

Turkey: Directors' And Officers* Liability Insurance In View Of The New Turkish Commercial Code

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I. Introduction and General Background

The use of directors' and officers' ("D&O") liability insurance is relatively new and limited in Turkey. The new and elevated standards on corporate governance rules introduced by the new Turkish Commercial Code ("the TCC") such as the introduction of universal accounting and auditing standards and rules for increase of transparency is expected to support the operability of liability provisions and lead to increase in demand for D&O policies.

The provisions of the insurance section of the old TCC were very insufficient in scope and content to meet the dynamic needs of today's insurance practice. The TCC introduced a significantly wider section on general provisions applicable to all types of insurance contracts and for the first time in Turkish insurance law a specific section on third party liability insurances have been introduced by a Code.

There are no specific D&O insurance law provisions in the Turkish legislation and limited case law has evolved. The TCC for the first time refers to D&O insurance but only within the context of corporate governance standards.¹ There are currently no general conditions approved by the Turkish Treasury with respect to D&O policies. Professional liability insurance general provisions are used currently used to the extent applicable.

This Article provides an overview of the new law with respect to various issues related to D&O insurance.

II. Overview² of Liability³ of Directors & Officers

As in the old TCC, members of the board of directors, deputy directors and executive directors of a JSC bear liability towards the company, its shareholders and creditors for losses arising from their willful or negligent failure in their duties and obligations imposed on them by law or the articles of association of the company.

The standard of care and loyalty expected from a director or officer is that of a prudent director who acting in caution and considering in good faith the interests of the company can give "business judgments". The TCC aims to shift from the current practice of a heavier level of duty of care. It introduces a new provision that no D&O can be held liable for incompliance or irregularities outside the scope of his control thereby protecting directors from a liability based on an abstract duty of supervision and care where there is no causal link between their acts and the occurrence of a loss. According to the TCC the lack of liability in such case cannot be defeated by reason of the duties of supervision and care.

In addition to general liability provisions, the TCC introduces certain special type of liability provisions i.e. liability for (1) illegal and misrepresented documentations and declarations (2) misrepresentation on capital subscriptions and payments (3) collection of funds from the public

with the intention or promise to found a company or to increase the capital of a company without compliance with relevant capital markets legislation (4) misvaluation of the value of capital in rem of the company or the property or the business enterprise to be acquired by incorporation. The TCC also provides for another special type of liability for losses arising from mergers, demergers and changes in legal form of the company.

D&O's who have delegated their duties (to the extent legally possible) arising from the law or the articles of association do not bear any liability for acts and decisions of the delegated D&O's unless it has been established that they failed to show reasonable care in the selection of these officers.

The TCC introduced provisions to the effect that in case of liability by various individuals for the same loss, liability shall arise according to the specific circumstances and the degree of fault of each individual and to the extent the loss can personally be attributed to each individual. Where more than one individual has been sued for the same loss the judge will identify the amount of liability of each defendant accordingly. In the previous practice **jointly liable directors** would have to indemnify the loss irrespective of the degree of their fault and a causal link between their involvement and the loss.

Losses incurred by the company can be claimed by the company and its shareholders. Shareholders can in this case only request payment of compensation to the company. The TCC limited the **claim of creditors** to cases where the company declared bankruptcy provided the rights of shareholders and company creditors have not been pursued by the bankruptcy management. The creditors are not subject to such limitation where they sue for losses arising from abuse by a holding company of its controlling power on a subsidiary company. D&O's of subsidiary companies have been exempted from liability against shareholders and the company where they have complied with the instructions of the controlling holding company.

Shareholders and creditors can also pursue claims against D&O's for their direct type of losses as in the old system.

Criminal Liability under the TCC

The old TCC provided a couple of provisions with respect to criminal liabilities i.e. negligence by the initial board members in detecting any irregularity in the formation of the company, contribution to fraud in the evaluation of capital in rem or a proposed asset/business subject to acquisition, with the consequence of imprisonment or criminal monetary fines. Additionally the Code provided criminal sanctions for failure of lawful keeping of certain commercial books, failure of or unlawful registration of issues subject to registration, non – compliance with the requirements regarding company commercial name and unfair competition.

The TCC extends the scope and number of criminal liabilities for D&O's and introduces more detailed provisions in that regard. Non – compliance with the rules of Turkish Financial Reporting Standards, failure by directors of parent and subsidiary companies to comply with the reporting obligations regarding their internal relations on an annual basis, failure in disclosing books and documents to relevant supervising authorities; disclosure of commercial secrets by those who have access to company books and documents due to their duties; fraudulent, misleading, wrongful and unlawful statements in documents and disclosures with respect to incorporation, capital increase and decrease, merger, spin-off, change in company type, issuance of bonds; making wrongful entries to commercial books, misleading third parties with

respect to unpaid capital of the company; collection of funds from the public with the intention or promise to found a company or to increase the capital of a company without compliance with relevant capital markets legislation, non – compliance with requirements of keeping a website; non-compliance with restrictions imposed on members of the board and persons and companies related to them with respect to borrowing from the company; will be subject to imprisonment and/or criminal monetary penalties.

III. D&O Policies

Claims Made / Occurrence Based

One of the clarities introduced by the TCC is that a third party liability policy will be considered "occurrence based" unless otherwise indicated in the policy. Provisions for extended reporting periods or retroactive dates are in principle admissible.

Cover / Exclusions

The TCC unlike the old Code which had accepted the principle of "all risks" provides for "named perils". The TCC prohibits cover for losses arising from risks occurred as a result of willful acts of the insured, the policyholder or third parties for whose acts they bear legal liability. In the later case clarity has been provided that third parties who acted willfully in the occurrence of the risk must have acted with an intention to trigger policy indemnification as a further condition.⁴

Costs

A new provision of the TCC requires the insurer to pay reasonable expenses made by the insured or the policyholder for the purpose of determination of the extent of the risk or the insurance indemnity, even if these expenses have not proven useful⁵.

The TCC also extends liability of the insurer to pay for reasonable costs for measures taken by the Insured for prevention or mitigation of the loss. The TCC imposes a duty on the policyholder to take measures not only upon occurrence of the risk but also in cases where the likelihood of occurrence is high. The Code also explicitly provides that the policy holder shall to the extent possible take measures for the protection of the insurers rights of subrogation to third parties. The Insurer shall make an advance payment in relation to all these costs by request of the policyholder. The TCC with respect to third party liability policies provides that a specific policy condition is required for payment of these costs exceeding the insurance sum.⁶

Duties of Notification and Disclosure

Detailed provisions providing clarity with respect to many unsettled issues in that regard have been introduced by the TCC, in particular with respect to requirements for any link between non – compliance and the occurrence of the risk and its effect on insurance indemnity; consideration and consequences of the degree of fault with respect to the application of sanctions for failure to notify. The TCC also introduces new time periods for the use of respective rights. A clear distinction between the rights of the insurer in case of discovery of the non disclosure before and after the occurrence of the risk has also been provided.

1. Duty of Disclosure before the Conclusion of the Contract

As in the old system, the duty of disclosure before the conclusion of the contract is confined to the list of questions provided by the insurer. A new provision in that respect prevents the application of this provision where the policyholder concealed material facts in bad faith putting an end to legal controversy in that regard.

Alternative rights of avoidance (with retrospective effect) or collection of premium difference is given to the insurer in case of discovery of failure to notify before the occurrence of the risk, irrespective of the degree of fault in the non - disclosure. Where the non – disclosure was made in bad faith the insurer is entitled to premium for the period in which the risk was carried. The nature and consequences of the right of avoidance was controversial under the old Code.

There was no provision in the old TCC with respect to discovery of non - disclosure after the occurrence of the risk and there was controversy on the requirement of any link between the failure and the occurrence of the risk/ the amount of indemnity and on the affect of the degree of any failure. The TCC foresees a reduction in the indemnity according to the degree of negligence in the failure to disclose, provided the negligence has the potential to affect the occurrence of the risk or the amount of the indemnity. In case of willful failure to notify, the insurer's liability for indemnity is lifted provided that there is a connection between the non – disclosure and the occurrence of the risk. In case of lack of such connection, the proportion of the paid premium to the premium which should have been paid shall be taken in to consideration.⁷

Severability with regards to Statements in the Proposal Form

Severability clauses which in essence provide that that the knowledge of one insured person is not necessarily imputed to the other insureds may take several forms. There is no specific rule or precedent on severability clauses under the previous or the new systems, they are in principle admissible. The policyholder is in most times the company which makes declarations through its organs or representatives whose declarations would in principle bind the company and the other insureds with respect to declarations made to the insurer. The duty of disclosure before policy inception was under the old Code only imposed on the policyholder and no consequences were provided for any knowledge of other insureds. The new Code imposes the obligation on the policyholder but introduces a further provision that where the TCC attaches any legal consequence to the policyholder's behavior or knowledge, the same consequence shall attach also to the behavior of the representative or of the insured provided the insured was aware of the insurance contract.

2. Notification of the Increase in the Risk during the Contract

The provisions of the old TCC in that regard were insufficient and poorly drafted leading to controversy in particular with respect to applicable sanctions in certain cases. It provided a duty of notification of an increase in the risk lead to by the policyholder upon learning of which the insurer had the right to terminate the agreement to be used within eight days. The Turkish Court of Appeal had limited the application of this provision to cases where the lack of notification was learned before the occurrence of the risk.

Under the TCC the policyholder is under the duty to immediately notify increases in the risk (irrespective of whether the increase was led to by the policyholder or not) and where the increase has occurred without his knowledge within ten days of learning at the latest. The insurer has the right to terminate the policy or request premium difference within one month of

becoming aware of the increase. The right to terminate shall be ineffective if the status *ante quo* is reestablished. Where the non – disclosure was willful the insurer will keep the premium for the period he carried the risk. Where the increase has been learned after the occurrence of the risk, the same sanctions and conditions are applicable as in case of failure in the obligation of disclosure before the inception of the policy.

3. Notification of the Loss and Response of Insurer

The provision of the old TCC in terms of notification of the occurrence of the risk with respect to third party liability policies had led to a lot of controversy and impracticalities. It provided a five days notification period from learning by the policyholder of the court proceedings filed by third party where the insurance provided for control of the proceedings by the insurer, and five days from the date of the finalization of the court judgment or the actual payment made to the third party where the insurer is only under the obligation of indemnity payment. In case of willful failure to notify, the insurer would be released from liability, whereas negligent failure to notify would lead to reduction of indemnity according to the gravity of negligence.

The TCC introduces a duty for immediate notification upon learning by the insured of the occurrence of the risk. The TCC with respect to third party liability policies introduces a new duty on the insured to also notify events which may give rise to his liability within ten days of learning. Lack of notification or late notification shall lead to a reduction on the indemnity according to the gravity of negligence in the failure to disclose, provided that the failure led to an increase in the insurance indemnity.

The TCC also introduces a five days period from notification of the occurrence of the risk to decide and notify the insured whether the insurer will assume control over the legal procedures against the third party claimant. Where no such notification has been made by the insurer, any indemnity determined by finalized judicial decision must be paid by the insurer. According to the TCC settlement agreements cannot be made without the consent of the insurer.⁸

Non – Compliance with Conditions & Warranties – "Other Duties of the Policyholder"

The fact that certain duties are provided under terms of conditions or warranties (as usually transferred from English policy wordings) does not necessarily give the term the intended effect under Turkish law. Such provisions may be caught by semi – mandatory or mandatory provision of the TCC such as the duty to refrain from increasing the risk, no matter how the duty and the sanction is defined in the contract. The TCC introduces a new and specific provision in that regard and provides that where the insurance contract provides for partial or entire avoidance of the contract by the insurer for non – compliance with the duties by the insured by contract (where the sanction of non – compliance with such duty has not specifically been provided for in the TCC), any avoidance shall not take effect unless the non – compliance is based on fault. Where non – compliance is based on fault; the right to avoid the policy will drop where it has not been used within one month of learning of the circumstances. Also the insurer will not have the right to avoid the policy unless the non – compliance had any effect on the occurrence of the risk and the extent of the obligations of the insurer.

Class Actions

Class actions have been recently introduced by the new Turkish Civil Procedural Code⁹ Only associations and other legal entities are entitled to file class actions in order to protect the interest of their members or persons they represent. Real persons are not entitled to file class actions.

Direct Action against the D&O insurer

A new provision introduced by the TCC is the explicit recognition of the third party right for direct claim against liability insurers. Although the Turkish Court of Appeals, some special Codes and standard general conditions with respect to some liability insurance types had recognized the right of direct claim with respect to third party liability policies, various aspects in that regard were unclear or controversial due to lack of provisions in the old TCC.

Time Limitation against the Insurer

The time limitation period for claims against the insurer is two years from the maturity date. The TCC introduced an additional provision to the effect that a ten years time limitation period from the occurrence of the insured event shall apply in any event to claims for insurance indemnity. The old law provided for a period of two years and there was a lot of controversy on the maturity date from which the two years period would start.¹⁰

Footnotes

* An overview of liability of D&O's of the most common types of corporations in Turkey i.e. Joint Stock Companies ("JSC's") and Limited Liability Companies (LLC's) will be provided here. Explanations on duties and liabilities of JSC D&O's are also relevant for LLC D&O's unless otherwise indicated. The term "director" is used to refer to the members of the Board of Directors (Managers in an LLC) or managing directors and the term "officer" to executive directors (managers) in both companies.

With regard to LLCs, both the old and the new TCC provide that, unless otherwise stipulated in the Articles of Association of the company or partners' resolution, all partners are considered managers and are jointly authorized to manage and represent the company. Management and representation authority can be delegated to one or more partners or to a third person through partners' resolution.

1. The TCC provides that insurance cover for an amount exceeding 25% of a JSC's share capital for losses incurred by the company due to faulty actions of the members of the Board; will be considered in the evaluation of compliance with corporate governance standards.

2. This overview will focus on issues which were subject to amendment in the company law provisions of the TCC.

3. Apart from liabilities under company law, D&Os can obviously be subject to civil, administrative or criminal liabilities under various legislation such as Tax, Competition, Insurance, Environment, Employment, Intellectual Property and Environment, Bankruptcy and Enforcement, and Capital Markets etc., which will not be discussed in this article.

4. A mandatory provision non – compliance with which will render the entire contract void.

5. A semi – mandatory provision which cannot be amended contrary to the interests of the insured and/or the policyholder.

6. Semi – mandatory provisions which cannot be amended contrary to the interests of the insured and/or the policyholder.

7. The rules explained in that sanction are semi – mandatory provisions which cannot be amended contrary to the interests of the insured and/or the policyholder.

8. All semi mandatory provisions which cannot be amended contrary to the interests of the insured and/or policyholder.

9. Numbered 6100 and dated 12 January 2011 enforceable from 01 October 2011 – Article 113

10. Mandatory provision which cannot be amended by contract.