

## **Guidance on Companies (Audit, Investigations and Community Enterprise) Act 2004 provisions relating to directors' liability**

This document provides a guide to the provisions relating to directors' liability in the Companies (Audit, Investigations and Community Enterprise) Act 2004 ("the Act").

The guidance has no legal force but is intended to help directors, other company officers and shareholders understand the main features of the legislation and the circumstances in which it applies. Those affected by the provisions should refer to them for a full statement of the legal requirements and, in case of doubt, seek legal advice on questions of interpretation.

The Government has also published Explanatory Notes to the Act, with the aim of making the provisions of the Act accessible to readers who are not legally qualified and who have no specialised knowledge of the matters dealt with. They are intended to allow the reader to grasp what the Act sets out to achieve and place its effect in context. The Explanatory Notes are available at <http://www.legislation.hmso.gov.uk/acts/en2004/2004en27.htm>.

While every effort has been made to ensure that the information in this document is accurate, the Department of Trade and Industry cannot accept liability for any errors, omissions or misleading statements in that information.

## **Contents**

<i>Section</i>	<i>Subject</i>	<i>Page</i>
1	Introduction	3
2	Directors' liabilities	4
3	Indemnification by the company or by an associated company	6
4	Liability insurance	13
5	Disclosure	14
6	Liabilities of company officers other than directors	15
7	Glossary	16

## **Section 1 Introduction**

1.1 The Companies (Audit, Investigations and Community Enterprise) Act 2004 (“the C(AICE) Act”) received Royal Assent on 28 October 2004. This guidance deals with the provisions in sections 19 and 20 of the Act relating to directors’ liability.

**The provisions will come into force on 6 April 2005.**

1.2 Sections 19 and 20 of the C(AICE) Act will relax the current prohibition on provisions protecting directors and other company officers from liability. They were tabled by the Government as part of its response to its consultation on director and auditor liability of December 2003, which in turn built on the work of the independent Company Law Review and of the subsequent review of the role and effectiveness of non-executive directors undertaken by Sir Derek Higgs.

1.3 The Government’s consultation identified two particular concerns in relation to directors’ liability:

- exposure to liabilities arising from legal action against directors by third parties. The sharp rise in the number of class actions by groups of shareholders in the US has made this a particular concern for directors of British companies with a US listing;
- the cost of lengthy Court proceedings. Companies are currently permitted to indemnify a director against the cost of defending legal proceedings, but only when judgement has been given in the director’s favour or he has been acquitted.

Sections 19 and 20 of the C(AICE) Act seek to address these concerns.

1.4 Section 19 amends the existing provisions in the Companies Act 1985 relating to directors’ liability. It does two things:

- it inserts into the Companies Act 1985 three new sections - 309A, 309B and 309C - which replace the existing provisions on directors’ liability (but not auditors’ liability) in section 310 of that Act;
- secondly, it disapplies existing section 310 from directors and other officers.

1.5 Section 20 inserts a new section - section 337A - into the Companies Act 1985 which will permit companies to pay directors’ defence costs, either in civil or criminal cases, as they are incurred.

## **Section 2 Directors' liabilities**

### **Who is a director?**

2.1 Section 741 of the Companies Act 1985 explains that "director" for the purposes of that Act includes any person occupying the position of director, by whatever name called. The term "director" therefore includes:

- an executive director who has been properly appointed under the individual company's articles of association;
- a non-executive director who has been properly appointed under the individual company's articles of association;
- a *de facto* director (that is, a person who has assumed the status and functions of a company director so as to make himself responsible as if he were a properly appointed director).

2.2 A "shadow director" is defined by section 741 of the Companies Act 1985 as "a person in accordance with whose directions or instructions the directors of the company are accustomed to act. However, a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity".

### **Directors' duties and potential liabilities**

2.3 Directors and shadow directors have duties under common law and in legislation. These include:

- general duties to the company, which are commonly divided into duties of loyalty and duties of care, skill and diligence. These are at the moment to be found in case law, but the Government has said that it intends to provide a statutory statement of the duties in line with the recommendation of the independent Company Law Review;
- specific statutory or regulatory duties. Under the Companies Act, for example, directors are required to prepare financial statements that give a 'true and fair' view and for those financial statements to be independently audited.

Breach of these duties may give rise to a liability on the part of the director.

2.4 Directors may also have liabilities to third parties e.g. in respect of a class action by a group of shareholders in the US.

2.5 As directors' general duties are owed to the company rather than to individual shareholders, it falls to the company to take action for breach of duty (including the duty of care, skill and diligence). There are three main ways in which the company can take legal action against a director (or, more usually, a former director):

- through the board of directors;
- through a derivative action brought by one or more shareholders to enforce a right which is vested not in him- or herself but in the company;

- through the liquidator or administrator following the commencement of a formal insolvency procedure such as liquidation or administration.

## **Section 3 Indemnification**

3.1 This section addresses two issues:

- the extent to which companies will be permitted to indemnify directors under sections 19 and 20 of the Act;
- the factors which companies should consider in deciding whether to indemnify, or to what extent to indemnify, directors.

### **Under what circumstances may companies indemnify directors?**

#### *Summary*

3.2 Companies and associated companies will be permitted to:

- indemnify directors against some (but not all) liabilities to third parties (see paragraphs 3.9 - 3.11 below);
- pay directors' legal costs upfront, provided that that the director repays the loan if he is convicted in any criminal proceedings or judgement is given against him in any civil proceedings brought by the company or an associated company (see paragraphs 3.13 - 3.15 below);
- exempt company officers other than directors from, or indemnify them against, liability, including liability to the company (see chapter 6 below);
- purchase directors' and officers' liability insurance (see chapter 4 below).

3.3 Companies may not exempt directors from liability to the company, or limit a director's liability to the company (see paragraph 3.8 below).

3.4 Companies and associated companies may not:

- indemnify directors against liabilities to the company or to any associated company;
- indemnify directors against criminal penalties or penalties imposed by regulatory bodies such as the Financial Services Authority;
- indemnify the director against any liability incurred in defending any criminal proceedings in which he is convicted, in defending any civil proceedings brought by the company, or an associated company, in which judgment is given against him, or in an unsuccessful application for relief from liability

under the provisions for relief in the Companies Act (see paragraphs 3.10 and 3.11 below).

3.5 Associated companies may not indemnify a director where such indemnification by the company itself would not be permitted (see paragraph 3.12 below).

3.6 The details of these changes and the circumstances in which the changes will apply are set out below. The Annex provides a summary of what companies will in future be permitted to do, and what they will still not be permitted to do.

3.7 The Glossary in chapter 7 explains the legal terms used below.

### Detail

#### *Exemption from liability*

3.8 Under new section 309A of the Companies Act 1985, a company is prohibited from exempting a director from any liability “in connection with any negligence, default, breach of duty or breach of trust by him in relation to the company”. As a result, a company can neither exempt a director from liability for breach of one or more of his duties to the company or limit his liability for such a breach.

#### *Indemnification by the company*

3.9 A company is also prohibited from indemnifying a director against such a liability unless the indemnity provision is a “qualifying third party indemnity provision” (“QTPIP”).

3.10 New section 309B provides that a QTIPI must satisfy three conditions:

**Condition A** is that the provision does not indemnify the director against a liability to the company or to any associated company;

**Condition B** is that the provision does not indemnify the director against payment of a criminal fine or a regulatory penalty (such as a fine imposed by the Financial Services Authority);

**Condition C** is that the provision does not indemnify the director against any liability incurred:

- (a) in defending any criminal proceedings in which he is convicted;
- (b) in defending any civil proceedings brought by the company, or an associated company, in which judgment is given against him;
- (c) in an unsuccessful application for relief from liability under the provisions for relief in the Companies Act.

3.11 Subject to these conditions, companies will be permitted to indemnify directors in respect of liabilities arising from proceedings brought by third parties (e.g. class actions or actions by Shareholder Action Groups, or actions following mergers

and acquisitions or share issues). Companies will be able to indemnify directors in such cases against both legal costs and the financial costs of any adverse judgment. (This means that companies will be permitted to indemnify directors against any liability incurred in the defence of civil proceedings brought by a regulator, even if judgment is given against the director.) A QTPIP may indemnify a director against liabilities arising from the period before the new provisions came into force.

#### *Indemnification by an associated company*

3.12 Section 309A prohibits indemnification of a director by an associated company where such indemnification by the company itself would not be permitted. “Associated company” is defined in subsection (6) of new section 309A as, in effect, a company in the same group. The prohibition on indemnification by an “associated company” is intended to prevent parent companies and subsidiaries from assuming liabilities in circumstances where the company itself would not be permitted to assume such liabilities.

#### *Payment of directors’ legal costs as they are incurred*

3.13 Sections 330-344 of the Companies Act 1985 place restrictions on a company’s power to make loans or quasi-loans to directors, or to enter into certain types of credit transaction with a director. The prohibition has prevented a company from lending money to a director on an ‘as incurred’ basis even to pay his legal expenses.

3.14 New section 337A provides that a company is not prohibited from funding a director’s expenditure in defending any civil or criminal proceedings provided that the director is obliged to:

- repay any loan; and
- discharge any other liability to the company

if he is convicted in any criminal proceedings, or judgement is given against him in any civil proceedings, or he is unsuccessful in an application for relief from liability under the provisions for relief in the Companies Act.

3.15 In cases where a director is convicted or judgment is given against him:

- a loan to a director in respect of civil proceedings brought by a third party (including a regulator) could immediately be forgiven by the company under a QTPIP;
- a loan to a director in respect of criminal proceedings or civil proceedings brought by the company, or an associated company, could not be forgiven by the company under a QTPIP. In such cases, the loan would become liable to be repaid by the director in full at the point when a conviction or judgment becomes final, without the possibility of its being forgiven under a QTPIP.

**What factors should companies consider in deciding whether to indemnify, or to what extent to indemnify, directors?**

3.16 From 6 April 2005 companies will be permitted (but not required) to indemnify directors against some third party liabilities. There are however a number of important factors which companies will need to consider before agreeing to indemnify a director by means of a QTPIP.

*(a) Compliance with directors' general duties to the company*

3.17 The changes to the law relating to directors' liabilities do not permit directors to act in breach of their general duties to the company. Companies will therefore need to consider carefully how to use the new ability to indemnify directors. The board of directors should for example consider very carefully whether it would be in the best interests of the company to agree to pay a director's defence costs as they incurred even if the action were brought by the company itself. The directors should also consider in such cases how the company might recover the costs if judgment was given against the director, and how the company could verify the defence costs claimed by the director when it was acting on the other side of the litigation.

*(b) The company's articles of association*

3.18 The company's articles of association may:

- (i) provide for the indemnification of the directors (subject to the Companies Acts);
- (ii) restrict the ability of the company to indemnify directors and any other company officers, even where such indemnification would be permissible under the Companies Acts;
- (iii) a combination of (i) and (ii) above.

3.19 The articles of many (but by no means all) companies will currently include the following article (which is the current default article on indemnity under the 1985 model articles of association):

“Subject to the provisions of the Act but without prejudice to any indemnity to which a director may otherwise be entitled, every director or other officer or auditor of the company shall be indemnified out of the assets of the company against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted or in connection with any application in which relief is granted to him by the court from liability for negligence, default, breach of duty or breach of trust in relation to the affairs of the company”.

3.20 Companies should consider in the light of the reform of the law on indemnification whether to amend their articles of association. (This would require the agreement of the shareholders.) There are two main reasons why they may wish to do so:

- (i) to provide for the indemnification of the directors and other officers of the companies in ways which are permitted under the new provisions but which were not previously permitted;
- (ii) to restrict the ability of the company to indemnify directors and other company officers, particularly in relation to those areas where the law has been amended under the C(AICE) Act.

(c) *The extent of a QTPIP*

3.21 An indemnity which does not wholly satisfy the requirements of being a QTPIP will fail in its entirety, rather than merely to the extent that it does not. Companies should therefore consider the extent of a QTPIP very carefully.

(d) *The effect of the new rules on indemnification by an “associated company”*

3.22 As explained in paragraph 3.12, section 309A prohibits indemnification of a director by an associated company where such indemnification by the company itself would not be permitted. This is an important clarification of the law relating to directors’ liability. Companies should therefore review their current arrangements, if any, in respect of indemnification by an associated company.

3.23 Jacqui Smith, the Minister of State for Industry and the Regions, made the following announcement to Parliament on 19 October 2004:

“The provisions on directors' liability close what some regard as a current loophole under which parent or subsidiary companies may provide to directors indemnities that would be void if provided by the company itself. We want to close that loophole in the period between Royal Assent and the commencement of the provisions on directors' liability. We thus intend to provide in the commencement order that existing contracts that are currently permitted, but will become prohibited under the Bill, will remain effective only if they were made before Royal Assent”.

Indemnities provided to directors by associated companies will therefore remain effective only if they were so provided on or before 28 October 2004. All indemnities provided to directors by associated companies after 28 October 2004 will be void under new section 309A if the indemnity could not have been provided by the company itself.

**What the C(AICE) Act provisions will do**

- (i) Permit companies to indemnify directors against liabilities to third parties (e.g. shareholders who bring a class action in the US), subject to (ii) and (viii) below.
- (ii) Permit companies to pay directors' legal costs upfront, provided that that the director repays any loan or discharges any other liability to the company if he is convicted in any criminal proceedings or judgement is given against him in any civil proceedings brought by the company or an associated company.
- (iii) Remove the existing prohibition on exemption from, or indemnification against, liability in relation to company officers other than directors and auditors.
- (iv) Clarify the existing prohibition – and removing an important loophole – by stating clearly that an “associated company” may not indemnify a director where such indemnification by the company would not be permitted.
- (v) Require disclosure of indemnification by the company or an associated company. (The new disclosure requirements reflect companies' new freedom to indemnify directors. The requirements are not onerous, and companies which choose not to indemnify directors will not have to make any disclosure.)

**What the C(AICE) Act provisions will not do**

- (vi) Permit companies to exempt directors from liability to the company, or to limit a director's liability to the company
- (vii) Permit companies to indemnify directors against liabilities to the company or to any associated company.
- (viii) Permit companies to indemnify directors against criminal penalties or those imposed by regulatory bodies such as the FSA.

## **Section 4 Directors' liability insurance**

4.1 The Companies Act 1985 was amended in 1989 to make it clear that companies are permitted to purchase liability insurance for directors.

4.2 Companies are not required to purchase liability insurance for directors.

4.3 Directors' liability insurance policies may cover:

- the legal liabilities of the directors for wrongful acts committed in their capacity as directors of the company. This is often referred to as “Side A” cover; and
- the company, to the extent that the law permits it to indemnify its directors. This is usually known as the “company reimbursement” clause or “Side B” cover.

Companies should review their directors' and officers' liability insurance in the light of the change in the law on indemnification. (It is, for example, possible that the change in the law on indemnification will lead to an increase in claims under Side B cover as opposed to Side A cover. If the company does not provide an indemnity to its directors, individual directors may still be able to claim under the Side A cover in their liability insurance policy for losses suffered, but they should look carefully at the terms and conditions of the policy.)

4.4 The Institute of Chartered Secretaries and Administrators provides helpful guidance on directors' liability insurance on its website at:

<http://www.icsa.org.uk/pdfs/guidance/030925.pdf>.

## Section 5      Disclosure

5.1      New section 309C requires the company to make two forms of disclosure about indemnification by the company or an associated company:

- if a QTPIP is in force for the benefit of one or more directors or was in force during the previous year, this must be disclosed by the company in the directors' report (and where the director is of one company but the QTPIP is provided by an associated company, in the directors' reports of both companies). Companies which choose not to indemnify directors will not have to make any disclosure;
- it applies section 318 of the Companies Act 1985 (under which directors' service contracts must be open to inspection by shareholders) to QTPIPs, so that they must be available for inspection by shareholders. This will permit shareholders to look at an indemnity provision in detail if they have concerns about the propriety of any such provision.

5.2      A loan to a director by his company to enable him to pay his defence costs upfront may constitute a QTPIP, and therefore have to be disclosed under new section 309C.

5.3      Companies are not required to make any disclosure in relation to:

- (a) indemnification of a director other than by the company or an associated company;
- (b) directors' liability insurance.

## **Section 6      Liabilities of company officers other than directors**

6.1      Under section 744 of the Companies Act 1985, “”officer” in relation to a body corporate, includes a director, manager or secretary”. “Officer” implies that the person is holding or filling an office of the company with rights or duties attached to it.

The term “officer” therefore covers:

- directors (including *de facto* directors, but not shadow directors);
- the company secretary, and any deputies;
- managers.

6.2      Unlike the current prohibition in section 310 of the Companies Act 1985, the prohibition in new section 309(A) applies only to company directors. It therefore does not prohibit companies from indemnifying other officers such as the company secretary, even in respect of liability to the company.

6.3      Section 310 of the Companies Act 1985 will continue to prohibit companies from exempting “any person (whether an officer or not) employed by the company as auditor” from, or indemnifying them against, liability for breach of duty or breach of trust in relation to the company. (An auditor is a company officer in some cases but not in others.)

## **Section 7      Glossary**

Articles of association	The articles contain the internal regulations for the management of the company's affairs. (A set of model articles may be found in The Companies (Tables A-F) Regulations 1985. Table A provides model regulations for a company limited by shares.)
C(AICE) Act	Companies (Audit, Investigations and Community Enterprise) Act 2004
Directors and officers (D&O) liability insurance	Insurance policies indemnifying individuals against personal liabilities or legal expenses incurred in their capacity as directors or employees.
Exemption from liability	The effect of a provision, for example, in a contract between a company and a director that the director will not be liable if he fails to comply with his obligations to it.
Indemnity	An agreement under which, for example, a company agrees to pay to a director who is sued by a third party whatever he has to pay out as a result of that action (whether by way of costs or damages).
QTPIP	Qualifying third party indemnity provision (see paragraphs 3.9 – 3.11).