

CHAPTER

8

LIABILITY OF BOARD MEMBERS AND MITIGATION TOOLS

When Board members can be held personally liable, and which tools – including D&O insurance – help to manage that risk.

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8.1
LEGAL LIABILITY OF BOARD MEMBERS

Although all corporate and business decisions at Board level are adopted collectively, each individual Board member can, in certain circumstances, be held personally liable for the improper performance of their duties as a Board member. Depending on the type of unlawful conduct, a Board member may be subject to civil, administrative or criminal liability. Main principles of the statutory and case law on the Board liability are briefly described below to give Board members a better understanding of how liability works and guidance on how to identify and mitigate the associated risks.

Civil liability

This is the most common type of liability that may arise for a Board member for breach of their duties. The general principle is that a Board member may be held personally liable if they fail to perform their duties as a Board member and the company or a third person has incurred damage as a result.

The conditions for civil liability to arise are:

1. unlawful actions of the Board member (breach of statutory duties, fiduciary duties or the general duty of care);
2. damage incurred by the company or another person as a result of such unlawful actions;
3. a causal link between the unlawful actions and the damage; and
4. the fault of the Board member (which is presumed if the claimant proves the unlawful actions).

Under the law, the Board member is presumed to have acted lawfully and in the best interests of the company until it is proved otherwise, which means that the burden of proving that all the above conditions (except fault) are met lies with the person claiming damages.

In the vast majority of cases the claimant is the company on whose Board the defendant serves. Either the company itself brings a claim against the Board member, or a shareholder does so on behalf of the company by way of a derivative claim. If a derivative claim is successful, damages are awarded to the company and not to the shareholders who claimed on its behalf. Creditors also have the legal right to bring direct claims against Board members. In such cases, however, it has to be proved that the unlawful actions of the Board member were directed specifically against the claiming creditor, who as a result incurred individual

damage, that is, damage not incurred by the company or its other creditors (for example, where a Board member knowingly submitted incorrect information to a creditor, who was thereby misled into entering into a detrimental contract with the company). Creditors usually claim personal liability from Board members where the company is already insolvent and unable to satisfy creditors' claims in full.

The civil liability of Board members is personal, not collective. Board members do not automatically become personally liable if the Board as a whole does something that results in damage to the company: all the conditions for civil liability (except fault) have to be proved in respect of each Board member individually. For this reason, a Board member who voted against a Board decision that later turned out badly may be exempted from personal liability, whereas those who voted in favour could be held personally liable (provided, of course, that all the other conditions are met). As between the Board members, civil liability is joint and several, which means that the claimant may claim the entire damage from one or several Board members, who may later recover the respective shares from the remaining Board members.

It is very important to note that the approval of the shareholders or of the Board does not in itself relieve Board members from personal liability for breach of their duties. Each Board member must therefore at all times exercise independent judgement when performing their duties and avoid relying solely on the decisions of other corporate bodies of the company.

Business judgement rule and similar mechanisms to address risk aversion

The business judgement rule (BJR) is a central doctrine of corporate law that protects Board members from liability when business decisions turn out poorly, as long as those decisions were made properly.

Under the rule, courts will not review the business decisions of the Board if they were made:

1. in good faith, with honest intentions and no conflicts of interest;
2. with due care, on the basis of sufficient information and deliberation;
3. within the Board's authority, that is, within its powers under the law and the company's documents;
4. in the best interests of the company, even if the outcome was negative.

The aims of the BJR are:

– to encourage reasonable risk-taking, as business involves uncertainty and leaders need the freedom to innovate without fear of lawsuits for every failure; (

- to prevent hindsight bias, so that courts do not judge decisions only by their outcomes, since even careful choices can lead to losses; and
- to balance accountability and autonomy, which means that although Board members must be loyal and careful, they should not be punished for every misstep if they acted responsibly.

The business judgement rule was developed by the US courts to strike the right balance between the positive aspects of risky business decisions and the limitation of the Board's liability for business decisions that turned out to be unsuccessful. The rule was later adopted in many European jurisdictions, including Lithuania; certain aspects of it, but not the rule itself, are also applied in Latvia and Estonia too.

Lithuania

Lithuanian case law recognises that doing business inherently involves taking risks and that it would be unreasonable to hold Board members liable for business decisions that were adopted in good faith but later turned out to be detrimental to the company. The general principle is that a Board member may not be held personally liable for a business decision unless it is proved that, in arriving at that decision, they manifestly exceeded the reasonable limits of business risk or otherwise clearly acted in a grossly negligent manner. In cases where personal liability is claimed for a business decision, a higher burden of proof therefore applies, which protects Board members and allows them to take business risks on behalf of the company. Board members lose this protection, however, if the claimant shows that they acted in breach of their duty of loyalty, their duty of care or mandatory provisions of the applicable law (for example, provisions on the competence of the Board).[32]

Thus, the two key rules that Board members must follow in order to remain protected by the business judgement rule are:

1. Board members must always disclose all actual and potential conflicts of interest related to a particular business decision and recuse from participating in taking or in any way affecting tje business decisions in relation to which they have or may have a conflicting interest; and
2. Board members must exercise due care in adopting business decisions, which involves analysing and considering all the available information on the decision, collecting any additional information necessary to arrive at an informed decision (for example, by obtaining expert opinions), analyse all pertinent risks and

32 Civil Code of the Republic of Lithuania, Article 2.87 (duties of members of the bodies of a legal person); the business judgement rule has been developed in the case law of the Supreme Court of Lithuania.

consider how they will be managed, performing cost-benefit analysis of the proposed decision.

Latvia

There is no business judgement rule in Latvia, so, to avoid liability for the damages claimed, the Board member has to prove that they:[33]

1. acted as a prudent and careful manager. The principle of the "prudent and careful manager" is an objective standard, that is, what could be expected from a prudent and careful manager in business generally and in the specific line of business (a higher standard applies, for example, to entities in highly regulated sectors such as financial institutions); and
2. acted in good faith within the framework of a lawful decision of the shareholders' meeting.

Estonia

In Estonia, Board members are liable for any type of negligence, and there is no clear expression of the business judgement rule. The courts, however, distinguish between the decision-making process and the outcome of the Board member's act and have held that Board members are not liable solely because their business decisions were detrimental to the company.

Under Estonian corporate law, the obligations of Board members must be performed according to certain standards, primarily:

1. the standard of care;
2. the duty of loyalty.[34]

The standard of care includes the obligation of a Board member to act, in their decision-making, in the most economically purposeful manner. This standard is normally considered met if the Board member (i) is diligent, (ii) is sufficiently informed to take the decision and (iii) does not take unreasonable risks for the company. A Board member is normally considered sufficiently diligent if (i) they have no personal conflicting interest, (ii) they are informed to a degree that can be considered reasonable in the circumstances and (iii) a *bona fide* Board member in a similar situation could reasonably believe that the action or decision is in the best interests of the company.

33 Commercial Law of the Republic of Latvia, Section 169 (liability of Board members; the standard of the honest and careful manager).
34 Commercial Code of the Republic of Estonia, § 187 and § 315 (liability of members of the management board of a private limited company and of a public limited company).

The duty of loyalty requires the Board member to act in the interests of the company (and not, for example, in the interests of only one or some of the shareholders) and to ensure that their decisions are not affected by their personal interests.

Release of Board members from liability by the company

The laws of each of the three Baltic states allow the company (the shareholders' meeting) to release the Board or its members from liability. Although the laws vary in their details (for example, a general release or a release for specific actions or losses that have already occurred) and in the procedure, in all cases such a release:

1. is not valid in respect of conduct that was wilful or grossly negligent on the part of the Board or the Board member; and
2. does not prevent claims by shareholders who voted against the release, by creditors, by the bankruptcy administrator of the company or by other third parties with a right of claim against the Board or its members.

Administrative and criminal liability

Unlike managers of companies, Board members are rarely subject to administrative fines for breach of their duties. Board members may, for example, be found liable if the Board fails to convene the general meeting of shareholders in time, fails to observe the procedure for convening it, prevents shareholders from participating in it or violates other rights of shareholders.

Examples of crimes for which Board members may be held criminally liable include the misappropriation of company assets, fraud, money laundering, falsification of documents, bribery and tax evasion. Lithuanian law does not contain any special rules on the criminal liability of Board members, which means that it has to be proved beyond reasonable doubt that the Board member participated in the criminal activity.

Risk mitigation tools

Some of the tools commonly used by Board members to manage the risk of personal liability are:

1. understanding the duties and responsibilities of the Board and its members and performing them in a due and timely manner;
2. not intervening in the competence of other corporate bodies (for example, not micromanaging or doing management's work), since such actions may result in the Board or the Board member being held liable as de facto management;

3. clearly voting “in favour” or “against” each decision; there is no option to abstain, as decision-making, not decision avoidance, is one of the main tools, obligations and outputs of the Board;
4. acting at all times in the interests of the company and all its shareholders (not of one specific shareholder or group of shareholders, such as those who nominated the member for election), treating all shareholders and other stakeholders equitably and, whenever the company’s financial situation worsens, taking due account of the rights and interests of creditors, whose interests may take priority over those of the shareholders in a dire financial situation;
5. obtaining D&O insurance (see sub-chapter 8.2);
6. obtaining fairness or expert opinions where important business decisions are adopted;
7. relying on competitive sale processes (for example, selling assets by auction) where possible;
8. creating Board committees with specific functions (for example, a remuneration committee or a nomination committee) to analyse matters more thoroughly and make recommendations to the Board; Board members must not, however, rely blindly on the committee’s work and recommendations and must in each case make their own critical and informed assessment, as the final decision on each matter, and the liability for it, rests with the Board and not with the committee;
9. reviewing business processes and implementing appropriate compliance tools and policies;
10. improving effectiveness of oversight over management;
11. duly documenting the Board’s deliberations, so that the minutes reflect not only the decision taken but also the arguments and grounds on which the Board arrived at it, the risks identified and considered and how they were managed as well as dissenting opinions of members, if any.

A toolbox for staying on the safe side

1. Do not agree to serve on a Board if you are not actually and actively involved in the company’s governance.
2. Do not agree to serve on a Board if there is no trust.
3. Be aware of what is going on in the company, even outside your direct responsibilities.
4. Establish clear reporting systems to keep yourself informed.
5. Establish clear internal communication rules within the Board, between the Board and the shareholders, and between the Board and other key managers.

6. Make and keep your own notes on meetings and decisions, especially on sensitive or important matters, since after the end of your term you must return all information related to the company and your Board work and may not retain it.

KEY TAKEAWAYS

A. Board decisions are collective, but liability is personal: each Board member may be held civilly, administratively or criminally liable for the improper performance of their own duties, and the approval of the shareholders or the Supervisory Board does not relieve them of it.

B. Civil liability requires unlawful action, damage, a causal link and fault; fault is presumed once the unlawful action is proved. Claims are usually brought by the company or by shareholders on its behalf; creditors may claim directly where the company is insolvent and the harm was specific to them.

C. The business judgement rule protects decisions taken in good faith, with due care, within the Board's authority and in the company's interests. Lithuania applies it in case law; Latvia applies the standard of the prudent and careful manager; Estonia distinguishes the decision-making process from the outcome. In all three countries, proper management of conflicts of interest and an informed, documented decision are the minimum conditions for protection.

D. The main mitigation tools are knowing and performing one's duties, staying within the Board's competence, voting clearly, acting for the company and all its shareholders, taking creditors' interests into account when the finances deteriorate, obtaining expert opinions, using committees without relying on them blindly, and documenting the Board's deliberations in the minutes.

QUESTIONS FOR THE BOARD

1. *Do all Board members understand the conditions under which they can be held personally liable in the jurisdiction of the company, and when were they last briefed on this?*
2. *Are conflicts of interest declared and recorded at every meeting, and do conflicted members recused from participating in taking the decision and do not try to affect it in any other way?*
3. *Do our minutes show the information considered, the alternatives, the risks and the reasons for each significant decision, so that the business judgement rule would protect us?*
4. *Does the Board stay within its competence and avoid acting as de facto management?*
5. *Do we obtain independent expert or fairness opinions for major transactions, and do we record how committee recommendations were assessed?*
6. *Has the company's financial position deteriorated to the point where the interests of creditors must be given priority?*

8.2

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and officers' liability insurance (D&O insurance) is a special insurance cover that protects Board members and managers (officers) from personal losses if they are sued by shareholders or any third party.

The main benefits of D&O insurance for Board members, managers, the company and the shareholders are:

- greater ability to attract the best professionals to the Board and to executive positions, because candidates know that they will be protected in a fast-changing business environment full of uncertainties;
- protection of the personal assets of Board members and managers where claims are brought against them personally; the policy may cover defence and litigation costs, helping them to obtain legal representation, participate effectively in dispute resolution proceedings and present their position without bearing these costs personally;
- coverage of the legal defence costs incurred in defending lawsuits or investigations;
- protection of the financial stability of the company by covering legal costs and potential settlements;
- greater comfort for shareholders investing in the company, knowing that a process is in place to resolve possible leadership liability risks.

It is good practice for the company to have a D&O insurance policy. Board members and managers are advised to check the facts about the policy and to ask for its main terms and conditions to be presented to them. When the insurance is renewed, the terms and conditions should be presented to the Board and the managers.

Why do Board members need D&O insurance?

Companies are legal entities separate from the people who manage them. Even in companies which shareholders have limited liability, the liability of Board members is unlimited in many countries. Although most contracts between Board members and the company state that the company will indemnify them, this is not always possible, especially where the law or insolvency prevents it.

Any claim against a Board member, or investigation into their activities, will incur costs in preparation and defence even if the matter does not go to court, and if it does, those costs escalate quickly. The Board member's personal assets will be at risk if they do not have sufficient funds to pay for proper legal and other representation.

Why do companies purchase D&O policies?

In today's ever more complex world, all companies require good management in order to succeed. Good managers understand that they have to make difficult and complex decisions for which they are personally liable. Over and above the indemnification clauses in contracts, companies need to be able to offer secure D&O insurance to attract and retain the best managers.

Who can be covered?

All current, future and past directors and officers of a company and its subsidiaries are covered under a D&O policy, including Board. Employees with a managerial role are often also covered for their exposure to liability in that role, and there are a number of other possibilities to extend cover to additional people and positions.

What can be covered?

The main function of a D&O policy is to protect the personal assets of Board members. In practice, this often means that the policy pays the legal fees of Board members when they defend themselves against a claim or prepare to attend an investigation. If a settlement is to be paid to a third party, the policy will often pay some or all of that cost as well.

Most claims are settled out of court, but court costs are also covered where needed.

What cannot be covered?

D&O policies are "all risks" policies, covering all causes of claims unless excluded, so the policy exclusions are very important. They always include proven illegal acts and claim already made against Board members before the policy incepts. Other common exclusions are pollution claims, claims in the USA and claims for injury and damage to property.

It is important to distinguish between "absolute" exclusions, which remove cover for anything related to the excluded acts, and "for" exclusions, which exclude only claims that are specifically for the alleged act; the latter are preferable. Many exclusions relate to exposures that should be covered under other insurance

policies, such as property or professional liability insurance, so the exclusions should always be checked against the other policies.

The size of the insurance cover

Determining the right size of the D&O cover is very important for each company at each annual renewal. It should involve a careful assessment of the company's risk profile (the higher the risks the company takes, the higher the cover should be), its industry and regulatory environment (a more regulated environment may carry higher risks) and its operational complexity. There is no one-size-fits-all answer, and the recommended amount of cover can vary significantly depending on these factors.

Policy triggers

D&O policies have three main definitions that act as the policy triggers:

1. there needs to be a wrongful act (which generally means anything done or not done by a Board member);
2. there needs to be a claim against the Board member based on that wrongful act; and
3. there needs to be a financial loss for which the Board member is liable as a result of the claim (most often legal costs).

How does D&O insurance work in practice?

1. A Board member (or the whole Board) fails to perform their duties.
2. Someone (the shareholders, the company or another interested person or entity) suffers a loss and decides to claim compensation from the Board.
3. The Board is informed of the claim.
4. The Board engages legal defence.
5. The Board contacts the insurance company or broker and provides the details of the claim.
6. If the claim meets the conditions of the insurance cover, the insurer covers the defence costs.
7. If the claim is covered and the court case is lost, the insurer covers the defence costs and the losses, up to the insured sum.

An experienced and specialised insurance broker is an invaluable partner in this process, with access to claims data, benchmarking studies and in-depth knowledge of the D&O insurance market. In the event of an insured event, the broker should be approached immediately for professional help.

KEY TAKEAWAYS

A. D&O insurance protects the personal assets of Board members and managers against claims by shareholders or third parties, covers defence costs and settlements, supports the company's financial stability and helps to attract and retain good Board members and managers.

B. Cover extends to current, past and future directors and officers of the company and its subsidiaries, including non-executive and Supervisory Board members, and often to employees with managerial roles.

C. Policies are "all risks", so the exclusions matter most: proven illegal acts, claims made before inception, pollution, claims in the USA and injury or property damage are typically excluded; "for" wording is preferable to absolute exclusions, and exclusions should be checked against the company's other policies.

D. The size of the cover is reviewed at each annual renewal against the company's risk profile, regulatory environment and complexity; the policy is triggered by a wrongful act, a claim and a loss; an experienced broker should be involved at renewal and immediately when a claim arises.

E. Board members should ask to see the main terms and conditions of the policy and be informed of any changes at renewal.

QUESTIONS FOR THE BOARD

1. *Does the company have a D&O policy, and have Board members seen its main terms, exclusions and limit?*
2. *When was the size of the cover last reviewed against the company's risk profile, and who made that assessment?*
3. *Are all Board members, Supervisory Board members and relevant managers, including past and future ones, covered, and are subsidiaries included?*
4. *Do Board members know how to notify a claim or an investigation, and is a specialised broker engaged?*
5. *Are the exclusions consistent with the company's other insurance policies, so that no gaps remain?*