

## Directors' liability and indemnification

**New provisions relating to the protection of directors and other officers from potential liabilities came into force on 6 April this year yet they have been unnoticed by many. The provisions were introduced by the Companies (Audit, Investigations and Community Enterprise) Act 2004 and we outline below the key issues and a number of practical steps which companies might wish to consider.**

### Director's liability

The basic position regarding director's liability remains unchanged, ie a company is not permitted to 'exempt' a director from any liability attaching to the director in connection with any negligence, default, breach of duty or breach of trust by him in relation to the company.

What is new, however, is that under the new provisions, a company may now 'indemnify' a director against such a liability under what is known as a "qualifying third party indemnity provision". The exception to this rule is that a company may not indemnify a director against liabilities incurred by the director:

- to the company or an associated company
- to pay a criminal fine or regulatory penalty (such as a fine imposed by the FSA)
- in defending criminal proceeding of which he is convicted
- in defending 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 Companies Act 1985.

An 'associated company' (essentially, a company in the same group) may 'not' indemnify a director where the company of which he is a director may not do so, for any of the reasons above. (This is narrower than the old regime where a parent could indemnify directors of subsidiaries.)

### Funding a director

A company may now make loans to a director, to fund the cost of:

- defending criminal or civil proceedings (even if the company itself brings the action) and
- applying for relief from liability under the Companies Act 1985

but the director must repay costs to the company if the defence is unsuccessful or if the Court were to refuse an application for relief.

Whilst a company may now provide a director with funds, the company is not required to do so. Nor does the company have to obtain shareholder approval before granting a director an extended indemnity or paying a share of defence costs.

### What does this mean in practical terms?

- Companies should review their Articles of Association. Some companies may have provisions on directors' indemnities which refer specifically to Section 310 of the Companies Act 1985. As Section 310 no longer regulates directors' indemnities, such provisions should be amended. As a change in the articles, this will require shareholder approval (which could be dealt with at the company's next AGM).

Even if articles do not specifically refer

to Section 310, all companies should review their articles since some forms of directors' indemnity article may be wider than permitted and therefore be ineffective under the new regime. Some articles may need to be changed to allow directors' costs to be funded.

- Consider the terms upon which new directors are appointed. New directors (both executive and non-executive) will no doubt ask for express indemnities to be included in their appointment letters. Companies need to be aware that there may be circumstances in which they may not wish to meet defence costs automatically, for example, in cases where a company is pursuing a director for breach of duty.

This is likely to result in sensitive negotiations between companies and incoming directors on the circumstances in which a company will fund defence costs, since the company is likely to want to reserve its discretion as far as possible, whereas new directors may press for more certainty as to their position.

- Companies should review their 'existing' directors' indemnity agreements to consider amending them to provide the increased protection permitted as a result of the new Act.
- There are accounts disclosure requirements and shareholders will have the right to inspect indemnification agreements.

nick.janmohamed@speechlys.com  
andrew.collins@speechlys.com