The rising tide of litigation against directors

Clifford Chance's Claire Freeman, Philip Hill and Jeremy Kosky consider key issues when dealing with claims against directors, including tips for in-house counsel before and after litigation arises

Over the past few years in London, our disputes practice has seen a rising tide in big ticket claims against individual directors. We have also seen a similar trend across our global network and in some of the offshore jurisdictions where we have strong links with local firms.

Following the global financial crisis, there has been a strong upward trajectory in actions by international regulators and prosecution authorities to try to hold individuals to account. In parallel, there has been an increase in claims against directors for damages in the civil courts. Whatever the forum, these disputes are played out in the public domain. In the court of public opinion, there is ever greater scrutiny of the conduct of boards of directors by a range of media outlets. So, even if there is ultimately found to be no civil, criminal or regulatory liability, reputational damage can be significant and long lasting.

In England, we are seeing claims against individuals in a range of scenarios, including (i) for breach of fiduciary duty, brought by the company, shareholders or liquidators and (ii) for misstatements or omissions in listing particulars and prospectuses issued by publicly listed companies.

Outside England, we are seeing a rise in complaints being brought by public prosecutors, tax authorities and regulators in the US, Europe, Asia and Australia. And, criminal proceedings often facilitate claims by civil claimants, who simply join the criminal action and piggy-back the evidence gathering and arguments made by the prosecution attorneys.

Christopher Morvillo, a partner in our New York office, continues to see high levels of activity targeting corporate officers and directors in the criminal, regulatory and civil arenas of the US. This persistence is fully consistent with the various policy initiatives targeting individuals that US regulators have advanced over the past several years. And, of course, in the US, civil litigation against senior executives is sure to follow at the first whiff of corporate misfeasance.

Albert Moro, a partner in our Luxembourg office, has seen a rise in claims against directors in Luxembourg, particularly in the fund industry, and an increase in criminal complaints being filed by the public prosecutor against individuals after a company files for bankruptcy.

Antonio Golino, a partner in our Milan office, advises that the greatest risk for directors in Italy remains criminal proceedings for bankruptcy offences (typically involving serious allegations of asset stripping, fraud or misleading financial statements), to which it is common practice for investors to piggy-back with civil claims for damages. We have seen a rising tide of such proceedings in a number of sectors of the market not just the banking sector.

Burkhard Schneider, a partner in our Frankfurt office, says that directors and officers in Germany are facing increased legal enforcement pressure, which is further aggravated by a reversal of the burden of proof, requiring the defendant to disprove the allegations against them. Recently there have been a number of high profile cases in Germany involving claims against directors or officers of large companies relating to bribery, tax evasion and diesel emissions.

Brian Gilchrist, a partner in our Hong Kong office, is seeing more claims against individuals in tribunals (eg, Market Misconduct Tribunal) as well as in the Hong Kong courts. In its annual report in

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June 2018, the Hong Kong Securities & Futures Commission made plain its continued determination to take action against individuals: 'We have broad powers to hold directors and individuals responsible for misconduct committed by the companies they manage'.

Tim Grave, a partner in our Sydney office, is seeing a similar trend in Australia. A Royal Commission established in December 2017 is investigating whether banks and financial services firms have engaged in misconduct and whether criminal or other legal proceedings should be brought. Throughout the course of the Royal Commission hearings to date, there has been significant attention placed on the evidence heard in respect of the conduct of the banks and, in particular, on senior individuals driving decisions. The findings of the Royal Commission (currently due in September 2018 and February 2019) may lead to high-profile claims being brought against individuals.

There is no doubt that this is a difficult time to be a company director. For in-house counsel, there are a number of issues which need to be borne in mind to ensure that the interests of the individual and their employer company are protected.

What is driving the rise in litigation against individuals?

There are a number of factors:

- Claimants may sue high profile individuals simply to create headlines and to pressurise a corporate defendant, typically a large bank or company, to settle proceedings. But it may not be a mere pressure tactic. Even if the individual does not have sufficient personal liquid assets to meet the claim against them, he or she will likely have the benefit of directors' and officers' (D&O) insurance or an indemnity from the company which may mean that there is a financial benefit in pursuing them.

- There is a greater willingness on the part of activist shareholders to drive an alternative business agenda with a view to greater profitability and financial returns. And minority shareholders have greater flexibility to bring claims than in past times – the 2006 Companies Act broadened the scope of so-called derivative claims to make it easier for claims to be brought by minority shareholders. Even though the court has been given a mechanism for filtering out early unmeritorious claims, we are starting to see more of these types of claims being launched.

- A rise in claimant law firms means that there is a readier supply of specialist litigation boutiques with the experience and wherewithal to bring claims against big corporates.

- The UK High Street is in the midst of a radical restructuring and there are near weekly headlines about corporate failures. Where these turn into large insolvencies, administrators and liquidators are appointed and they will feel duty bound to bring proceedings against the former directors where they believe that there are viable claims.

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- Claimants have a new source of funding for their claims. There has been an explosion in the amount of third party funding which is being made available – one estimate reports that £70bn of litigation funding has been raised globally in recent years. There is a careful process before a claimant will get funding but it is an astonishing amount of money.

Practical tips to guard against claims

1) To avoid claims being brought at all, in-house counsel will want to remind and advise their boards how they should go about discharging their duties to the company. For example:

    a) Directors should attend regular, in person, board meetings and ensure that decisions are properly taken and minuted. Remember, the preparation and retention of contemporaneous documents may help a director recall and defend a decision that is challenged several years later.

    b) Prepare and retain detailed documentation for board meetings. Board packs dealing with a proposed transaction should set out the advantages and disadvantages of the proposed transaction, including steps taken to mitigate any material risks, and input provided by professional advisers.

    c) Directors should not 'rubber stamp' decisions – they should be encouraged to ask questions at board meetings and challenge what they are told, especially if they are a non-executive or nominee director who has less involvement in the underlying business or transaction – they should make independent commercial decisions based on the financial and legal information and advice available to them.

2) Directors should consider obtaining expert opinions (eg, legal, fairness, valuation) in relation to high-value/high-risk transactions.

3) Directors should receive periodic training on their fiduciary duties specific to the local jurisdiction where they are appointed.

4) Where directors have multiple roles in a transaction (for example, if a director of more than one company in the group) they need to consider what 'hat' they are wearing when making a decision and whether it is in the best interests of that company. Directors should ensure that the decision is independently made and recorded by the board of each relevant company.

5) Directors should ensure adequate and effective internal controls are implemented and maintained regarding the regular reporting of financial information to them. If there may be concerns about the company's long-term financial health, before making a dividend distribution, carefully consider its purpose, the interests of creditors and whether to obtain specialist insolvency advice. In England, a court found that an otherwise lawful dividend payment was made in breach of s423 of the Insolvency Act 1986 because it was a transaction at an undervalue (ie, for no consideration) and was made for the purpose of putting assets beyond the reach of a main creditor (*BTI 2014 LLC v Sequana & ors* [2016]).

6) Last but not least, directors should be wary of unguarded emails – would they be comfortable having an email read out in open court if it was subsequently disclosed in legal proceedings? Just because it was sent at 2am, does not mean it will be sympathetically assessed by a judge or by a (US) jury.

In-house counsel will also want to assess the scope and adequacy of any D&O insurance policy, and ensure familiarity with its terms, along with those of any indemnity from the company. One of the key benefits of D&O insurance for individuals is cover for their defence costs, which may be significant.

In-house counsel should carefully consider:

a) The length of cover – claimants may sue individuals years after they have left the company, and policies can provide 'run off' cover to capture such claims.

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b) The type of claims covered by the policy – does it capture a broad range of civil claims and extend to regulatory investigations and actions?

c) The scope of any exclusion clauses – policies exclude liability for fraud but does the policy go further in terms of its key exclusions – in particular in relation to US claims?

d) Any claw-back provisions – for example, the policy may cover defence costs for a claim in fraud but will then typically provide that the monies are repayable if the individual is subsequently and ultimately found guilty of fraud.

Practical tips once litigation is pending

If a claim is brought or threatened against a director, in-house counsel will find themselves in a pivotal position between the company and the individual being sued.

1) First and foremost, from day one in-house counsel will need to revisit the terms of any D&O insurance policy and company indemnity to:

   a) Notify any actual or likely claims to insurers without delay.

   b) Check when the cover kicks-in – for example, does the policy cover pre-action advice, correspondence or investigations?

   c) Check whether insurers' consent is needed before incurring defence costs and, if so, whether there is any cover for emergency costs.

   d) If multiple directors or officers are being sued, consider how the cover may be allocated between them.

   e) Update and consult with insurers regularly to ensure that cover is maintained, though carefully consider how to maintain privilege and confidentiality of communications with insurers, especially regarding the merits of the claim.

   f) If the individual has the benefit of D&O insurance and an indemnity, consider the interplay between the two and which responds first.

2) In addition, on day one, consider whether the individual will need independent legal representation. Depending on how the claim is framed, the company may have different interests and therefore it may be better for all concerned if the individual director has independent representation from the outset.

3) Only certain communications will be covered by privilege and therefore safe from disclosure in proceedings. Once litigation is in contemplation, it is important to agree lines of communication as soon as possible and stick to them, to protect privilege. Ensure that any internal review is conducted in a way that will attract legal professional privilege.

4) Consider how best to manage the sharing of company documents. It may be important not to blur the lines between documents in the possession and control of the individual directors who are being sued and the company's broader corpus of documents. Similarly, consider whether you will need to obtain documents from third parties, such as professional advisers, in order to defend the claims and consider this from the perspectives of the individual directors and the company.

5) Consider how to manage any publicity about the proceedings. Responsible journalists and media outlets will not allow themselves to be manipulated into publishing inaccurate and unbalanced articles, but aggressive claimants may seek to skew public coverage of the proceedings to exert pressure. Consider instructing a PR team to help engage with the media constructively.

6) Finally, the psychological effects of being personally sued or prosecuted cannot be underestimated. Holistic counselling of individuals through the process and preparing them for giving evidence on events which may have taken place many years ago requires sensitive and specialist advice. ■