



INSURING PROGRESS

d&onews

ACE Bermuda International • Newsletter Issue 1 • June 2009

Directors' exposures in an increasingly aggressive claims environment

Directors of UK companies presently face an increasingly perilous environment in which claims are more likely than ever to be made against them and consequently their personal assets. This article examines some of the factors contributing to this increased risk, particularly:

- The credit crisis and the deteriorating global economy are causing the environment for bringing claims against directors of UK companies to become increasingly aggressive;
- Changes in the law, and the growth of litigation funding since the last recession, have made it easier to bring claims against directors and enabled claimants to mitigate the financial risks of doing so.

The Credit Crisis

Background

One of the most prominent initial victims of the credit crisis was Bear Stearns which was near to collapsing when it was purchased by JP Morgan Chase in March 2008. The distressed sale was precipitated by increasing write-downs arising from troubled mortgage-backed securities. In September 2008, Lehman Brothers filed for Chapter 11 bankruptcy in the United States for similar reasons.

Meanwhile, Northern Rock and Bradford & Bingley were experiencing difficulties as a result of an over-reliance on short-term debt funding, coupled with an under-reliance on funding via consumers' retail deposits. Hedge funds then aggressively short-sold shares in some of the institutions affected by those issues. This exacerbated the difficulties of some of those institutions by driving down their share prices and their value.

In response to this combination of factors, many financial institutions adopted increasingly protectionist attitudes towards lending to each other and to their consumers. As a result, businesses and consumers alike were finding it increasingly difficult to find credit, which was often readily available in the past. Moreover, businesses (of all sizes and in all sectors) and consumers have also been put in financial difficulty as lenders called in loans.

Consequently, insolvencies and unemployment are increasing and consumer spending has declined signifi-

cantly. Even the strongest companies, with the best credit ratings, are having difficulty in rolling over their funding requirements. The situation does not seem to be improving and the ongoing volatility in the commodity, stock and currency markets will hardly settle anyone's nerves.

The credit crisis is different from the previous recession

The depreciation in a company's market capital is likely to result in dissatisfied investors to search for a defendant traditionally perceived as "deep-pocketed" (i.e. auditors and directors) to be held responsible for their losses. Indeed the market capitalisation of entire industries (banking and mining being obvious examples) is now subject to significant media scrutiny, with an increased likelihood of claims being launched by action groups sponsored or supported by major shareholders or organisations such as the UK Shareholders Association. Insolvencies in the UK are rising and are a further source of D&O claims as liquidators look to recover as much as possible for the companies' creditors.

The present recession is different to previous recessions as it is much more widespread and has affected many industry sectors, with the overall damage being more severe and quicker wherever it has occurred. This means that the environment for D&O claims in the UK is becoming increasingly aggressive. The comfort of having a CODA contract (that protects the personal assets of directors & officers) is increasing its appeal to a wider audience of UK companies as a result.

Further, directors now have to contend with two risks which did not exist in the early 1990s to the extent they do now:

- Reputational risk - as demonstrated by recent outcries over "rewards for failure" and the pension arrangements of senior executives or board members considered responsible for bringing their companies to the brink of insolvency;
- Regulatory risk - regulators (especially the FSA) are increasingly willing to scrutinise directors' conduct. Indeed, the FSA has recently announced its intention to focus more attention on non-executive directors because: "it is not enough for risk information to remain in the hands of the specialists. Those leading a firm must take reasonable steps to understand the risks the firm is running."

Company Law and the Growth of Litigation Funding

Re D'Jan

Until 1994, the Courts analysed directors' duties subjectively; the test of whether a director breached any duties owed to the company was determined by what the director actually knew and did. However, since the *Re D'Jan* case in 1994, the Courts have analysed directors' conduct objectively, namely how a hypothetical director holding the knowledge, skill and experience that may reasonably be expected of a person carrying out his functions as a director, would have acted in the same circumstances.

Consequently, since 1994, even where an individual director was not aware of certain facts or matters, he can still be found to have breached his duties if the Court thinks he should have been aware of those facts/matters.

Companies Act 2006

The Companies Act 2006 codified the traditional directors' duties - these are now stated for the first time in one place and could result in an increase in claims against directors in two respects. First, it introduced a new duty so that directors must, in good faith, act in the way they think best promotes the success of the company, bearing in mind the interests of all of its stakeholders such as employees, creditors, the community and the wider environment. The interests of these stakeholders might conflict with each other, meaning the directors should consider key decisions carefully.

The second relevant factor is the ability of the company's auditors for the first time to limit or cap their liability to the companies. The result is that the claimant may not be able to recover all losses from the auditors and so may have to target the directors in particular for any shortfall.

Derivative actions

Minority shareholders can bring claims in the name of the company against directors more easily via section 260 of the Companies Act 2006. Claimants no longer need to show that a director has made a wrongful or fraudulent personal benefit in order to bring such an action; breach of directors' duties or negligence will suffice. By lowering this threshold, Parliament has made it easier for shareholders to bring derivative claims against directors.

Growth of third party litigation funding

During the last recession, high legal costs deterred claimants from pursuing claims against directors. The availability of litigation funding has changed since the last recession in two respects. Conditional fees were introduced in the mid-1990s. These are 'no win no fee' agreements, so claimants do not pay their lawyers if the claim is unsuccessful, thereby removing a large element of risk when deciding whether to pursue a claim.

In addition, the law has recently changed to allow specialist investment vehicles such as hedge funds to fund litigation in return for a proportion of the damages. The combination of conditional fees and specialist litigation funders results in claimants potentially having no risk in pursuing claims, and this will likely result in an increased appetite to pursue claims in the future.

“Parliament has made it easier for shareholders to bring derivative claims against directors.”

Directors' potential liability overseas

A further factor is the increased potential for UK directors to be sued in overseas jurisdictions. Indeed, the media has recently highlighted the willingness of shareholders to bring potential claims against directors of UK institutions in the US. A significant number of UK companies have faced securities litigation in the US; large securities class-action settlements involving non-US companies demonstrate that such companies and their directors and officers can face potentially catastrophic liability exposures under US securities laws, as some US district courts continue to exhibit a willingness to deny motions to dismiss on jurisdictional grounds and to appoint foreign investors as lead plaintiffs.

Conclusion

Precipitous stock drops and resulting loss in company value, changes in company ownership and insolvencies are all rising as a result of the credit crisis and global economic downturn. Those factors, coupled with the changes to the law since the last recession and the increase in third party litigation funding, mean it has never been easier, or cheaper, to bring claims against directors personally. Some directors have executed deeds of indemnity with their company in order to give them some protection from claims. However, if that company becomes insolvent and a claim is subsequently made against a director, then that indemnity is unlikely to give the director much protection in practice.

As D&O claims may continue to increase for at least as long as the credit crisis continues, directors should take advantage of every available protection against claims, including purchasing D&O insurance. If no D&O insurance is available, or the existing D&O cover has been exhausted, directors may face a claim against their personal assets. This is at least one reason for the increased demand for D&O insurance, in particular D&O products like CODA that focus on protecting the personal assets of directors & officers.

Deeds of Indemnity and D&O Insurance – Two Essential Shields

Director indemnification is a relatively new concept in English law, which has only clearly permitted companies to indemnify their directors (subject to some limitations – see below) since 6 April 2005. Before then, English law largely prohibited director indemnification by companies. Claims against directors are increasingly likely in the current economic and legal environment. This makes it all the more important that directors obtain every available protection from potential claims. This is particularly true for directors of large or multinational companies, who can often face the greatest potential exposure to claims.

Company indemnities: useful, but by no means complete, protection.

Company indemnities are an important shield, although they do not provide complete protection.

If an indemnity is wider than that allowed by the Companies Act 2006 it will be void in its entirety. That Act allows companies to indemnify directors in relation to their costs of defending claims made against them (albeit subject to a clawback if the director acted dishonestly or fraudulently) and in relation to all sums paid to settle claims brought by third parties.

However, companies cannot indemnify their directors in relation to damages or settlements payable by a director to the company. This is a significant limitation because the company is one of the principal sources of claims against directors (as directors owe their duties to the company). Another source of claims against directors is an insolvent company's liquidators. Deeds of indemnity might not provide any protection if a company is insolvent, financially unable or otherwise unwilling to indemnify, or in the case of defence costs, where the costs are vulnerable to a clawback.

Finally, companies cannot indemnify their directors in relation to damages/fines payable as a result of criminal or regulatory proceedings.

Claims against directors are increasingly likely in the current economic and legal environment

How can directors maximise their protection in the current claims environment?

Directors' employment contracts (and the protections that come with them) usually terminate upon their resignation or dismissal. They might not, therefore, provide the director with adequate protection because most claims are made against directors after they leave their positions. For example, in the *Equitable Life* case, a substantially new board took over shortly after the company's near-collapse and promptly sued the old board for mismanagement.

English law allows companies to indemnify their directors, but does not oblige them to do so. Similarly, a company's articles of association often permit director indemnification but cannot oblige the company to indemnify. Therefore, directors should take positive steps to obtain an indemnity from the company upon joining it (in addition to their contract of employment); if they do not do so, then the company could either decide not to provide an indemnity or could simply overlook the issue. Indemnities are contracts between the director and the company and (unlike the articles of association) give directors legally enforceable rights. Directors can therefore maximise their protection by:

- Requiring the company to provide an indemnity to the fullest extent permitted by the law;
- Insisting the indemnity contains an obligation on the part of the company to buy D&O insurance. Some D&O policies require the company to indemnify its directors and insurers can give directors further protection by enforcing such clauses;
- Mandating upon joining the company that their indemnity endures after their resignation or dismissal. There is nothing to stop a director from requesting a deed of indemnity retrospectively, although the company is unlikely to agree to provide one, particularly after the director has left; and
- Securing separate legal representation to review their indemnification arrangements. Companies should be willing to pay for this as per the Combined Code on Corporate Governance.

Directors can obtain further protection through appropriate D&O insurance, which responds to liabilities which might not be covered by their company indemnities. The D&O insurance market is innovative and offers different products to meet the needs of different companies and their directors. Specialist D&O insurance like CODA, which is designed to indemnify the director if their company/D&O insurers cannot or will not pay, and which drops down to plug gaps in company indemnities and underlying D&O cover, is available.



Captive Insurers: Can they indemnify a director if the company does not?

Many large companies have captive insurers. These are insurance companies set up as subsidiaries, primarily to write the parent company's own insurance cover.

D&O insurance and company indemnification are the two principal sources of protection from claims available to directors. What, then, happens if a director has an indemnity from the parent company and his D&O insurance is written by that company's captive insurer? And can the captive indemnify the director if the parent company refuses to do so?

“D&O insurance and company indemnification are the two principal sources of protection from claims available to directors”

The Companies Act 2006 (section 233) is widely drafted and does not prohibit captives from writing D&O insurance, nor from covering the parent company's directors, provided that the indemnity is an arm's length transaction and the insurance is written on standard market terms.

However, in practice, the thought of the captive covering a director could be unpalatable for the company and its shareholders. They may consider it an inappropriate use of the company's funds since they might wish to bring claims against the directors either directly (in the case of the company) or via a derivative action (in the case of the shareholders).

A further practical issue is that it is difficult to see how a captive writing insurance for its parent company's directors can be an arms length transaction. For example, conflict of interest issues would undoubtedly arise if a director of the captive seeks cover under the policy, especially if the director is also the parent company's risk manager. Further, as a matter of market practice, captives are often used to give cover which the rest of the market cannot, or will not, give (at least at the price requested). Therefore, it is not easy to see how the required market terms would be measured.

Finally, the majority of claims made against directors are made after they have left the company and only if something has (or has allegedly) gone wrong. In such cases, the shareholders and the parent company could have an incentive to put the captive under significant pressure to decline to indemnify the defendant director.

Accordingly, whilst there is no legal reason why a captive cannot write D&O insurance or indemnify a director in respect of claims against him, that arrangement is an awkward one for company and director alike. It is therefore prudent for directors to view such arrangements with caution. If in doubt, a director should seek independent advice from solicitors and insurance brokers.

The Editors of D&O News are Edward Smerdon and Jeremy Hewitt. Mr. Smerdon is a partner in the International Risks and Reinsurance department of City of London law firm Reynolds Porter Chamberlain LLP. He specialises in directors' and officers' liability and has become a leading authority on the interrelationship between D&O insurance and indemnification, and lectures widely on the subject. Mr. Hewitt is an associate at Reynolds Porter Chamberlain LLP, also specialising in directors' and officers' liability work.

D&O News is a periodic publication distributed as a service to policyholders and other interested parties by ACE Bermuda International. The contents of this publication are compiled for informational purposes only, and should not be utilised as a substitute for legal counselling. Readers should not act upon the information contained herein without seeking professional legal guidance.

For more information about ACE Bermuda International's products, please contact us or your broker.

ACE Bermuda International
The ACE Building
100 Leadenhall Street
London EC3A 3BP
United Kingdom
+44 (0)20 7173 7000

abi.info@acegroup.com
www.acebermudainternational.com



INSURING PROGRESS

ACE Bermuda International is the registered trading name of ACE Bermuda International Reinsurance (Ireland) Limited and its wholly owned subsidiary, ACE Bermuda International Insurance (Ireland) Limited, both of whom are regulated by the Irish Financial Regulator.

