insured against.

On the other hand, the arguments in favour of D&O cover are particularly strong. Without such cover, suitable directors and officers might not take on such positions, particularly in the environment of increased shareholder activism. To attract good directors, organisations are increasingly realising that D&O cover is an essential component of any remuneration package. In addition, directors and officers without cover may become unduly risk averse in the running of the business, which in turn may have unintended adverse effects on shareholder value. Eliminating the potential financial risk or effect of personal litigation is one way of ensuring that the actions of directors and officers are in line with the interests of stakeholders.

It should be noted that, while Section 78 of the Companies Act allows for D&O, it provides that an organisation *may not* relieve a director or officer of the duties imposed on them in certain circumstances, such as in cases of willful misconduct, or if the director or officer knowingly allowed the organisation's business to be conducted recklessly, with gross negligence, with intent to defraud any person, or in insolvent circumstances.

As part of their underwriting process, insurance companies will carefully scrutinise an organisation's corporate governance practices and risk-management safeguards, as well as other aspects relating to the running of the organisation. It is therefore essential that D&O cover is correctly structured within the context of good governance protocols.

\* The Corporate Governance Framework® is a registered trademark of CGF Research Institute (Pty) Ltd.

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