

## D&O Update

December 2009

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In the current economic environment, shareholders are increasingly looking to non-executive directors to play a more central role in managing companies' risk. In turn, regulators are expecting much more from non-executive directors. In this article, we consider the extent to which increased oversight is likely to translate into a more hostile litigation environment for non-executive directors and the implications for D&O insurers. [More...](#)

### FSA criminal prosecutions

While there is a focus on the nature of future financial services regulation, the FSA's Enforcement Division continues to assiduously pursue enforcement cases. The FSA is unique amongst UK enforcement authorities in that, for the same contravention, it can often bring civil/regulatory or criminal cases. [More...](#)

### Derivative claims update

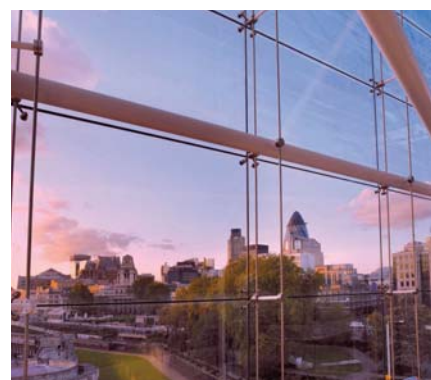
One of the much vaunted reforms introduced by the Companies Act 2006 (the Act) was a statutory right for shareholders of a company to bring claims against a director in the name of the company. The right to bring so-called Derivative Claims has always existed under English law, but the Act has relaxed the requirements that have to be satisfied in order for such claims to be pursued. [More...](#)

### Case notes

#### Attributing a director's knowledge to the company

*Moore Stephens (a firm) v Stone & Rolls Limited (In Liquidation)*

The recent House of Lords case of Moore Stephens v Stone & Rolls provides guidance on the circumstances in which the acts of an individual can be attributed to a company. This decision could impact on the availability of cover for companies under the securities entity coverage section of its D&O policy, or under other insurance policies indemnifying the company itself in respect of losses and claims. [More...](#)



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# A new dawn for non-executive directors

In the current economic environment, shareholders are increasingly looking to non-executive directors to play a more central role in managing companies' risk. In turn, regulators are expecting much more from non-executive directors. In this article, we consider the extent to which increased oversight is likely to translate into a more hostile litigation environment for non-executive directors and the implications for D&O insurers.

## Regulators are getting tougher

Non-executive directors of regulated companies are invariably categorised by the FSA as holding a "significant influence over the firm" (SIF holders) and they have a personal responsibility to comply with certain FSA rules.

Following the bail out of the banks, now more than ever there is political momentum at the FSA to initiate investigations and bring enforcement proceedings against SIF holders. Indeed, the FSA's head of enforcement has recently warned: *"we won't shy away from pursuing cases against SIF holders who've breached our principles and Code"*.

The FSA has recently made an unambiguous statement of intent in terms of its attitude towards non-executive directors in particular. In a consultation paper proposing new guidance for non-executive directors, and detailing what it sees as their responsibilities, the FSA said:

*"In the past we have said that we will not discipline non-executives if they have acted in accordance with their roles and responsibilities when things go wrong. In the future, we will look at non-executives more closely in these cases if we believe that they should have intervened where executives are making sustained poor decisions."*

## Non-executive directors get sued too

Reported cases against directors in the UK (particularly non-executive directors) are still uncommon, but the recent Court of Appeal decision in *Lexi Holdings plc v Luqman* illustrates how non-executive directors can be held liable for failing to intervene to prevent a company suffering a loss.

The executive director of the company in question was fraudulently drawing on the company's credit facility for his own benefit. The company's administrators brought a claim against two non-executive directors (who were related to the fraudulent executive director), in which it was alleged that:

- the non-executive directors ought to have suspected that a directors' loan account showing in the company's accounts (in the executive director's name) was fictitious, and reported the matter
- had that been done the company's accounts would have been qualified, with the result that the executive director would have been prevented from drawing on the credit facility (it was a condition precedent of the facility that the company's last set of accounts were unqualified)



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At first instance the trial judge dismissed the claim, on grounds of causation. He found that although the non-executive directors should have been suspicious about the directors' loan account and confronted the executive director with their concerns, had they done so the executive director – “a persuasive, sophisticated, charming and highly intelligent liar” – would have given an explanation that would have alleviated their suspicion.

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The Court of Appeal overturned the decision. Whilst ultimately the non-executive directors would have been manipulated and deceived by the executive director into not reporting the concerns that they should have had, this was held to be irrelevant. Allowing themselves to be ‘duped’ in this way by the executive director would have constituted a further breach of duty to the company. The non-executive directors were ordered to reimburse the company to the value of the executive director’s fraudulent draw downs on the company’s credit facility.

The case is significant on two levels. First, it shows that the courts are ready to impose liability on non-executive directors who have neglected their duties to the company in terms of being alive to fraud by the executive directors and reporting their suspicions where appropriate.

Second, on a wider level, it illustrates that non-executive directors will not be able to escape liability on the basis that they were persuaded to defer to the greater experience or skill of an executive director, where being so persuaded would constitute a breach of duty in itself.

### Implications

We anticipate that, as a result of the FSA’s hardening attitude towards non-executives in particular, and the political momentum for a more interventionist FSA, the number of FSA investigations into the conduct of non-executive directors will increase.

Invariably, such formal investigations will constitute a ‘claim’ or an ‘investigation’ under most D&O policies, and so will trigger the ‘legal representation expenses’ cover. In our experience, the legal costs of ‘defending’ an FSA investigation can be high, even where the enquiry is relatively limited. The legal costs incurred in defending more wide ranging investigations can often rival the costs incurred in defending large-scale commercial litigation.

The issue of costs is often a significant ‘pinch point’ for D&O insurers and directors, but steps can be taken to try and minimise the potential for conflict. Early engagement between D&O insurers and directors (and their advisers) in relation to costs and what approach should be taken in relation to the investigation can build trust and avoid the potential for future disagreement.

Claims such as *Lexi Holdings* are still comparatively rare, although there has been an increase in the detection of frauds, so there is potential for an increase in such claims in the future.

D&O insurers have limited scope to seek to reduce their exposure to claims. Although the D&O policy will contain a dishonesty/fraud exclusion, this would not have excluded the claim against the non-executive directors in *Lexi Holdings*.

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Invariably the dishonesty/fraud exclusion only excludes “loss” incurred by a director arising from his/her own dishonesty. The “loss” incurred by the non-executive directors in *Lexi Holdings* will have arisen from the dishonesty of the executive director. Consequently the exclusion will not have applied.

One approach that D&O insurers could adopt to better assess the likelihood of claims such as *Lexi Holdings* being made against non-executive directors that they insure would be to analyse the relationships between non-executive and executive directors, in order to ascertain whether the non-executive directors are genuinely independent and aware of the duties they owe.

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## FSA criminal prosecutions

**While there is a focus on the nature of future financial services regulation, the FSA’s Enforcement Division continues to assiduously pursue enforcement cases. The FSA is unique amongst UK enforcement authorities in that, for the same contravention, it can often bring civil/regulatory or criminal cases.**

Although it is still relatively uncommon for the FSA to pursue criminal charges against directors, it has signalled its intention to bring more criminal prosecutions in the future. It is important that directors, their advisers and insurers understand the various stages of the criminal and investigations process and the issues that can arise.

### Areas where the FSA can pursue criminal prosecutions

#### Market manipulation

- There are many ways of committing the FSA’s “Misleading Statements and Practices” offence at section 397 of the Financial Services and Markets Act 2000 (FSMA 2000). We may see investigated cases that involve those who circulate false information about a stock, aiming to benefit from the subsequent movement in its share price.

#### Carrying out a regulated activity without authorisation

- Carrying out unauthorised regulated activities is known as “breaching the general prohibition” or “breaching the perimeter” and carries a maximum penalty of two years imprisonment together with fines.
- Some breaches of the perimeter can be viewed as technical only, while others, in particular the operation of Ponzi or pyramid schemes, involve conduct that amounts to fraud on a grand scale.

#### Failure to co-operate with FSA investigations

- A failure to attend an interview with the FSA arranged through its statutory powers can be prosecuted under FSMA 2000 and can lead to imprisonment or a fine.

#### Insider dealing

- Insider dealing is a complicated offence. Since its introduction to the statute books very few cases have proceeded to court.
- Those who commit insider dealing range from unauthorised day traders right through to those involved in support operations



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within firms, eg those who photocopy prospectuses or who circulate documents around investment firms.

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Other breaches that could lead to a criminal prosecution include making misleading statements with the intention of inducing investment activity or falsely claiming to be FSA authorised when one is not.

## **The major stages in an FSA criminal investigation and prosecution**

### **Detecting criminal activity**

- There are a variety of means used by the FSA to detect criminal activity. These include whistleblower disclosures, firms' suspicious transactions reports, adopting sophisticated methods of monitoring stock market activity, and use of covert human intelligent sources to identify those who may be vulnerable in, eg an insider dealing ring, and persuade them to assist in the prosecution of others.
- The FSA will expect regulated firms to co-operate fully with their investigations. Firms which do not may well find themselves in breach of the FSA's Principles for Businesses.

### **Investigating a possible crime**

- The FSA will determine quickly which leads are promising and which should be abandoned. The Enforcement Division does not have sufficient resources to pursue all cases and a rigorous culling operation takes place to ensure that lawyers and investigators do not waste their time on cases which will be difficult to pursue.
- For example, the FSA may conduct telephone interviews, ideally within days or even hours of the suspicious dealing, in order to assess whether there is an innocent explanation for what would otherwise be a suspect trade.
- The FSA might conduct a search and seizure operation, otherwise known as a dawn raid. It does this in conjunction with the police forces with whom it has entered into memoranda of understanding. Historically the FSA was not keen on dawn raids, regarding them as expensive and rarely yielding anything useful, but we predict that the use of raids will increase in the next few years.
- Suspects will be taken to a police station to be interviewed under caution. It is at this stage that those under investigation will ask for legal advice. Attending a formal interview without legal advice is a situation of enormous danger. The FSA also has statutory powers to conduct interviews under compulsion although, unlike some other law enforcement agencies, it has taken the view that it will not use its compulsion powers to compel information from those it suspects of having committed criminal offences.
- D&O insurers will be expected to cover the costs of lawyers who attend and give advice in relation to interviews. Given the enormity of the situation those being interviewed will expect the best advice. There is only a limited pool of lawyers capable of advising, the vast majority of whom have formerly worked at the FSA or other prosecuting bodies and understand the mindsets and objectives of those conducting the investigation. This advice does not come cheaply.

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### Freezing the suspects' assets

- When it conducts a raid, and makes its interest in the suspect known to him/her, the FSA will attempt to obtain a freezing injunction under proceeds of crime legislation. The purpose of this is to ensure that any fine is likely to be effective and that the suspect has the assets to repay those who may have suffered loss.
- Injunctions typically allow the suspect reasonable living expenses, although this may be as little as £250 a week to cover rent/accommodation costs, school fees, food and clothing. An enormous amount of time can be spent by the FSA investigators and by the suspects and their lawyers dealing with applications to vary the order so that the suspect can live a relatively normal life in the period before trial when (after all) the law presumes he/she is innocent.
- The suspect may be subject to the freezing order for a lengthy period of time as it can take years before a criminal investigation reaches the trial stage.

### Charging the suspect

- When deciding whether to prosecute following a criminal investigation the FSA has to adopt the Code for Crown Prosecutors. In the first instance, it must determine whether there is enough admissible evidence to enable a jury to convict. This is the evidential test. If the evidential test is satisfied, the FSA must be satisfied that a prosecution will be in the public interest.
- More difficult for the FSA will be cases where the evidential test is satisfied, but perhaps on a marginal basis because some of the evidence is not as reliable as it might be, and the FSA must face the fact that it could bring a much more straightforward market abuse case in front of a more sympathetic tribunal than a jury. The FSA will not want to face the criticism, should it lose a Crown Court trial, that it was over-ambitious. That said, there is little evidence at the moment that the FSA is adopting a cautious approach.
- Prior to charge there will be conversations and meetings with the suspect's lawyer, who will attempt to persuade the FSA that it has too little evidence to bring the case or that a prosecution would not be in the public interest.

### Before trial

- There will be numerous court appearances before trial. The majority of will have little ultimate consequence, but the defendant's lawyers will still need to attend.
- Disclosure – the process by which the prosecutor discloses material relevant to the case – will involve many documents that will have to be sifted, read and analysed. The vast majority will have little relevance to the case brought at trial.

### Trial

- For D&O insurers, this is where the real costs are generated. Trials will be lengthy and hard fought and, in most cases, only an experienced QC at the top of his/her game will be an appropriate advocate. If the director is found not guilty then he will be able to recover a proportion of his costs but, as is the case in civil litigation, there is likely to be a significant shortfall.

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### A successful prosecution

- If the defendant is found guilty of the crime he/she can face fines and custodial sentences. The FSA recently warned that it would be seeking jail sentences more regularly.
- Such is the uncertainty about the law and the paucity of guidance regarding sentencing that appeals will be common.

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## Derivative claims update

**One of the much vaunted reforms introduced by the Companies Act 2006 (the Act) was a statutory right for shareholders of a company to bring claims against a director in the name of the company. The right to bring so-called Derivative Claims has always existed under English law, but the Act has relaxed the requirements that have to be satisfied in order for such claims to be pursued.**

Under the Act, it is necessary for prospective claimants to obtain permission from the court to commence a Derivative Claim. At the time of the Act's introduction, we took the view this was an important safeguard that would prevent vexatious and unmeritorious claims and, as a result, the impact of the new right would be limited. Three years on from the passing of the Act, it seems our initial prediction of the likely impact of the new right to bring Derivative Claims has been proved correct.

The High Court has yet to grant permission for any Derivative Claims to proceed, although it has exercised its discretion under Section 261 (4) (c) of the Act to order the board of a company to re-consider whether or not to pursue a defence to a claim against the company. In addition, the factors which the court is taking into account in considering whether to grant permission to bring a Derivative Claim are likely to further restrict the circumstances in which they can successfully be brought.

There have been five reported cases where shareholders have sought permission from the court to commence a Derivative Claim. In determining whether to grant permission, the recent cases demonstrate that two factors in particular will weigh heavily in the court's consideration:

- The importance of a person acting in accordance with their duty to promote the success of the company (the 'Hypothetical Director' test)
- Whether the shareholder has an alternative remedy

The importance of the first point was considered in *Stimpson v Southern Landlords Association*. The judge concluded that the 'hypothetical director' would not continue the Derivative Claim, in light of his/her duty, as the claim increased the possibility of job losses. This decision is significant as it demonstrates the court's readiness to take commercial factors into account and the interests of all a company's stakeholders (eg its employees), as well as its shareholders.



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## Derivative claims update continued...

The second point to take from the recent cases is that the court is unlikely to grant permission to pursue a Derivative Claim if the shareholder has alternative remedy it can pursue. Hence, in *Franbar Holding Ltd v Patel* the court concluded that where the shareholder had a right to pursue a so called “Unfair Prejudice” Claim (pursuant to section 994 of the Act), that remedy was adequate and, as a result, the court would not grant permission to the shareholder to commence a Derivative Claim.

It would be wrong to suggest that the court will never grant permission for shareholders to pursue Derivative Claims, but these recent cases confirm that the circumstances in which the court will grant permission are limited. As a result, directors’ (and their insurers’) exposure to Derivative Claims remains largely theoretical.

## Case note

### Attributing a director’s knowledge to the company

#### *Moore Stephens (a firm) v Stone & Rolls Limited (In Liquidation)*

The recent House of Lords case of *Moore Stephens v Stone & Rolls* provides guidance on the circumstances in which the acts of an individual can be attributed to a company. This decision could impact on the availability of cover for companies under the securities entity coverage section of its D&O policy, or under other insurance policies indemnifying the company itself in respect of losses and claims.

Stone & Rolls was used as a vehicle by its beneficial owner, Zvonko Stojevic, to defraud a number of banks using a letter of credit scam. One of those banks successfully sued Stone & Rolls which subsequently went into liquidation. Its liquidators brought an action in negligence against Stone & Rolls’ auditors, Moore Stephens, claiming that the failure of Moore Stephens to carry out their responsibilities as auditors had allowed Stojevic to perpetrate the fraud.

The House of Lords considered whether Stojevic’s fraudulent conduct was attributable to Stone & Rolls in order to establish whether Stone & Rolls could recover its loss from Moore Stephens.

The court considered the extent to which two legal principles prevented Mr Stojevic’s fraudulent conduct being attributed to Stone & Rolls:

- the “Hampshire Land” principle, that the knowledge of an agent will not be attributed to his principal when the knowledge relates to the agent’s own breach of duty to his principal



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- the “adverse interest rule”, that the knowledge and conduct of an agent will not be attributed to the principal where the agent’s actions are adverse to the interests of his principal

The case was complex and decided on a majority decision. In summary, the Law Lords found that Mr Stojevic was the directing mind and will of Stone & Rolls and was using the company for his own dishonest purposes. In those circumstances, neither the Hampshire Land principle nor the adverse interest rule prevented Mr Stojevic’s fraud from being attributed to Stone & Rolls. Stone & Rolls’ claim was therefore dismissed and the third parties funders who supported the claim have been left with a large bill of costs.

Such cases are necessarily fact sensitive and it is possible the case would have been decided differently if Stone & Rolls had “innocent” shareholders and executive directors, but the case serves as a useful reminder of the circumstances in which it may be possible for Insurers to attribute an individual’s fraud to the company.

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