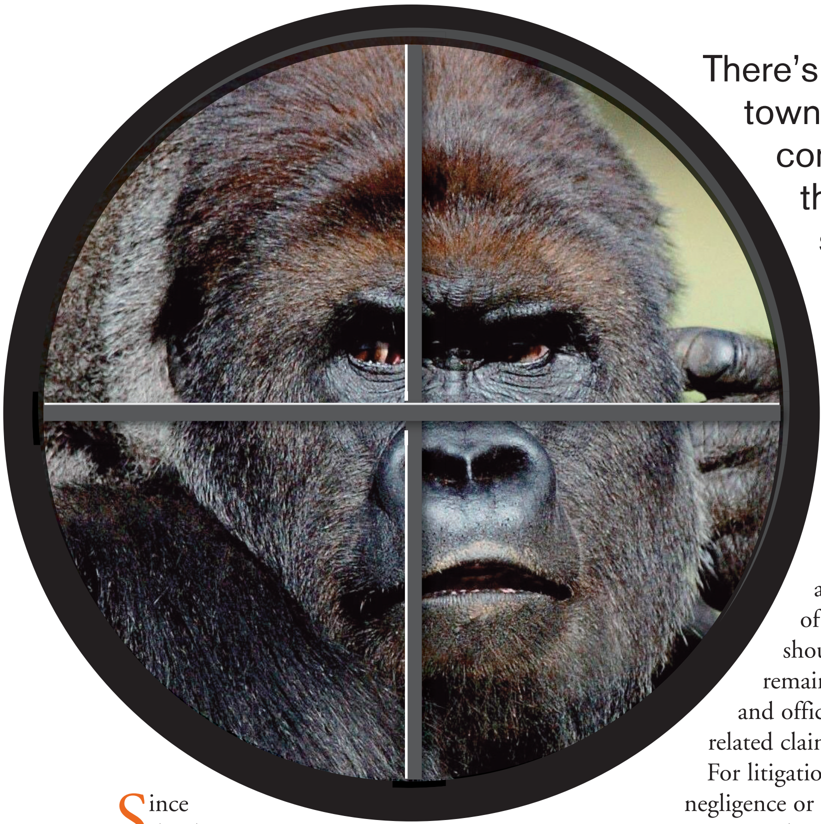
HUNTING THE GORILLA



There's a new big game in town. Directors of companies caught up in the credit crunch are squarely in the sights of the big game hunters – legal claimants. **Gavin Coull** and **Michael Wharfe** guide us through the D&O jungle.

Since the demise of Lehman Brothers and the virtual evisceration of Wall Street, we continue to witness financial failures, bail-outs and reconfiguration of the world's financial markets. With governmental and regulatory investigations focussing the blame on executive responsibility, directors and officers are squarely in the sights of the big game hunters, namely potential claimants, with the Wall Street Gorilla, Richard Fuld, CEO of Lehman Brothers, already taking fire.

With the credit crisis driving scores of institutions into insolvency or rescue deals, destroying shareholder value, collapsing the wholesale lending market, and destabilising the broader financial markets, drastic steps are being taken. As the victims mount, the US plaintiff bar is taking the lead, with the number of "sub-prime" related lawsuits increasing as fast as the world's markets fall. There is no doubt that, in turn, the directors and officers being hunted will seek recourse from the D & O market.

D&O policies are increasingly varied and complex, and after a period of relatively limited take-up amongst large corporate entities, buying of coverage has increased, although it should not be forgotten that many SMEs remain uncovered and hence their directors and officers are at real risk from insolvency related claims as the wider economy struggles.

For litigation to arise there needs to be some negligence or misconduct, and an economic reason to sue i.e. losses and the prospect of recovery. There is increasing shareholder activism following the failure of institutions, in part due to the emotive impact of executive remuneration. Directors and officers can expect criticism for the business models adopted, the risks taken, and the failure to merge or sell the companies before the value was eroded. There is a risk of fraud by directors and officers, highlighting the perceived self-interest in concealing poor performance. Although fraud is generally excluded from coverage, factors such as these mean that shareholders and investors will seek to recover their losses elsewhere, and D&O or professional indemnity policies are likely to offer the best chance of recovery.

FRONTLINE

The financial crisis presents different problems for different financial institutions. Lenders are in the frontline, having borrowed aggressively on the wholesale markets to support highly leveraged lending. Investment banks produced, and invested in, products based on these loans. Retail banks, hedge funds, asset managers and pension funds purchased

Gorilla: PA Wire

the investments produced by the investment banks, leading to the next tier of exposure. Directors of businesses which sustained heavy losses through investments in complex financial instruments may face problems in explaining to the Court that they adequately understood these transactions when taking decisions on investment strategies. This presents a real likelihood of D&O claims beyond the companies with direct exposure to residential real estate or sub-prime lending.

Another affected group is the companies hurt by the unavailability of credit required to operate their businesses. The extent of this problem was largely unforeseeable, so it is less likely that failures in these companies, due to the general unavailability of credit, will found actions against directors and officers of those companies.

INVESTIGATIONS

Apart from direct claims, there is also a huge exposure for D&O policies resulting from the likely growth in regulatory and other investigations, such as those already launched by the FBI and the SEC. Given the global scale of the problem, level of losses incurred, and complexity of the financial instruments at the heart of the problem, the costs of investigations may be considerable, and may in truth represent the biggest tangible exposure for underwriters. Are there any positives for D&O business in the current environment? Whilst the fear of insurance claims (or at the very least significant defence cost exposures) is a negative headline, opportunity exists for the cautious underwriter, witnessed by an unprecedented surge in demand for D&O cover. Two years ago, only 10% of the FTSE 250 companies were buying D&O insurance, with this figure now standing at nearer 50%.

New opportunities may also exist outside of the traditional US and UK D&O markets, with standards of corporate governance being raised in Asia, creating a new market in the developing regions between India and China. Similarly, Russia plans legislative reforms which may introduce executive liability for work place injuries, creating attendant corporate exposures.

However, in the present financial market, in which questions are arising about the security of some participants, the financial stability of insurers is becoming a major consideration for companies seeking to take out the D&O coverage. While Lloyd's remains cautious, opportunities exist for insurers who can strike a balance between competitive pricing, cover and profitability.

All in all, D&O underwriters will be exposed to a tumultuous claims environment. Once the big game hunters have shot the gorillas to extinction, they will invariably look for new targets, and the only questions are which is next, and who is firing the gun.

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Coverage issues that may arise

Key coverage questions which might arise include:

- Was the insured aware of the potential for a claim prior to inception of the policy?
- Is there any suggestion of fraud, misconduct, or personal benefit in the circumstances giving rise to the claim?
- Are the losses being sought actually caused by the act or omission in question?
- Are the legal expenses incurred confined to the covered claim?
- At what stage of investigations is coverage triggered and to what extent are internal or external investigation costs covered?
- How many occurrences are comprised by the losses in question?
- Is there any other coverage which may respond to the claim?
- What is the timing of the losses?

Not just a US problem

Whilst traditionally D & O exposures were viewed as a US problem, changes to the Companies Act 2006 ("the Act"), which took effect on 1 October 2007, codified directors' duties, and also introduced a new form of derivative action under English law. The codified duties broadly reflect the existing common law, but with one key difference – the primary duty on a director is to act "in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole". This is a subjective test.

Previously, derivative actions by shareholders were generally expensive and complex, which proved a strong financial deterrent. Section 260 of the Act has, however, simplified the procedure by introducing a new right for shareholders to bring a claim against directors in relation to actual or proposed acts or omissions by directors involving negligence, default, breach of duty or breach of trust by a director. Board approval is not required to bring a claim and the shareholder need not have held shares at the time of the alleged wrongdoing in order to bring a claim. That said, safeguards have been built into the Act, as losses recoverable are limited to those incurred by the company, and damages payable go to the company as a whole and not to the nominal claimant or any specific group of shareholders. Quite how the new provisions will play out will be determined in the current context of animosity towards the financial markets and perceived profligate behaviour.

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