

UAE Free Zone

White Paper June 2010

**Directors' Responsibilities and Duties**  
Directors and Officers Liability Insurance



# **The responsibilities and duties of directors of free zone companies in the United Arab Emirates: The emergence of Directors and Officers Liability Insurance**

## **Introduction**

Corporate governance, and in particular the duties (and potential liabilities) of directors, officers and senior management, has become an issue of the foremost importance for companies incorporated in the United Arab Emirates (UAE).

Directors and officers of companies in the region are increasingly at risk from exposure to personal financial liability arising from claims brought against them in connection with the discharge of their duties as directors and officers. As the leading Directors and Officers Liability Insurer in the Middle East, we have commissioned Clyde & Co LLP, a leading international law firm, to summarise and outline the responsibilities and duties of directors and officers of offshore companies in the UAE.

Increasingly stringent legislative requirements, together with the enforcement of existing standards and a growing number of corporate governance related regulatory investigations, are of course an immediate response to the significant financial failures experienced in the UAE as a result of the global financial crisis. Yet, as the markets look towards future growth, there are clear signs that the move to embrace and institutionalise good corporate governance principles may also reflect an underlying shift towards an economic model that favours sustainable growth through transparency, responsibility and accountability.

Directors and officers of UAE companies must therefore adapt to this increasingly regulated environment to ensure that compliance with good corporate governance principles is given due consideration and priority, or risk increasing exposure to corporate (and potentially personal) litigation, and regulatory and/or criminal investigation.

## **An introduction to the duties of directors and officers in the UAE**

A number of different forms of companies may be established in the UAE, either 'onshore' (ie within the UAE, but outside one of the free zones), or offshore within one of the UAE's free zones. Each type of corporate entity is subject to different types of corporate governance requirements, as set out in the respective laws applicable to each type of company.

This paper focuses on the duties (and potential liabilities) of directors and officers of companies incorporated offshore in the UAE. There are numerous free zones within the UAE, each being established to encourage the growth and development of a particular type of sector, service or industry. Free zone companies may be incorporated with full foreign ownership, unlike companies established onshore in the UAE. However, a free zone company's trade licence does not permit the company to trade onshore in the UAE, outside of the respective free zone.

Companies incorporated in free zones are largely governed by the rules and regulations of the respective free zone, and so the responsibilities of directors and officers is very much dependant on the regulatory regime established in the free zone of incorporation. In certain circumstances, the federal civil and commercial laws applicable to companies incorporated onshore in the UAE may apply, whereas in some free zones, there may be supplementary or alternative requirements.

By way of example, this paper considers free zone companies incorporated in the Dubai International Financial Center (DIFC), a free zone that focuses on financial services. The DIFC is unique in that companies incorporated in the DIFC are not subject to the federal civil and commercial laws that apply onshore, but are instead subject to the DIFC Companies Law No. 2 of 2009 (the DIFC Companies Law). However, the Penal Code (UAE Law No. 3 of 1987) (the Penal Code), which applies to companies incorporated onshore in the UAE, continues to apply.

If you would like to find out more about the duties of directors of onshore companies, please refer to our paper on the duties (and potential liabilities) of onshore companies, which explores the responsibilities of directors and officers under the Commercial Companies Law (Federal Law No. 8 of 1984) (the Companies Law), the Code of Commercial Practice (Federal Law No. 18 of 1993) (the Commercial Code), and the Civil Code (UAE Law No. 5 of 1985) (the Civil Code).

## The duties of directors and officers pursuant to the DIFC Companies Law

Different types of companies may be established in the DIFC, including companies limited by shares and limited liability companies. This paper considers companies limited by shares (a DIFCO). DIFCOs are managed by their directors who may delegate the management of the company to the company's officers. A DIFCO must have a general manager and at least two directors.

The corporate governance regime established in the DIFC may be contrasted to the more traditional onshore laws, which are generally negative and prohibitory in nature, for example prescribing certain types of activities that directors may not engage in, and penalising those directors who breach such requirements. In many respects, the duties of directors and officers under the DIFC Companies Law are comparable to the 'principle' based regimes adopted in other developed legal systems, for example the duties of directors under the Companies Act 2006 in the United Kingdom.

By way of example, the DIFC Companies Law places a number of positive obligations on directors that are intended to entrench the values of good corporate governance and promote integrity. All DIFCO directors must exercise their powers:

- honestly;
- in good faith;
- lawfully;
- with reasonable care, diligence and skill; and
- with a view to the best interests of the company.

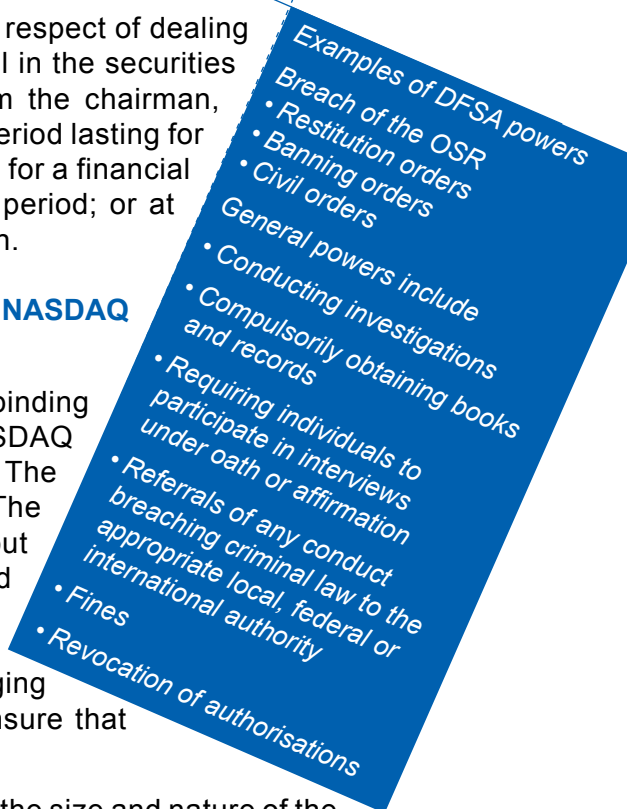
A director of a DIFCO must also disclose to the company any direct or indirect interest that he or she has in a transaction which may conflict with the company's interests. Failure to do so may mean that a director is liable to account to the company for any profit, gain or benefit obtained. Additionally, financial assistance by a DIFCO to its directors is prohibited, unless one of the express exceptions applies (including where the shareholders' prior approval has been acquired).

There are also restrictions on the directors of a listed DIFCO in respect of dealing in securities of the company. Generally, a director may not deal in the securities of the company without receiving prior written clearance from the chairman, however additional restrictions come into effect during a close period lasting for one month before the announcement of the financial statements for a financial period until the disclosure of the financial statements for that period; or at any time when a director holds undisclosed material information.

### Additional duties of directors and officers for DIFCOs listed on NASDAQ Dubai, or which have made a public offer of securities

The DFSA Offered Securities Rules (OSR) set out further binding rules in respect of the governance of DIFCOs listed on NASDAQ Dubai, or which have made a public offer of securities. The NASDAQ Dubai Listing Rules also apply to listed DIFCOs. The OSR requires that the board must meet regularly throughout the year in order to discharge its corporate governance related duties, whilst the OSR imposes a continuous disclosure regime for listed DIFCOs, requiring the timely disclosure of material price-sensitive information about the company, and obliging listed DIFCOs to have appropriate systems and controls to ensure that it, its directors and its employees cannot breach the rules.

The OSR also requires listed DIFCOs to consider, depending on the size and nature of the company's operation, establishing a nominations and remuneration committee (the latter to assess the remuneration of directors (including the chairman)). The company must however establish and maintain an audit committee to monitor and review the company's internal audit function; appoint, remove and set the terms of engagement of external auditors; and to make recommendations to the board in respect of the appointment, removal and terms of engagement of external auditors. At least two independent non-executive directors should be appointed to such a committee.



## The DFSA

DIFCOs that are engaged in or associated with Financial Services (as defined in the DFSA Rulebook) are also proactively regulated by the Dubai Financial Services Authority (the DFSA). The DFSA has the power to make wide-ranging orders, and has proven itself to be a proactive and tough regulator that is serious about enforcing corporate governance principles. The DFSA has an intimidating arsenal of sanctions that may be imposed on directors breaching the law. For example, in 2008 the DFSA implemented two enforcement actions involving financial penalties of approximately USD one million and the suspension of one firm, whilst in 2009 it received and assessed over eighty allegations of misconduct, and commenced nine investigations. The DFSA also responded to 18 requests for mutual assistance from international regulators.

*In 2008 the DFSA implemented two enforcement actions involving financial penalties of approximately USD one million and the suspension of one firm, whilst in 2009 it received and assessed over eighty allegations of misconduct, and commenced nine investigations.*

## The Penal Code

The Penal Code provides that directors and officers of a company may be found criminally liable for fraud or embezzlement of the company's property or legal rights or for the disclosure of confidential information in order to obtain a personal benefit. It may also come as a particular surprise to directors and officers that they may be held criminally liable for writing a cheque on the company's behalf when the company cannot meet payment, a position that extends the potential liabilities of directors and officers far beyond that of many other jurisdictions.

### Is it possible for the company to indemnify a director against liabilities?

A DIFCO may indemnify a director or officer for liability caused by his negligence, default, breach of duty or trust. Directors of DIFCOs may also obtain their own liability insurance.

*The Penal Code: what you need to know Directors may be criminally liable for:*

- Fraud
- Embezzlement of company rights or property
- The disclosure of confidential information for personal gain
- Writing a cheque on the company's behalf where the company cannot meet payment

## Protection through D&O Insurance

Directors and Officers liability insurance (D&O) provides coverage for directors and officers in respect of wrongful acts undertaken in the course of the performance of their duties. D&O cover therefore protects the personal assets of directors and officers. Chartis offers its Corporate Guard policy to cover such liabilities.

D&O insurance may be purchased by a company for a number of reasons. Typically it is acquired for the benefit of the directors and officers as individual insureds, to protect them from personal financial liabilities. However, D&O insurance can also provide balance sheet protection for the company. In particular, a D&O insurance policy may provide for the reimbursement of the company where the company has indemnified a director in respect of a claim made against them. However, it is also important that, in the event that the company is unable to reimburse the director, the policy will pay the individual directly. This is especially relevant in the event of the insolvency of the company, and the policy should allow directors and officers to claim under the policy directly, even where the company is insolvent.

D&O insurance therefore protects directors and officers and the company from the financial consequences of their actions. Importantly, it will typically provide an advance to cover defence costs in civil proceedings against the director or office. Chartis Corporate Guard D&O policy also provides coverage for legal expenses incurred in responding to investigations by regulators. The policy also provides coverage in respect of criminal proceedings up until the point of final adjudication (although criminal offences are excluded).

There are no specific laws or regulations governing D&O insurance, although this is a position that may change as the UAE Insurance Authority is expected to issue a number of new regulations in 2010 and 2011. General UAE insurance legislation requires insurance to be placed locally with a licensed insurance company. However, DIFCOs may purchase D&O insurance directly from an insurance company licensed in the DIFC.

Chartis Corporate Guard offers protection to executives from the financial consequences of their past, present and future actions. Coverage can include the following circumstances:

- **Regulatory protection.** An increasingly controlled regulatory environment and reporting requirements inevitably mean that investigation by the authorities is an ever increasing concern. Chartis Corporate Guard will respond to investigation costs and the legal fees and expenses for attendance at an investigation of an Insured.
- **Bankruptcy/Insolvency protection.** In the event that an Insured company becomes insolvent and a Director or Officer is subsequently named in a claim, the policy will be able to respond directly to the individual. This coverage will not be subject to a deductible.
- **International exposures, including the United States.** As businesses become more international due to globalization, directors and officers should be aware that claims in some international courts, such as in the UK and the US are increasingly common and even where such courts can be persuaded to decline the jurisdiction, legal costs will be necessarily incurred in preliminary hearings to challenge this jurisdiction. The Chartis Corporate Guard policy will cover legal costs in relation to (alleged) mismanagement.
- **Shareholder claims and claims from Insured Persons.** Business losses can be the result of internal disputes. The Chartis Corporate Guard policy can provide coverage for claims made by shareholders and insured persons alleging mismanagement.
- **Exposures arising from directorships of subsidiary and non-subsidiary companies.** With ever more complex group structures, directors are often appointed to the boards of several entities within a group. Automatic coverage is provided for new subsidiaries acquired during the policy period. Coverage is also available for directors representing the company at other entities, in which the company has a minority shareholding.
- **Emergency costs.** Emergencies may require the company to enlist legal counsel immediately, without having time to contact Chartis for permission. In this event we give retrospective cover for costs up to a pre-agreed amount.
- **Employment practices violations.** Claims made by employees alleging violations of their legal rights as employees. Possible lawsuits against directors and officers include claims for sexual harassment, breach of employment contract, wrongful termination, discrimination and failure to hire or promote.

## The future

For many directors and officers, the global financial crisis has raised awareness of their respective duties, bringing with it a realisation that the litigation risk and potential liabilities attaching to directors of offshore companies in the UAE are just as real as in other developed jurisdictions, and in specific circumstances, perhaps more rigorous.

Shareholders creditors and counterparties of affected companies are increasingly seeking to obtain compensation for alleged mismanagement or wrongful acts by bringing actions against companies and/or directors and officers personally. Anecdotally, it would appear that the number of such claims is rising, not only as a consequence of increased regulatory scrutiny (itself attributable to the global economic crisis), but also because such parties are more aware of, and willing to enforce, their legal rights. This is a trend that is expected to continue.

D&O insurance, which is common in developed marketplaces, is a principle means by which a company can protect its directors and officers, and also its own balance sheet. A D&O policy may also assist companies to attract and retain talented directors and officers.

As the UAE economy looks beyond the economic slowdown, and becomes an increasingly sophisticated marketplace, it is inevitable that the future will bring more regulation, particularly as far as corporate governance and the duties of directors and officers are concerned. Yet there are also strong indications that the desire to entrench directors' duties and the principles of good corporate governance, herald recognition of the fact that having a strong business model that promotes transparency, responsibility and accountability ultimately positions businesses for more profitable and sustainable growth, by minimising trading risks and potential exposure to liability, for example.

It is therefore of paramount importance that directors not only ensure compliance with corporate governance principles, but also give appropriate consideration to how any action against the company (and themselves personally) might be properly defended.

## About Chartis Insurance

Chartis is a world leading property-casualty and general insurance organization serving more than 40 million clients in over 160 countries and jurisdictions. With a 90-year history, one of the industry's most extensive ranges of products and services, deep claims expertise and excellent financial strength, Chartis enables its commercial and personal insurance clients alike to manage virtually any risk with confidence. Chartis is the marketing name for the worldwide property-casualty and general insurance operations of Chartis Inc.

أميريكان هوم اشورانس كومپاني

### **American Home Assurance Company**

JW Marriott, Office Block A, 5th Floor  
P.O. Box 40569, Dubai, UAE  
Tel: +971 4 214-3000 / +971 4 601-4444  
e-mail: [customerservice-uae@chartisinsurance.com](mailto:customerservice-uae@chartisinsurance.com)  
[www.chartisinsurance.com](http://www.chartisinsurance.com)

Registered under UAE Federal Law No. 6 of 2007.  
Insurance Authority No. 79.  
Commercial License No. 613392.

The information and descriptions contained herein is not intended to constitute legal advice and should not be relied upon in lieu of consultation with appropriate legal advisors. The information and descriptions of the D&O insurance product is for general informational purposes only. Please refer to the actual policy wording, which will contain reductions, limitations, exclusions and termination provisions. If there is any conflict between the contents of this document and the policy wording, the policy wording will govern. The products and services are brought to you by American Home Assurance Company, a wholly owned subsidiary of Chartis Inc. Certain names, words, titles, phrases, logos, icons, graphics or designs may constitute trade names, registered or unregistered trade-marks ("Trade-marks") of Chartis Inc. used under license by Chartis Inc.