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## Directors' Exposures in an Increasingly Aggressive Claims Environment

The landscape for claims against directors is becoming increasingly aggressive as a result of the challenging economic conditions and changes in the law over the last couple of years. It would be time well spent if clients and their brokers were now to review their D&O wordings, whether it be the adequacy of the breadth of the cover or the sufficiency of the limit. The following are some suggested drivers for the review:

- 1) 2009 saw record numbers of personal and corporate insolvencies.
- 2) Public sector borrowing for this financial year currently stands at £122bn and is forecast to rise to £178bn by April. These are the highest figures since official records began in 1993. Additionally, public sector net debt was £848bn at the end of January, which is also the highest since records began.
- 3) The Financial Reporting Council (FRC) intend to issue an updated Combined Code from mid 2010 (see detail below), and
- 4) The UK economy is only marginally out of recession and the outlook for the next 12 months remains fairly bleak.

The landscape for claims against directors is unlikely to become more benign until the economy recovers from those fundamental issues and bank lending increases significantly; indeed the paucity of credit is still preventing any significant recovery.

## Governments and Regulators Sharpening their Teeth

In that backdrop, and fuelled by the public's desire to find scapegoats for the recession, the Government, Government bodies and regulators are using the recession as an opportunity to tighten regulation of companies and their directors. Regulatory reform is the hot topic of the moment and it is here to stay.

The Walker Review on corporate governance was released in November 2009. Its recommendations are aimed at enhancing boards' performance and awareness of their strengths and weaknesses. They are taking legal shape already in the form of the FRC's review of the Combined Code on Corporate Governance and the Financial Services Bill.





On 1 December, the FRC published its final report, and a draft updated Combined Code which sets out new principles on:

- the roles of the chairman and non-executive directors;
- the need for the board to have an appropriate mix of skills, experience and independence;
- the commitment levels expected of directors;
- the board's responsibility for defining the company's risk appetite and tolerance;
- board evaluation reviews (to be facilitated externally at least every three years);
- the need for the chairman to hold regular development reviews with all directors; and
- the need for companies to report on their business model and overall financial strategy.

Changes to the Listing Rules might also be necessary and the FRC intends its recommendations to apply to all FSA regulated institutions and all companies with a premium listing (formerly known as primary listing) from 29 June 2010 onwards. Therefore directors of all listed companies (not just those in the banking sector) will clearly be affected.

The precise nature of the changes remains to be confirmed. The consultation procedure is ongoing and the updated Code will be implemented early in the year on a "comply or explain" basis. This will mean more pitfalls for directors and the FSA intends to monitor compliance very carefully.

Some companies are changing their corporate governance structures already, in anticipation of the changes, by establishing separate risk and audit committees and giving careful consideration to directors' remits. They will be ahead of the game come June, but such changes could be poisoned chalices if the updated Code throws up any surprises.

In particular, the FRC are clamping down on non-executive directors by obliging them to spend substantially more time on the job and undergo regular training to enable them to "assess risk and ask tough questions about strategy". As a result, non-executive directors will have to increase their time commitment to the company and focus much more on risk and compliance issues. This will inevitably mean more accountability and potential compliance pitfalls.

The EU has also jumped on the regulatory bandwagon by introducing a further draft of the Alternative Investment Fund Managers ("AIFM") Directive. It is largely aimed at hedge funds, but is wide enough to encompass some FSA regulated funds and intends to regulate: (i) their fund managers; (ii) the funds themselves; and (iii) the marketing of the funds. It has caused controversy both in and out of Europe and is the subject of much ongoing European parliamentary debate. Directors of financial institutions should watch this space for further regulatory burdens and pitfalls.

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### Shareholder Action Groups and Derivative Actions

The current economic crisis has given rise to numerous class actions in the US where groups of people are seeking collective redress. Whilst this is not common practice in the UK, we are seeing more group litigation as result of the worsening economy. Indeed, an increasing number of UK law firms are making a living out of these kind of claims.

Many shareholder class actions assert that prospectuses accompanying companies' rights issues were misleading. More often than not, those prospectuses will have been issued by financial institutions.

One difficulty with class actions is bringing together enough shareholders to fund the claim and make it financially worthwhile. This is largely taking care of itself with the increase in shareholder action groups. In the UK, the UK Shareholders Association (UKSA) has set up several action groups with the aim of cobbling together sufficient funds to take legal advice on whether claims can be brought against several ailing companies and/or their directors and, if so, to pursue them.

“ Directors are particularly at risk of being on the receiving end of funded claims...” ”

Such groups are a relatively new phenomenon in the UK, but are set to become more prominent. The UKSA is getting better organised; it has its own website with links to separate websites for each of its action groups. Northern Rock's shareholders, with the UKSA's assistance, took their case to the Supreme Court late last year. Although the court refused permission to appeal, this has not stopped their determination; they are asking the European Court of Human Rights to hear their case. That the UKSA is encouraging this, whilst simultaneously helping shareholders lobby their MPs and planning more demonstrations in April / May 2010, is an indication of the growing dedication and drive of such action groups.

### Litigation Funding



The litigation finance industry in the UK is growing quickly and is on its way towards becoming a global industry. Litigation finance firms operate in most developed countries and a broker network is evolving which is increasingly bringing together investors and claimants.

An increasing number of commentators anticipate that ongoing reform of legal services and access to justice will transform the global litigation finance market. This process has picked up speed in the last few months.

One of the biggest brokers of litigation funding, Calunius Capital, has begun investing in its own cases. Calunius has also seen an increase in entrants to the litigation funding market. As a result, capacity in this market has never been higher.

A major litigation funding firm, Burford Capital, recently floated on the London Stock Exchange raising £80m. This followed in the footsteps of Juridica Investments, which raised a similar sum by floating in 2008.

Recently, the first ever list of third party funders was published. This makes it easier for claimants to know who to target for funding and gives details of the kind of cases the third party will fund and how much capital they are willing to risk and on what terms. The list also demonstrates how quickly the market is developing to cater for a range of requirements; many funders now do not insist that lawyers work on a "no win no fee" arrangement because funders increasingly do not want to turn down a potentially lucrative case purely for that reason.

The impact of those developments, however, has to be balanced with the outcome of the *Stone & Rolls v Moore Stephens* case, which was decided in July 2009. That was the first major case in which the claimant (which was in liquidation) was funded by a third party. Despite that financial assistance, the claimant lost, after two appeals, and was ordered to pay both sides' costs, resulting in a significant loss to the funding party. At the very least, this decision will encourage third party funders to think twice before agreeing to fund a claim.

Premiums for after the event insurance (which covers a claimant's liability for costs) are dropping and many insurers will now defer payment of the premium until the end of the case. This further incentivises claimants to pursue claims because there is little financial risk in doing so.

Law firms are also adapting; three large firms recently launched "funding packages", offering a combination of no win no fee arrangements, after the event insurance and third party funding to induce both the claimant and the funder to take on claims. Directors are particularly at risk of being on the receiving end of funded claims because of the perception that they are backed by insurers and therefore have deep pockets. One of the main factors in deciding whether to pursue a claim is "can the defendant pay?". When it comes to a director the answer will almost certainly be "yes".

In short, there is a funding product out there which will suit the vast majority of claimants. With the myriad of choices available it is likely that more cases will be pursued against directors sooner or later.



## Conclusion

A marked increase in the regulation of directors is imminent in the shape of the new Combined Code and changes to the Listing Rules. Once implemented, those changes will likely be here to stay, given the public's apparent ongoing support for them. Moreover, the FSA intends to monitor compliance with the new regime carefully. As a result, directors' potential exposure to claims and regulatory investigations can only increase.

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Coupled with that, there has been an increase in claims against directors as a result of the credit crunch. Whilst the Stone & Rolls decision should make litigation funders think twice before parting with their cash, new funders are entering that market, so its capacity can only increase. There has never been a better time for directors and officers to review their own liability insurance with the help of qualified brokers to ensure that they are getting the benefit of the latest dedicated protection available in the marketplace.

*The Editors of D&O News are Rupert Boswall and Jeremy Hewitt. Mr. Boswall is a commercial litigator with City of London law firm Reynolds Porter Chamberlain LLP acting on complex financial disputes particularly involving asset managers, hedge funds, financial institutions, accountants, and stockbrokers. He is regularly involved in litigation relating to offshore entities, prime brokers, directors and officers, trustees and administrators. Mr Boswall lectures on commercial litigation issues in this field and is regularly quoted in the broadsheet press on financial disputes. Mr. Hewitt is an associate of Reynolds Porter Chamberlain LLP, specialising in directors' and officers' liability work.*

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### Dublin Head Office:

ACE Bermuda International  
5 George's Dock  
International Financial Services Centre  
Dublin 1  
Ireland  
+353 (0)1 440 1700

### London Branch Office:

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

[abi.info@acegroup.com](mailto:abi.info@acegroup.com)  
[www.acebermudainternational.com](http://www.acebermudainternational.com)



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