

International review

May 2016

Keeping you in touch with international developments

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Since our last update, there have been significant developments in the FI and D&O landscape. November saw the first ever UK deferred prosecution agreement (DPA) announced between the SFO and Standard Bank. The DPA process has been available but unused since 2014 so the judgment and the SFO's comments thereafter provided some much needed guidance on what the process involved. Significantly, weight was placed on Standard Bank's early self-reporting and cooperation. Interestingly, the Sweett Group tried and failed to obtain a DPA, with one of the reasons cited for the failure being their lack of early cooperation, and they found themselves convicted under the Bribery Act and facing a substantial fine. We await with interest whether more companies will try and agree such an agreement with the SFO in the future and the implications this will inevitably have for D&Os and their insurers.

Individual accountability and responsibility of directors and senior managers has come into focus with the introduction of the Senior Managers Regime (in force from 7 March 2016) and the new FCA rules on whistleblowing (coming into force September 2016). Regulators want financial institutions and directors and officers to take responsibility for their actions in order to prevent a reoccurrence of the global financial crisis. The coverage issues that these regimes throw up, in relation to investigation costs and admissions for example, deserve particular scrutiny and insurers may need to consider how these are dealt with in their policies.

Elsewhere in this Review, we provide a roundup of the FI and D&O landscape in the United States, examine the importance of corporate culture from an Australian point of view, look at insolvency issues in Canada and provide an analysis on the key issues in the UK, including the recent string of mis-selling claims handed down and the threat posed by cyber attacks. To finish, we give our usual case summary round up.

Europe



IRHP mis-selling claims continue to be a thorn in the side for banks

Laura Cooke, Partner, London
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The behemoth that was PPI mis-selling may be winding down, but there is a new kid on the block, or is there?

It all began in 2012 when the Financial Services Authority (“**FSA**”), as predecessor to the Financial Conduct Authority (“**FCA**”), identified failings in the way that some banks sold structured collars, swaps, simple collars and cap products, often referred to as interest rate hedging products (“**IRHPs**”), to non-sophisticated customers (a number of which were small businesses) and ordered a review (the “**Redress Scheme**”).

Nine banks, including Barclays, RBS and HSBC, agreed to review sales of IRHPs made to non-sophisticated customers since 2001, each having to appoint an independent third party (the “**Independent Reviewer**”). Once affected customers had been identified, their participation in the Redress Scheme depended on the type of product purchased. Those who had purchased structured collars were automatically included, whereas purchasers of cap products needed to proactively complain to their banks to be included. Purchasers of all other types of IRHPs would be invited to opt-in if assessed as non-sophisticated.

By December 2015, the banks had nearly completed their reviews, having sent a redress determination letter to 18,100 businesses and paid over GBP 2.1bn in redress, including GBP 464m to deal with consequential losses. On paper, the Redress Scheme was relatively successful, with 92% of offers having been accepted.

However, the FCA’s statistics have been somewhat overshadowed by a series of legal battles relating to the IRHP Redress Scheme, as well as negative press.

Many customers had little choice but to participate in the Redress Scheme, as their legal claims were time-barred, which meant they did not have the alternative option of court proceedings should their review be unsuccessful.

Small companies also complained that: the compensation was inadequate; they were offered alternative hedging products; or excluded from the process on technicalities.

Time bar

A good example of the time bar issues is the recent case of *CGL Group Ltd v Royal Bank of Scotland*.

In 2006, CGL bought a base rate collar trade and a swap from RBS which were closed out after interest rates fell. In 2013, RBS accepted that CGL fell within the Redress Scheme for its base rate collar trade, but not for its swap.

CGL commenced proceedings against RBS for mis-selling. CGL

argued that their claim for breach of duty was not time-barred as, applying section 14A Limitation Act 1980, they only obtained the necessary ‘knowledge’ in 2012 when the Redress Scheme was reported in the media. RBS sought to strike out CGL’s claim on the basis that CGL had acquired the relevant “knowledge” in November 2009, three years before proceedings were issued.

The Court agreed; evidence at trial proved that CGL had more than a mere suspicion that it had been mis-sold by September 2009.

Interestingly, at the same time as RBS’s application for strike out, CGL brought an application to amend its claim on *Suremime* grounds (more on which below), but was unsuccessful in meeting the relevant test, being the same as for summary judgment.

Timely claim but no advice

By contrast, the family-run business that was the claimant in the case of *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* was brought in time but failed as the claimant was unable to demonstrate an advisory relationship, despite some criticism being levied against the bank by the judge. The bank was able to rely on its disclaimers.

The case was due to be appealed in April 2016, but an out-of-court-settlement was achieved.

An alternative avenue?

The case of *Suremime Limited v Barclays Bank Plc* began as a straightforward swaps mis-selling claim, but took an interesting turn in July 2015.

Suremime had participated in the Redress Scheme but was dissatisfied with its offer of redress. It had already issued a swaps mis-selling claim against Barclays in relation to the original sale. As well as alleging negligent misrepresentation, breach of contract and/or negligent advice or negligent provision of information, *Suremime* sought to claim, by virtue of section 1 of the Contracts (Rights of Third Parties) Act 1999, to enforce the agreements made between the FSA and Barclays under which the Redress Scheme arose. Whilst



novel, it ultimately failed when it transpired that the agreements between the FSA and Barclays expressly excluded third party rights.

Undeterred, Suremime applied to amend its claim to include three new claims for Barclays' alleged breach of contract and/or negligence in conducting the Redress Scheme.

Barclays argued that its duty was only to the FCA and that it could not therefore be liable to its customer if the review failed to meet the standard required by the FCA and came to the wrong conclusion. It asked the judge not to allow these claims to be added because it said they had "no real prospect of success".

The judge disagreed, finding that it was "more than merely arguable" that Barclays did owe a duty to the customer in carrying out the review and so there was sufficient merit and importance in the argument for it to be fully aired at trial. The tort claims could proceed, but he dismissed the contract claim as unsustainable due to lack of consideration.

The judge also acknowledged that as many customers are now unable to bring claims for the original mis-selling for time-bar reasons, the existence of a right to sue for the negligent implementation of the review would be particularly important, providing another compelling reason why the issue should be allowed to proceed to trial.

On its face, the decision in *Suremime* may be at odds with the decision in *CGL* given the contrasting outcomes as to whether it could be said that a duty of care in operating a redress scheme was at least arguable. However, in *CGL*, the Court had all of the facts in front of it, whereas in *Suremime* it did not; the Court in *CGL* stated that if all of the available facts were before the Court in *Suremime*, it was wrongly decided.

It remains to be seen if *Suremime* will be successful on the merits, but it is undoubtedly being watched with close interest by others similarly placed, though the pathway seems less clear in light of *CGL*.

Judicial review

Another key case of interest is *R (Holmcraft Properties Ltd) v KPMG*.

Holmcraft Properties, a nursing home operator, was sold an IRHP by Barclays and was included in the Redress Scheme. Holmcraft received redress by way of compensation for overpayments it had made and then made a consequential loss claim under the scheme against Barclays for further losses, which failed. Holmcraft was concerned that KPMG, the Independent Reviewer appointed by Barclays, appeared to have little or no involvement or engagement with Holmcraft and did not appear to have properly fulfilled the role required by the FCA in the Redress Scheme.

In April 2015, Holmcraft applied for judicial review and was granted permission on the basis that it was arguable that the arrangements put in place by the Redress Scheme had a sufficient public law dimension to make the Independent Reviewer amenable to judicial review.

The much-anticipated hearing came before the High Court in

January 2016. It concluded, however, that KPMG's duties did not have "sufficient public law flavour to render it amenable to judicial review" and, further, that, even if it were amenable to judicial review, there was on the facts no unfairness by Barclays in the procedure adopted and therefore there could be no material breach by KPMG of any public law duty to secure fair process.

In April 2016, Holmcraft applied for permission to appeal to the Court of Appeal.

Commentary

It has been something of a bumpy ride for aggrieved purchasers of IRHPs with some early success in cases such as *Suremime*, but the end of the road for the types of claims argued in *Holmcraft* (unless they can mount a successful appeal).

Prior to the hearing, Holmcraft's lawyers had lined up litigation funding to bring similar claims for other affected small businesses. It remains to be seen whether they will continue in view of January's ruling, but IRHP mis-selling does appear to be an area ripe for creative arguments and proceedings for some time to come.

Ageas reaches settlement with Fortis' shareholders for EUR 1.2bn

In the biggest European securities settlement yet, Ageas, the Belgian insurer formed from the insurance arm of the collapsed Fortis group, has agreed to pay EUR 1.2bn to Fortis' shareholders.

In Ageas' press release of 14 March 2016, Ageas admitted no wrongdoing and stated that the settlement related to "among others acquisition of parts of ABN AMRO and capital increase in September/October 2007, announcement of the solvency plan in June 2008, divestment of the banking activities and Dutch insurance activities in September/October 2008." Anyone who owned Fortis shares between February 2007 and October 2008 will be able to claim under the settlement agreement.

The next step is to get the settlement approved by the Dutch courts on an opt-out basis that should be recognised throughout Europe. This opt-out function is beneficial to both parties, especially the defendants, as it is an effective means to ensure the most complete resolution to the Fortis claims. This is despite the fact that those who opt out are not bound by the settlement and any judge who decides on their case is free to deviate from the settlement.

The Dutch system is growing in popularity and the news of this settlement may well spur shareholders of other companies, such as Tesco, Petrobras and VW, to continue to pursue their claims under the collective settlement procedures available in The Netherlands. The appeal is obvious – investors from numerous countries are able to group together and resolve their claims through the procedures and, in this case, even the separate Belgian proceedings were encompassed within the settlement, going some way to resolving the issue of multiple competing actions, (though this may not be possible in all actions).



Will whistleblowing lead to a blow in cover?

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With the FCA's new rules regarding self-reporting and whistleblowing due to be fully implemented by September 2016, one question at the forefront of insurers' minds is whether this will lead to a rise in claims.

The rules follow a number of recent banking scandals, such as the attempted manipulation of the Libor rate. They encourage employees to speak up and challenge poor practice or unlawful behaviour within their business. The firms affected by the rules are expected to have in place a strong framework to facilitate whistleblowing by employees, primarily ensuring that all concerns reported are properly investigated with no personal repercussions.

The FCA website summarises the new rules. They require relevant firms to:

- Appoint a Senior Manager as their whistleblowers' champion
- Put in place internal whistleblowing arrangements sufficient to handle all types of disclosure from all types of person
- Include text in settlement agreements explaining that workers have a legal right to blow the whistle;
- Present a report on whistleblowing to the board at least annually
- Inform the FCA if it loses an employment tribunal with a whistleblower
- Tell UK-based employees about the FCA and PRA whistleblowing services and
- Require its appointed representatives and tied agents to tell their UK-based employees about the FCA's whistleblowing service

Although, presently, the new rules only apply to (most) large banks, building societies and insurance firms, they should act as non-binding guidance for all other businesses regulated by the FCA.

However, despite the new regime expanding the scope of the previous rules and guidance considerably, the impact of the rules may not be as significant as one might expect, as the rules are largely reflecting, and to a certain extent codifying, today's standard practices.

The number of whistleblowing reports being made to the relevant authorities has increased steadily over recent years and whistleblowers have continued to provide crucial intelligence,

allowing regulatory action to be taken against many firms and individuals.

So will these new rules really lead to more D&O claims here in the UK? Certainly, in other countries where stricter whistleblowing rules already prevail there has been a marked increase in the number of formal investigations commenced in connection with alleged wrongdoings by companies and/or their senior management. Clearly, if whistleblowing is actively encouraged, this will lead to an increase in reports though it should be borne in mind that in some jurisdictions, such as the United States, there are financial incentives for whistleblowing which may have contributed to the increase.

It is therefore possible that the implementation of the FCA's new rules could lead to an increased exposure for D&O insurers. In what continues to be a soft market, further revisions in cover, afforded to firms operating in the financial services industry and beyond, should not be ruled out.

What are the coverage implications?

The anticipated increase in complaints received from employees may prompt the need for more thorough internal investigations by the management to determine whether a formal report needs to be made to the relevant authorities. The costs of such investigations may not be covered under standard D&O policies on the basis that internal investigations do not typically constitute a "Claim" in relation to which "Loss" is usually recovered. It is usually the case that in order for the policy to cover costs of an investigation, it would need to be an official or formal investigation of some kind. As such, insurers may need to consider whether they wish to indemnify these types of costs.

Whether these types of costs should attract cover is not necessarily a new issue for the London market. However, the implementation of the new rules may require insurers to revisit it once again, especially as clarity is likely to be sought by insureds and brokers.

Of course, one advantage of companies, and their directors and officers, being provided with cover from the outset of a matter means that they should be able to deploy a more robust defence immediately, which may allow them to avoid a more formal



investigation being launched and therefore reduce insurers' overall exposure. However, the costs of such investigations can be significant and could easily erode the limits of indemnity available, leaving the individual insureds with deficient cover in the event of an actual claim. Some commentators still believe this is, and always has been, a business expense.

A solution to this could be to sub limit the cover available under an appropriate extension, protecting the main limits.

Insurers may also need to consider how to treat the admissions that will inevitably be made by whistleblowers and/or the company to the relevant authorities in return for more favourable outcomes. Most standard D&O policies will contain a clause prohibiting admissions of liability being made without the prior written consent of insurers. If this is stipulated to be a condition precedent to indemnity this may cause problems for insureds, especially where they are facing time constraints in which to reach an agreement with the authorities, coupled with strict confidentiality requirements. Insurers may be placed under pressure to revisit such clauses given the well documented changes in the regulatory environment in which their insureds operate.

Furthermore, the making of an admission may have additional coverage implications. For example, most conduct exclusions

require "final adjudication" before they trigger. However, some D&O policies allow insurers to rely on this exclusion where there has been a written admission of liability. If the policy is not specific as to the form that the admission must take, and by whom it must be made, insurers should analyse whether they can rely on an admission made in correspondence with the authorities.

An admission may also trigger the "deliberate misconduct" exclusion, to the extent it exists in the policy. It is likely that insureds will insist on there being clear and unanimous severability provisions in the policy so that the acts and knowledge of one individual insured cannot be imputed to another.

Lastly, an increase in the levels of cooperation between the company, some employees and the relevant authorities could of course trigger a typical insured v insured exclusion. If this exclusion begins to cause difficulties for insureds, it is likely that a further carve out may be required for this scenario, diluting the application of the exclusion clause even further, assuming it is still present in the policy.

The new sentencing guideline's implications for D&Os

February saw the UK implement the Sentencing Council's landmark "definitive guideline" on the sentencing of defendants convicted of offences relating to health and safety, corporate manslaughter and food safety and hygiene offences, regardless of the date of offence.

In addition to the unprecedented hike in fines, the codification of the sentencing of individuals convicted under the Health & Safety at Work etc. Act 1974 (usually, directors) introduces a custodial sentence even for offences that have the lowest degree of culpability.

Fines now have a "starting point" linked to turnover, adjusted upwards or downwards depending on relevant aggravating and mitigating features, allied to relevant financial information.

The guideline, while providing relative clarity on fines for micro, small and medium-sized businesses with turnovers of less than GBP 50m, creates significant uncertainty for larger businesses by categorising them as having a turnover exceeding GBP 50m.

It seems inconceivable that a business with a turnover of GBP 800m could be fined a similar sum to one with a turnover of GBP 50m.

Further, with a "very large" business defined in *R v Sellafeld Ltd* [2014] as one with a turnover of over GBP 1bn, the die is already cast for significant fines for "very large" businesses, even where culpability and harm are both very low.

Defence costs covering health and safety or corporate manslaughter-type offences are commonly included as a standalone insuring clause in commercial D&O policies. The greater the risk of custodial sentencing, the more likely a director is to want to access the D&O policy to retain the best legal representation available, particularly given that director disqualification proceedings could also follow conviction.

The new guidelines may have broader implications, however. The potential for larger fines against the entity for HSE failings could trigger claims by investors against the D&Os where the entity's share price has suffered as a result, or the entity has gone bust.



Cyber attacks and insurance: prevention better than the cure?

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Cyber insurance is a booming business, with global premiums increasing by USD 500m, to USD 2.5bn. It is estimated that the market will continue to grow, with premiums reaching USD 7.5bn by 2020.

However, cyber attacks are also on the increase: PwC estimates that 1 in 4 UK companies were attacked by cyber criminals in the past two years. Such attacks cause significant financial, business and reputational damage costing businesses USD 400bn annually.

There have been many high profile examples of the consequences of cyber attacks. The 2014 cyber attack on Sony by the “Guardians of Peace”, filled column inches for several months, assisted by the stolen data containing unreleased films and film stars’ salaries.

In the UK, telecoms company TalkTalk was infamously hacked in 2014 and again in October 2015. In the 2015 attack more than 150,000 customers’ personal details were accessed and over 20,000 bank account numbers and sort codes were stolen. According to TalkTalk’s recent financial results, that attack cost the company GBP 60m and the loss of 95,000 customers.

In addition to high profile hackings, a typical business could be the victim of a cyber attack via one or more of the following methods:

- A corrupt current or former employee, service-provider or consultant accessing a company’s systems to steal confidential information or to deploy hostile software, known as malware
- “Phishing” or fraud using electronic communications such as emails, letters or instant messages. The communications appear to be an authentic communication from a trusted source but will typically invite the recipient to disclose confidential information, transfer funds or visit websites hosting malicious content or
- “Vishing” or scams which take place over the telephone or via text message. Vishing might involve the fraudster impersonating the victim’s bank or solicitor and deceiving the recipient to disclose information or transfer funds

What happens following a cyber attack?

If the cyber attack involved the theft of money, then the fraudsters will work quickly to transfer and convert the funds in

order to obscure the audit trail. The speed at which fraudsters are able to transfer and convert stolen funds makes it very difficult to trace and recover funds, particularly if the funds are moved across international borders or converted to digital currencies. It is unsurprising that 70% of RBS’ customers who were victims of scams did not receive a penny back.

If the attack involved the theft of information, such as bank account or other personal details, then the fraudsters will quickly look for ways to capitalise on that information. This might include selling the information on the “dark web” or using the information to enable further, even more sophisticated cyber attacks.

Impact of cyber attacks

Clearly, cyber attacks can cause significant first and third party loss, including business interruption, reputational damage, a fall in share price and litigation.

In addition, cyber attacks can lead to regulatory fines. Sony was fined GBP 250,000 in the UK for breaches of the Data Protection Act following the 2011 hack of its PlayStation Network. Data protection fines are expected to increase when the General Data Protection Regulation comes into force, currently expected in 2018. This will include penalties of up to 5% of worldwide turnover or €100m, whichever is bigger, for breaches.

In the FI Sector, the FCA provides guidance and enforces ongoing obligations on firms to identify cyber risks, update their fraud prevention systems and scrutinise transactions. It will be interesting to see if the FCA will also exercise its enforcement powers to sanction firms whose systems are found to be inadequate.

D&O policies also might not be immune from the impact of cyber attacks. Following the 2013 cyber attack on US retail giant Target, shareholders sued the directors and officers alleging that the directors knew or ought to have known that a cyber attack would cause substantial financial and reputational damage to the company and that the directors failed to take actions that



would have prevented the cyber attack. These proceedings are continuing but we expect that the trend for shareholder claims and consequent claims under D&O policies will follow.

Recoveries

Given the difficulties of tracing stolen funds and presuming that the fraudster cannot be found (or is impecunious) then an option to recover financial losses might be to claim against the bank. Such a claim would be on the basis that the transfer to the fraudster was not authorised, breached the bank's mandate and/or was negligent.

Since 2009, payments have been regulated by the FCA and the Payment Services Regulations ("PSR"). If the payer did not consent to a payment via the agreed procedure then the transaction is considered to be unauthorised and, under PSR 61, the bank or payment service provider ("PSP") is obliged to refund the full amount to the payer.

That said, if a payment was made in line with the agreed process then it is deemed to have been authorised, even if the payer was tricked into making the payment or disclosing confidential security information.

However, if it appears that the PSR has been negligent or not followed its own fraud prevention or notification processes then a recovery action against a PSP might still succeed.

Prevention and due diligence

The sophistication and ever-changing nature of fraudsters' methods makes preventing cyber attacks a constant challenge for insurers and their insureds.

Insurers can first start to manage that challenge via the policy's proposal form. This should be used to obtain information about an insured's cyber risk-profile, including its use of security systems, cyber attack testing and incident response plans.

Obtaining good due diligence from the proposal form combined with imposing appropriate minimum cyber-security standards puts insureds in a better position to prevent cyber attacks and avoid expensive claims. Given the financial, regulatory and reputational implications of a cyber attack, it is undoubtedly in the interests of all to be vigilant and prioritise investing in preventing cyber attacks.

Guidance for directors of companies fully or partly owned by the public sector

On 10 February 2016, the Cabinet Office published guidance for directors of companies fully or partly owned by the public sector, a summary of which is as follows.

Directors' responsibilities and duties

In addition to responsibilities under the Companies Act 2006 (CA 2006), directors appointed by a public sector body must also continue to act in accordance with other applicable legislation, relevant civil service and public sector guidelines, which include directions on managing public money and standards for conduct in public life.

Potential conflicts of interest

The guidance notes that a conflict of interest might occur where:

- There are conflicts between different professional duties, for example, where a director is a member of two boards, or where a director has competing

loyalties to their public sector employer and the commercial venture to which they have been appointed director or

- There are conflicts between director duties and private interests, such as a financial or family interest

The duties in section 175 CA 2006 apply to all directors and all conflicts must be disclosed to the board and, in the case of directors who are public servants, to line managers. Failure to acknowledge and report the conflict may have significant consequences.

Directors' liability and indemnity protection.

The guidance refers to the chapter in CA 2006 which deals with directors' liabilities and notes that "where there is a publicly owned company, Government will decide on a case by case basis, with regard to the Companies Act 2006 whether it will offer any kind of indemnity to Directors."

The full guidance can be found on the government's website.



The Senior Managers Regime - “the age of irresponsibility is over”*

Nick Elwell-Sutton, Partner, London

On 7 March 2016, a new regulatory regime designed to make senior managers in financial services more personally accountable for their firms’ failures came into force.

The emphasis on personal accountability increases the risk of senior managers being subject to more investigations into possible misconduct. This could have serious consequences for the individual concerned and expose D&Os and their insurers to claims.

Why has the new regime been introduced?

Following the 2008 financial crisis and the LIBOR scandal, the Parliamentary Commission on banking standards was set up in 2012 to enquire into professional standards and culture within the banking industry. Its report was highly critical of the “approved persons regime” which regulated a large proportion of the financial services industry, and, specifically, the fact that the regime failed to empower regulators to hold senior managers to account.

How will the new regime work?

The regulators to the financial services industry, the Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA) will oversee the new regime.

The regime, which applies to UK incorporated banks, building societies, credit unions and PRA designated investment firms in the UK, as well as branches of foreign banks, consists of:

- The Senior Managers Regime (SMR) which focusses on individuals performing a Senior Management Function (SMF). These SMFs are specified by either the PRA or the FCA who will approve individuals wishing to perform those functions before they can be appointed to their specific role
- The Certification Regime which applies to the employees of relevant firms who could pose a risk of significant harm to the firm, or any of its customers. These individuals are not pre-approved by the regulators but must be certified by their firms that they are fit and proper for their roles on an ongoing basis

The insurance industry did not come under as much criticism as the banking sector following the financial crisis. However, the regulators believed it makes sense to align the approved persons regime for insurers with a corresponding regime for banks. The regime applying to insurers is known as the Senior Insurance Managers’ Regime (SIMR) and differs in a variety of ways (see below for more details).

What are the key features of the Senior Manager’s Regime?

The regime comprises the following key features:

- Individual senior managers are allocated specific “prescribed responsibilities” by their firm. For each senior manager, the firm must provide a form which is submitted to the regulator recording precisely what the senior manager is responsible for
- New key controlled functions must be allocated to persons approved to perform such function by the relevant regulator. The firm must draw up a map to include the responsibilities assigned to each SMF and any other information that is relevant to the controlled function they perform
- New conduct rules, in force on 7 March 2016, are designed to hold senior managers to account by means of disciplinary action, including fines and suspension
- Fitness and propriety checks and new rules concerning regulatory references
- New whistleblowing requirements (see Whistleblowing article for more information)

The duty of responsibility

Under the SMR it was originally proposed that a senior manager would be deemed guilty of misconduct if a breach occurred in one of the firm’s activities for which they were responsible. The only defence to this would have been for the senior manager to show that they “have taken such steps as a person in their position could reasonably be expected to have taken to avoid the breach”.

As originally proposed, the burden was firmly on the individual to prove his or her innocence. However, this so called “presumption of responsibility” has now been reversed by the Bank of England Financial Services Bill which is currently in the final stages of the Parliamentary process. The effect of this new provision is to place the burden of proof on the regulator so that it can only take enforcement action against an individual if it can show that the “senior manager did not take such steps as a person in the senior manager’s position could reasonably be expected to take to avoid the contravention occurring (or continuing)”.

The duty of responsibility does not currently apply to insurers but the regulators have nevertheless emphasised the importance of clear individual accountability.



The new conduct rules

The new conduct rules apply to all senior managers and staff caught by the SMR, Certification Regime and SIMR. The rules are a key feature of the regime designed to hold individuals to account by means of disciplinary action, including fines and suspension. The regulator can take disciplinary action up to six years from the date on which it becomes aware of the issue.

A person will only be in breach of the conduct rules where they are personally culpable. Personal culpability arises where either:

- A person's conduct was deliberate
- The person's standard of conduct was below that which would be reasonable in all the circumstances

Firms are under a positive obligation to take all reasonable steps to ensure that all staff understand how the new conduct rules will affect them. The prospect of being personally culpable will inevitably lead to more whistleblowing by senior managers, as well as stricter record keeping. Appropriate delegation of responsibilities has been identified as an issue requiring a new conduct rule so senior managers would be well advised to keep records relating to any delegation of their responsibilities.

Fitness and propriety and regulatory references

Senior managers and those falling within the certification regime, as well as those performing a controlled function or key function holders within insurers must meet certain standards of fitness and propriety. The regulators have not made fundamental changes to their existing fitness and propriety standards although both have introduced requirements about the evidence that firms should collect as part of the checks they need to do. One particularly significant check relates to the proposed requirement to obtain

references going back six years, applying generally on appointment into a new role (even on an internal transfer). For those firms who have given such a reference, there will be an obligation to keep that reference up to date for six years. These new rules are expected to come into force in the summer of 2016.

What are the key differences between the SIMR for insurers and the SMR for banks?

- Under the SMR there is a new criminal offence of reckless misconduct in the management of a bank
- The duty of responsibility applicable under SMR does not currently apply to an individual performing relevant controlled functions within insurers
- For insurers, the conduct rules only apply to individuals requiring regulator pre-approval, whereas most bank employees will be subject to the new conduct rules
- Insurers are not required to provide verifications for their employees i.e. there is no certification regime for insurers

Looking ahead

HM Treasury published a policy paper in October 2015 containing a proposal to extend, by 2018, the SMR (and the related certification regime) to all firms authorised under the Financial Services and Markets Act 2000 (FSMA). This will include all insurers, as well as investment firms, asset managers, insurance and mortgage brokers and consumer credit firms. This means that senior managers of these firms will have an increased risk of personal liability since they will become subject to the duty of responsibility currently only relevant to the SMR.

*Mark Carney, Governor of the Bank of England

Deferred Prosecution Agreements (DPAs): An Update

In November 2015, the first UK DPA was announced. Standard Bank Plc (now ICBC Standard Bank Plc) was the subject of an indictment alleging failure to prevent bribery contrary to section 7 Bribery Act 2010.

The charge related to a USD 6m payment by a former sister company of Standard Bank, Stanbic Bank Tanzania, in March 2013 to a local partner in Tanzania. The SFO alleges that the payment was intended to induce members of the Government of Tanzania to show favour to Stanbic Tanzania and Standard Bank's proposal for a USD 600m private placement to be carried out on behalf of the Government of Tanzania.

Following the DPA, Standard Bank will pay financial orders of USD 25.2m and will be required to pay the Government of Tanzania a further USD 7m in compensation on top of the SFO's reasonable costs of GBP 330,000 in relation to the

investigation and subsequent resolution of the DPA. Standard Bank also agreed to continue to cooperate fully with the SFO and to be subject to an independent review of its existing anti-bribery and corruption controls and policies.

In July 2014, the SFO announced that it had opened an investigation into the activities of Sweett Group, following allegations of bribery reported in the Wall Street Journal. Sweett's cooperation ultimately came too late and despite hopes for a DPA, the company ended up being prosecuted under Section 7. Sweett Group pleaded guilty and was ordered to pay GBP 2.25m in February 2016. Recently, it was also reported that a DPA could be issued for Sarclad, a British company that provides technology for the metals industry, which is thought to be in negotiations with the SFO. We will watch with interest to see how common such agreements will become in the future.



The Americas

United States FI and D&O developments: A Snapshot

Edward (Ned) Kirk, Partner, New York

The liability and regulatory landscape in the U.S. continues to evolve and remains one of the highest risk areas for FI/D&O insurers worldwide. As in past years, 2015 had a mix of both positive and negative developments from the standpoint of FI/D&O exposures.

We provide below an overview of developments relevant for FI/D&O insurers with U.S. exposures, including a review of the current litigation landscape, regulatory investigations and actions, current and potential trends to watch and recent coverage decisions.

Current Litigation Landscape

Securities Class Actions

Securities class actions continued to be the most dangerous types of lawsuits for public companies and their D&Os. The 189 new filings in 2015 was an increase of 11% from 2014 and above the average annual number of filings (188) for the first time since 2008. Despite the elevated numbers, there were no new major filing trends in 2015 and most of those cases were so-called “traditional filings” alleging Rule 10b-5 and/or Sections 11 and 12 violations.

The likelihood that a public company in the U.S. will be named in a securities class action continues to increase as the number of publicly listed companies decreases. In 2015, 4% of U.S. listed companies were sued, compared to an average of 2.9% from 1997-2014. The most targeted industries were biotech, healthcare and pharmaceutical. Interestingly, filings against financial institutions dropped by 35% in 2015, and no banks were named in a securities class action for the first time since 2006.

Securities class actions are being filed faster (with a median of 10 days from the end of the class period to filing), but dismissed or settled more slowly. This will likely lengthen the litigation and increase defence costs as well as plaintiffs’ settlement expectations as they invest more time and money in their cases.

The average securities class action settlement was up 46% in 2015 to \$52 million, although a few large settlements drove this number up. Most cases were not much more expensive to settle in 2015 than in 2014.

Market capitalisation losses and potential damages were also up in 2015, but they were still not as high as in previous years.

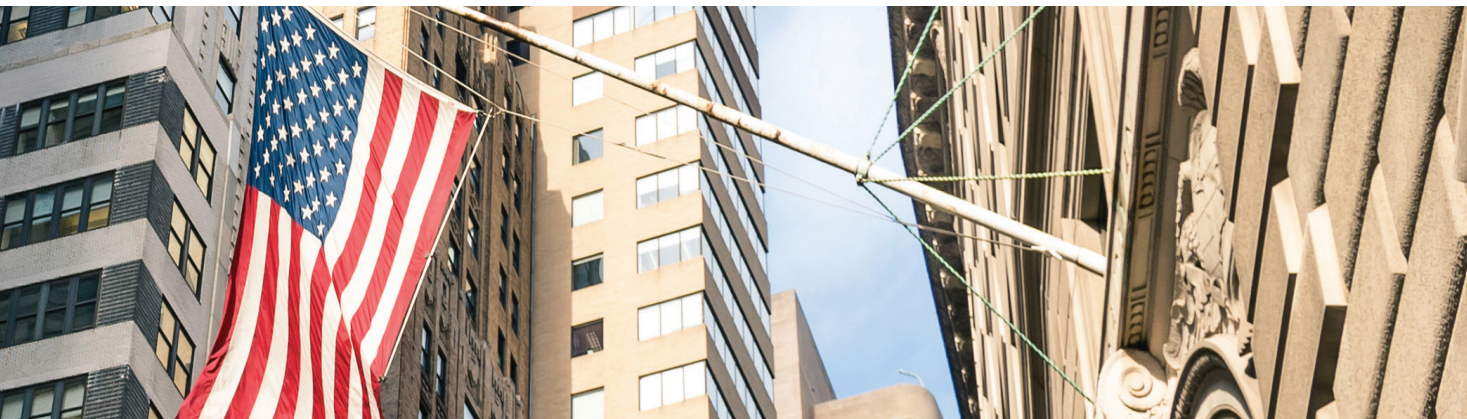
Merger Objection Lawsuits

In the past few years, plaintiffs filed significant numbers of lawsuits following the announcement of a merger or acquisition. In 2014, almost every M&A transaction was accompanied by litigation (95%), often multiple lawsuits. These merger objection lawsuits are often filed in the form of shareholder derivative lawsuits against the companies and their D&Os. The litigation is often resolved through so-called disclosure only settlements in which the defendants agree to additional disclosures about the transaction, plus a payment for the plaintiffs’ attorneys’ fees.

In the second half of 2015, there was a sharp drop in the number of new M&A lawsuits as a result of some favourable developments in the Delaware Chancery Court, where many of these cases are filed. In a number of decisions, the court was highly critical of merger objection lawsuits and/or rejected disclosure only settlements. The judges found that the value provided to shareholders by such settlements was

Merger Objection Lawsuits

- May 2015, Vice Chancellor Laster refused to approve the disclosure only settlement of Cobham’s acquisition of Aeroflex
- September 2015, Vice Chancellor Glasscock III granted approval of a settlement in the Riverbed case, but indicated reluctance to approve disclosure only settlements and attorney fees awards
- October 2015, Vice Chancellor Laster rejected disclosure only settlement re Hewlett-Packard’s acquisition of Aruba Networks
- January 2016, Chancellor Bouchard rejected disclosure settlement arising out of Zillow’s acquisition of Trulia



insufficient consideration for the broad releases granted to the defendants.¹

As a result, it appears that we will see a sharp drop in merger objection lawsuits in 2016. This is good news for D&O insurers who may be asked to foot the bill for defence costs and plaintiffs' attorneys' fees paid in such settlements.

Regulatory Investigations and Actions

In 2015, U.S. regulators continued to aggressively pursue companies and their D&Os on a number of fronts.

SEC enforcement actions increased by 7% to 807 in 2015, with 85% of SEC actions alleging violations of reporting and disclosure provisions of federal securities laws or FCPA. These cases are often pursued in the SEC administrative court, making it easier for the SEC to prosecute, although there has been push back regarding the constitutionality of such actions.

In addition, SEC investigations have increased in length to an average of 21 months, which will increase the cost to respond to such matters.

But there is some good news - the total value of SEC settlements in 2015 (USD 547m) was less than half of what was recovered in 2014 (USD 1.254bn) and below the 2010-2015 average (USD 620m).

A number of factors contributed to the increase in regulatory actions in 2015, including the SEC's use of administrative proceedings, initiatives to detect fraudulent financial reporting, such as the Robocop program, and the SEC Whistleblower program, which continues to gain in popularity around the world due to the sizeable bounties being paid out. In 2015, there were 3923 reports made under the SEC Whistleblower program, an increase of 8.3% from 2014. These reports involved a wide range of activity, including corporate disclosures and reporting, offering fraud, manipulation, insider trading and FCPA violations. To date, USD 55m has been paid out to 22 individuals, USD 37m of which was in 2015, and approximately USD 400m is in the

Investor Protection Fund for further bounty payments.

New DOJ Directive Against Individuals

In September 2015, the Department of Justice (DOJ) announced a new directive to target and hold accountable corporate executives. Pursuant to the so-called Yates Memo, to earn cooperation credit, companies must turn over evidence of wrongdoing by individuals at the company. According to the DOJ, "it's all or nothing." Going forward, the DOJ reportedly will not agree to corporate resolutions that include dismissal of charges against or immunity for individuals and it intends to file actions regardless of the ability to collect fines from individuals. This will likely result in broader and more costly actions against individuals, who will increasingly rely on D&O insurance to defend themselves.

Trends to Watch

Foreign Companies Increasingly Targeted

One of the current trends to watch is the rising number of securities class actions filed against foreign companies in the U.S. Although the *Morrison v National Australia Bank* decision in 2010 limited actions by investors in foreign securities, plaintiffs have increasingly focused on foreign companies trading on U.S. exchanges. In 2015, 35 cases were filed against foreign issuers, which is well above the 1997-2014 average of 22 per year.

In particular, plaintiffs' firms have shown a renewed interest in Chinese companies trading on U.S. exchanges. In 2015, 15 securities class actions were filed against Chinese companies and their D&Os. A number of factors have contributed to this trend, including the downturn in the Chinese economy, inconsistencies in reporting, weak corporate governance and questionable accounting practices by some companies.

Cyber Related D&O Actions?

Cyber risks continue to be a major cause for concern in the U.S., although the anticipated lawsuits and regulatory actions against D&Os relating to cyber have not yet materialized.

It is inevitable, however, that companies will incur a data breach or cyber attack at some point, and the potential for significant harm is well-known, particularly in light of headline attacks during 2014, including those on Target, Sony, Home Depot and several U.S. banks. There is an ever expanding and complex web of regulations that companies must comply with regarding cyber security and, in 2015, regulators were quite active in examining companies' cyber securities and compliance.

¹ For example, in May 2015, Vice Chancellor Laster refused to approve a disclosure only settlement relating to Cobham's acquisition of Aeroflex. In September 2015, Vice Chancellor Glasscock granted approval of a settlement in the Riverbed case, but indicated reluctance to approve disclosure only settlements and attorney fees awards. In Oct. 2015, Vice Chancellor Laster rejected another disclosure only settlement relating to Hewlett-Packard's acquisition of Aruba Networks. In Jan. 2016, Chancellor Bouchard rejected a disclosure settlement arising out of Zillow's acquisition of Trulia.



Cyber risks are increasingly recognised as a top corporate risk, and could surpass financial reporting as the number one concern for corporate boards. Boards will be expected to address cyber risks in a number of ways and may be sued if they fail to do so.

During 2015, two regulatory actions may foreshadow the types of actions that may be filed against companies and their D&Os when they do not properly address and disclose cyber risks. In *RT Jones Capital*, the SEC found that by failing to establish cyber policies to safeguard customer information a company wilfully violated Rule 30(a) of Regulation S-P. In *FTC v Wyndham Worldwide Corp*, the FTC determined that a company's failure to employ reasonable cyber security measures constituted an unfair business practice under the FTC Act. These cases also demonstrate that a number of regulators can bring actions for cyber breaches under different regulations.

IPO Litigation

Although the number of IPOs was down by 43% in 2015 compared to 2014, the large number of IPOs in 2013-2014 may produce a large number of IPO securities class actions in view of the three year statute of limitations. Such cases, brought under Section 11 of the Securities Act, are easier to bring than Section 10(b) cases under the Exchange Act as plaintiffs are not required to plead reliance, scienter or causation, and may be costlier to defend and settle.

U.S. Supreme Court

During 2015 and into 2016, the U.S. Supreme Court continued to show an interest in business litigation issues, particularly class actions.

In its March 2015 *Omnicare* decision, the court set a higher standard for liability for opinions under Section 11 of the Securities Act, requiring actual knowledge of falsity, or that the speaker omitted a material fact needed to make the opinion not misleading.

In January 2016, the Court held in *Campbell Ewald* that plaintiffs cannot remove a lead plaintiff and defeat a class by merely offering to pay the lead plaintiff's damages (i.e., the so called "pick off" defence), therefore removing standing for the class representative.

Looking down the road, the Court will address, in a case called *Spokeo*, whether a plaintiff who alleges his/her statutory rights were violated but can show no concrete harm has standing to bring a claim, which could impact liability for cyber and data breaches where damages are often not determined until some later date.

With the recent death of Justice Scalia, who drafted

numerous significant business decisions, including *Morrison and Tellabs*, we may not see as much activity by the Court this year as the battle rages over his replacement.

Environmental and Climate Change Disclosures

There has also been renewed interest by both regulators and plaintiffs' counsel regarding disclosure of climate change and other environmental risks. In 2015, the SEC reviewed what companies should disclose with respect to climate change, and it is possible that we will see new rules in that regard during 2016.

The energy sector is already being targeted. In November 2015, the New York Attorney General (NYAG) subpoenaed Exxon Mobil regarding the sufficiency of its disclosures on the impact of climate change on their business.

Also in November 2015, NYAG reached a settlement with Peabody Energy in which it agreed to disclose more about climate change risks.

These types of actions could spill over into other industries, including insurance.

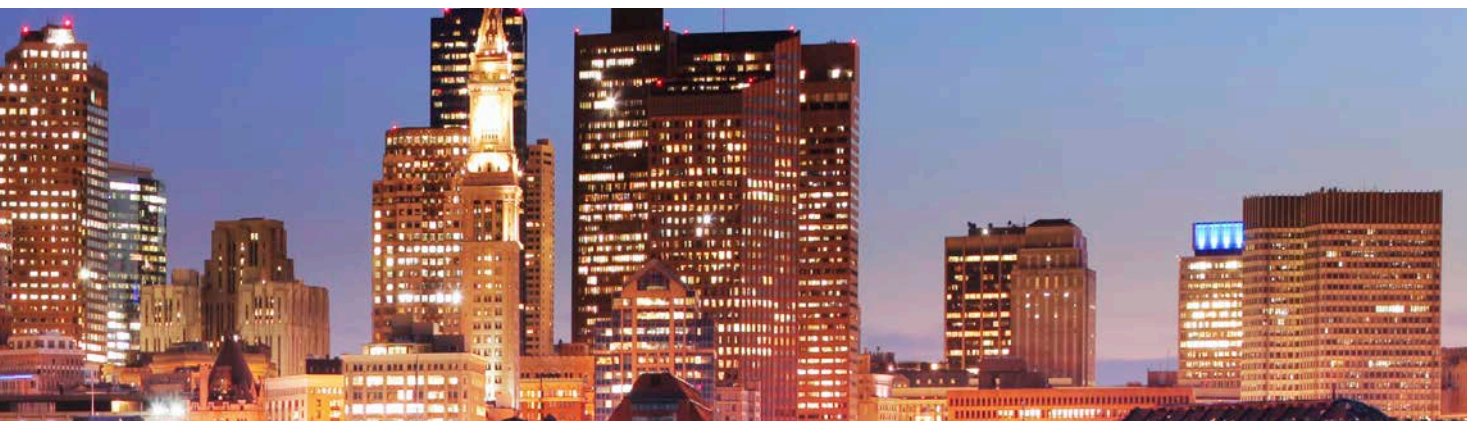
Recent Coverage Decisions

In view of the increasingly aggressive regulators and their push to hold individuals accountable, we could see higher defence costs claims and more guilty pleas or adjudications of guilt by insured D&Os and companies. As a result, there may be more disputes between insurers and their insureds regarding whether dishonest acts exclusions or other provisions triggered by judgments or adjudications apply. If such exclusions are triggered after the insurer has advanced defence costs, we might see more efforts by insurers to recoup or obtain repayment of defence costs advanced under a reservation or rights.

During 2015, two appellate courts grappled with these issues. In *Protection Strategies*, the 4th Circuit found that guilty pleas by the insured D&Os triggered dishonesty and personal profit exclusions, which entitled the insurer to recoup defence costs advanced prior to the plea agreements. In that case, the policy specified that the insurer could obtain repayment of costs if there was a finding that the insureds were not entitled to coverage.

In *GDC Acquisitions*, the 2d Circuit found that the imposition of a fraud sentence was a "final adjudication" within the context of a dishonest acts exclusion, and that the insurer was entitled to a finding of no coverage and recoupment of previously advanced defence costs, even though the insured officer's appeal of the sentence remained pending.

Another coverage issue that insurers and insureds have



struggled over in the U.S. is whether separate claims involving interrelated wrongful acts should be deemed a single claim made at the time the earliest claim was first made.

In *Nomura Holdings v Federal*, the 2nd Circuit held that because five residential mortgage-backed securities actions relating to the subprime crisis related back to a lawsuit filed before the policy inception, the claim was not first made in the applicable policy period and the claims made coverage was not available. The court was critical of the factual nexus test applied in other cases, but reached its holding based on the unambiguous definition of “interrelated wrongful acts” in the relevant policy.

In another case, *W.C. and A.N. Miller Devel. Corp.*, the plaintiff alleged that the defendants fraudulently transferred assets to frustrate enforcement of a judgment. The 4th Circuit found that the interrelated wrongful acts definition was expansive and unambiguous. The court determined that the two lawsuits were a single claim as they arose from the same land development project, the same contract, a dispute over the same fee and were brought by the same claimant.²

² In producing this article we consulted a number of sources for which we give thanks. These are:

- Cornerstone Research, Securities Class Action Filings 2015 year in Review, NERA Economic Consulting and SEC Enforcement Activity Against Public Company Defendants
- Recent trends in Securities Class Action Litigation: 2015 Full-Year Review
- Berkeley Law (Cain & Solomon), Takeover Litigation in 2015
- 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program.



Directors & Officers in An Era of Insolvency

Roderic McLauchlan, Partner, Toronto

The rapid downturn in the price of oil and gas and decline in the price of commodities has sent ripples through the Canadian economy. It is therefore timely to consider the exposures directors and officers of Canadian companies can face, especially if their companies are in the vicinity of insolvency.

Distressed companies may either file for bankruptcy protection under the Bankruptcy and Insolvency Act ("BIA") or seek protection from creditors while they seek to rearrange their businesses under the Companies Creditors Arrangements Acts ("CCAA"). The BIA provides for both restructuring through proposals and liquidations through bankruptcy proceedings. The CCAA is used primarily for the restructuring of more complex corporate businesses, although it can be used for a sale or liquidation.

Officers and directors face substantial responsibilities under Canadian corporate law. Leading Canadian decisions, including from the Supreme Court of Canada in *People's Department Store v. Wise* and *BCE v. 1976 Debentureholders*, established that an honest and good faith but unsuccessful attempt to address a company's financial problems does not constitute a breach of those duties. The duty of a director is owed to the corporation, as opposed to shareholders or creditors. While the company is solvent, the interests of shareholders and creditors are usually aligned with that of the corporation. However, such interests can diverge when a company is in financial difficulty, with creditors seeking repayment of their debts while the company and shareholders may be more focussed on maintaining economic operations. This will require careful assessment of the impact of any particular decision on the corporation's creditors.

Under Canadian corporate governance legislation, most notably the Canadian Business Corporations Act ("CBCA"), directors owe both a statutory fiduciary duty and duty of loyalty to the corporation to avoid conflicts of interest in self-dealing as well as a duty of care to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Other statutes impose liability on directors and officers in insolvency, securities, tax, employment and environmental matters. The following are types of conduct that may lead to exposure:

- Failure to take reasonable steps to minimize losses to creditors - where insolvency is inevitable would

be a breach of duty leading to claims by creditors, or insolvency practitioners, for the added debts and damages incurred. However, where there are diverging interests between groups of stakeholders, such failure may not be a breach of duty

- Misappropriation of corporate assets - may trigger both civil and criminal liability
- Directors and officers can be liable for preferential transfers at undervalue (usually for the difference between the value of the consideration received and the fair market value of the assets at the date of disposition). Paying out of dividends while the company is unable to meet its obligations is problematic. Directors and officers should be aware of the "solvency test", namely, whether there are reasonable grounds to believe that the company would, after a particular action, be unable to pay its liabilities as they become due ("going concern test") or if the asset value of the company is less than its liabilities ("balance sheet insolvency"). With volatile commodity prices, many resource companies need to pay particular attention to these issues
- If directors and officers know the company is on a verge of insolvency but do not take steps to mitigate losses and inform creditors, they may face a statutory "oppression" claim
- Preferential payments to one creditor as opposed to another when insufficient monies are available to pay both can be attacked by the trustee in bankruptcy if it took place within three months (if made at arm's length) or within a year of bankruptcy if made to a related person
- Continuing to trade where there is little prospect of being able to pay debts when due

Other statutory liabilities

Besides causes of action under the various insolvency and corporate statutes, directors and officers face numerous statutory liabilities during insolvency situations:



(a) Liabilities to the employees of the company

Under various statutes directors can be personally liable for unpaid claims of employees (e.g., CBCA section 119 and the Employment Standards Act, section 81(7)). These claims are very common against directors and officers of insolvent companies. It can be brought individually by the employees or on their behalf by provincial employment agencies. If many employees are involved, the liabilities can be significant. Increasingly, insolvency practitioners and government agencies are aware of D&O insurance and expect that it will respond.

(b) Personal liability for failure to remit sales tax or to withhold at source deductions

Claims include payroll (Income Tax Act, section 227.1) and sales tax deductions. These generally impose joint and several liability on directors and officers, and any one executive may face the entire claim with the right to sue the other directors.

(c) Environmental liabilities

This is an important recent development in terms of liability for directors. Notably, the Directors of insolvent companies can be personally liable for remediation orders issued by the Ministry of the Environment, even if the pollution occurred prior to their involvement. Recent cases have led to D&O coverage becoming a major topic in the D&O market leading to expanded attempts to include that coverage.

(d) Statutory construction liens liabilities

These are claims where subcontractors' fees are unpaid, monies have not been kept in a separate statutory trust by the insolvent building company, and the subcontractors sue the directors and officers personally for the amounts outstanding if the executives have acquiesced in the dissipation of these monies.

(e) Liabilities under the Pensions Benefits Act

This is for failure to take steps to prevent the corporation from acting in a way that breaches the duties it usually owes as administrator of a pension plan.

Generally, the statutes above allow directors and officers a defence if they establish that they exercised due diligence to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances. Historically, this is a high hurdle to meet. Furthermore, the government agencies are notoriously aggressive in prosecuting employee and tax liability related claims.

Outside directors and the de-facto directors

It is not only appointed directors who face liability but also those who perform these functions. As seen in *Hatrell v Canada*, 2008, FCJ No. 228 (FCA) de-facto directors may be liable for the corporation's failure to remit income taxes.

Can these exposures be minimized?

In order to set up possible due diligence defences, executives need to attend all board meetings and take steps to try to ensure that the financial reporting and payment systems are timely and effective.

Expert advice should be sought about any significant transactions or decisions. Indemnity agreements with the corporation should be reviewed. Security arrangements to support the indemnities, such by means of a segregated trust, can be considered under expert advice.

Resignation can be appropriate, especially if the executive is in disagreement with proposed courses of action. If they continue to manage the business affairs of the corporation, liability for unpaid taxes or wages may accrue. Furthermore, if a corporation is dissolved but subsequently revived, the liability remains.

Depending on the size of the company, consideration should be given to the benefits of a restructuring under the CCAA. Plans approved by the Court and creditors usually include a release of claims against directors.

Other considerations

Besides these exposures, directors face significant claims under securities laws in connection with misrepresentations or other conduct issues related to the capital markets. One area to consider is the exposure to privacy claims, especially if there are any issues dealing with sensitive information that might be affected by the insolvency. Steps need to be taken to continue to preserve personal and private information. The Office of the Privacy Commissioner of Canada is currently examining the standards applicable to directors and officers in connection with such matters, and will be issuing commentary and guidelines in due course. Watch this space.



Asia Pacific

Risk Assessment: The Importance of Considering the Insured's Corporate Culture

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Culture is a term that we all understand to mean the shared set of values or assumptions that reflect the underlying mind-set of an organisation. Management consultants have for years highlighted the need for companies to promote a positive and supportive culture.

For insurers, the culture of the organisations they underwrite is increasingly becoming a critical issue in order to assess risk. This is because companies with poor culture are exposed to greater litigation risks, regulatory scrutiny, fines and penalties. Examples of poor culture can be seen in the Australian Security and Investment Commission's (ASIC) current investigation of the incentive structures of three major Australian Banks, the misconduct investigation of IOOF Holdings, and the global response to the Volkswagen emission scandal.

Globally a number of regulators have flagged an intention to crack down on organisations with poor culture.

Against this backdrop there are a number of key factors insurers can consider when assessing whether their insured's promote a good corporate culture.

Incentives and Rewards

The incentive and rewards structure of an insured's business provides a key insight into its culture. These structures have a high degree of influence over employee conduct and their interaction with stakeholders. Excessive commissions and rewards for sales-volume have been found to encourage work practices that undermine adherence to the organisation's wider legal obligations.

ASIC has identified a correlation between inappropriate incentive structures and organisations that breach Australia's Corporations Act. The UK Financial Conduct Authority, the Reserve Bank of New York, ASIC and the Australian Prudential Regulatory Authority (APRA) have all emphasised the importance of ensuring that bonuses, promotions and other forms of incentives are connected to good outcomes for clients, and align with the compliance obligations of the company.

The Australian Stock Exchange (ASX) recommends that listed entities have a separate and independent remuneration committee to review and update remuneration policies and that remuneration should be assessed against the overall roles and responsibilities of employees, and not solely financial targets.

Training and Compliance

Training and compliance structures have also been cited as key drivers of corporate conduct by the regulators. When assessing whether companies have poor culture, the regulators have looked at the education programs in place, and whether these programs emphasise the values of the organisation and the behaviour expected of staff. Up-to-date training was identified by Australia's Trowbridge Report as being an essential tool in remedying any poor practices within an organisation. Companies that do not promote regular training will hold a greater risk of having poor culture.

Risk Management and Transparency

A lack of transparency when dealing with clients is often a sign of poor culture within a company. A lack of accountability and transparency can encourage mind-sets where it is acceptable to cover up mistakes and avoid addressing potential misconduct. The Organisation for Economic Co-Operation and Development (OECD) has blamed a lack of transparency as a key reason many company boards failed to appropriately manage risk in the lead up to the global financial crisis.

Many jurisdictions, such as Australia, also require heightened disclosure obligations for financial services organisations and include requirements that disclosure to clients be timely, relevant to the needs of clients, and sufficient to encourage product understanding and



comparison. Transparency has also been found to require a strong reporting culture, where clients regularly receive information on potential risks and can make informed decisions. A failure to provide regular advice to clients has been identified as a trend leading towards poor culture.

Complaints Handling

Recently, ASIC Commissioner, Greg Tanzer, stated that a positive culture required accountability and open communication so that ineffective and risky practices can be challenged and so that employees are able to come forward without fear of retaliation. Similarly, regulators have identified whistle-blower and staff complaint policies as key culture indicators.

If a company is subject to regulatory oversight, a regulator is also likely to require evidence showing that company concerns are investigated quickly, escalated to the appropriate level of management, and are in line with principles of procedural fairness. All of these elements should be taken into account when an insurer is assessing the culture risk posed by its insureds.

What must insurers not forget?

The above all are key factors to take into account when doing a risk assessment of an insured. It is clear though that a positive culture requires active promotion by the leadership team and this should not be overlooked by insurers. The attitudes of management and company gatekeepers are key indicators of an organisation's overall attitude, and whether good culture will be promoted. Indeed, Justice Heerey in *ACCC v Visy Industries Holdings Pty Ltd (No 3)* noted that unless compliance is prioritised by leadership, individuals may still embark on unlawful conduct, and policies and procedure may well be written in Sanskrit for all the notice staff will take.



Case summaries

Worth the wait? Court considers professional advisers' duties: *Worthing and Worthing v Lloyds Bank Plc* (2015)

In this case, the claimants sued Lloyds Bank over a GBP 700,000 investment. The claimants met with Lloyds in 2006 and January 2007 and based on Lloyds' assessment of their attitude to risk, various "balanced/medium risk" investments were recommended.

Thereafter, the claimants signed Lloyds' standard terms and conditions, stating that Lloyds would periodically check for changes in the claimants' circumstances that could affect their investment objectives.

In March 2008, Lloyds conducted a review meeting. Despite the value of the initial investment dropping due to the financial crisis, Lloyds advised the claimants to retain their investment. The claimants eventually instructed Lloyds to liquidate their portfolio in July 2008 and sustained a loss of GBP 43,000 on the original amount invested.

In March 2013, the claimants issued proceedings claiming Lloyds acted negligently, in breach of contract and its statutory duties (under s.150 FSMA 2000 and breaches of FSA conduct rules) regarding the initial investment advice. They argued the investment was not suited to their appetite for risk - which they submitted was "cautious/low".

While conceding their causes of action concerning the alleged negligent advice given in January 2007 had expired, they argued Lloyds were under a continuing duty of care to re-consider the advice (and correct it) at the subsequent review meeting.

The court held the initial advice was not negligent, meaning Lloyds could not be deemed negligent for subsequently failing to correct it. The Judge held that the duty arose at the point of the original advice; once that advice was given, the duty of care was discharged. Further, the duty would only be continuing if the claimants were able to identify a contractual obligation that remained unperformed (distinguishing it from *Midland Bank Trust Co Ltd v Hett, Stubbs & Kemp* [1979]).

This case provides welcome news for the finance industry and insurers. It also provides useful guidance to other professionals who may face similar arguments from claimants.

When is a relationship a special relationship? *Sharp & Ors v Blank & Ors* (2015)

This case concerns a group action brought by the shareholders of Lloyds TSB against the company and its directors in relation to Lloyds' acquisition of Halifax Bank of Scotland Plc ("HBOS") in 2008. The shareholders alleged that the communications by the directors contained material misrepresentations and omissions, and that the directors' recommendation that the shareholders approve the HBOS transaction was in breach of the duties they owed to the shareholders. The claimant shareholders argued that the duties arose because the directors had vastly superior knowledge to the shareholders, and the shareholders relied on the directors to provide them with information.

In line with established principles, on a summary judgment application, the court held that directors owe fiduciary duties to the company but do not, solely by virtue of their office of director, owe fiduciary duties to the company's shareholders. Although directors can owe fiduciary duties to shareholders, those cases are limited to where the facts demonstrate a special relationship between the directors and the shareholders, which the claimants were unable to establish. If directors owed fiduciary duties to shareholders, they would be liable to "harassing actions by minority shareholders, and exposed to a multiplicity of actions, each shareholder having his own personal claim". Moreover, if directors owed a general fiduciary duty to shareholders, not only would this place an unfair burden on them, it would also place directors frequently in a position where their duty to the company conflicts with their duty to shareholders.

The decision is not new law but rather a reaffirmation of the established principles of fiduciary duties. The case serves as a reminder that fiduciary duty is a special kind of duty reserved for a particular set of circumstances and within narrow confines. This is a welcome decision for directors and their D&O insurers alike.

Acting with improper purpose? The Supreme Court considers the proper purpose rule in *Eclairs Group Ltd and Glengary Overseas Ltd v JKN Oil & Gas plc* (2015)

The Supreme Court has reaffirmed the "proper purpose"

rule holding that directors who had imposed restrictions on shares pursuant to a legitimate power to do so had nonetheless imposed them for an improper purpose.

In this case, the board was concerned that certain minority shareholders (Eclairs and Glengary) were planning a corporate raid on the company so issued disclosure notices under s.793 Companies Act 2006 seeking information from the shareholders regarding the number of shares held, the beneficial interests and any agreements between them. Eclairs subsequently publicly urged shareholders to oppose upcoming AGM company resolutions, which included resolutions to re-elect certain directors.

Believing the responses to be inadequate, the board decided to exercise its powers under article 42 of the Articles of Association to issue restriction notices to Eclairs and Glengary for failing to comply with the disclosure notice, which suspended their voting and transfer rights. This was challenged by Eclairs and Glengary on the grounds of section 171(1)(b) Companies Act 2006 - a director must only exercise powers for the purposes for which they were conferred.

Mann J held, at first instance, that the proper purpose rule applied and the restrictions should be set aside as the board had exercised their power for the purpose of influencing the resolutions at the AGM. The Court of Appeal rejected this, holding that the rule did not apply as the shareholders could have remedied their situation by providing fuller answers.

The Supreme Court, reversing the Court of Appeal decision, held that the directors acted with an improper purpose and the rule thus applied; whilst they had acted within their power, the purpose of the power in Article 42 was largely to provide a sanction/incentive to remedy a failure to comply adequately with a disclosure notice; its purpose was not for influencing resolutions at an AGM.

Interest swap mis-selling: *Thornbridge Limited v Barclays Bank Plc* (2015)

Following the judgment in *JP Morgan Chase Bank v Springwell Navigation Corporation* (2008), the court held that a bank did not assume an advisory duty in agreeing an interest rate swap and the court will look at all the evidence of the relationship between the parties to determine whether an advisory relationship exists.

Thornbridge was a property investment company. Thornbridge sought a loan from Barclays which was

entered into in April 2008. In May 2008, as part of the conditions for obtaining the loan, Thornbridge entered into an interest rate swap agreement with Barclays. Later in 2008, there were a number of reductions in the Bank of England base rate, to which payments under the swap were linked. Subsequently, the swap payments due from Thornbridge increased significantly. After the swap matured, Thornbridge claimed against Barclays for damages for losses arising from alleged negligence, breach of contract and breach of statutory duty.

The court held that Barclays had not recommended the swap nor assumed an advisory duty. A factor against the finding of Barclays having provided investment advice is that Barclays did not receive a fee for any advice. The court drew a distinction between the advice of an investment adviser and the advice given by a salesperson.

Even if advice was given, Thornbridge was contractually estopped from asserting that Barclays had advised it to enter into the transaction. In the absence of an advisory relationship there was no common law duty to provide information, simply a duty not to mislead. Barclays did not mislead Thornbridge and there was no duty to give full information about the advantages and disadvantages of the products.

This judgment will be welcomed by banks and the detailed reasoning in the judgment may serve to prevent similar claims in the future. The judgment is currently being appealed.

Continuous cover clauses: *ARC Capital Partners Limited v (1) Brit Syndicates Limited and (2) QBE Underwriting Limited* (2016)

These clauses are sometimes found in policies in the UK but are more commonly found in other jurisdictions, for example, Singapore. The effect of such clauses is to extend cover to claims under a current policy which should have been notified under an earlier one.

In this case, an insured entered into an agreement in 2008 which arguably led to it entering into a further agreement in 2010. It was alleged that the insured had committed certain errors and omissions. A claim was notified to insurers under a 2013/14 policy.

The defendants had entered into consecutive annual contracts of insurance on similar terms for periods prior and subsequent to the relevant cover, starting on 9 June 2009.

The policy had a retroactive date clause excluding coverage of a Claim that was “in any way involving any act, error or omission” committed before 5 June 2009; a notification clause, as a condition precedent for coverage; and a continuous cover clause extending cover to claims that should have been notified under the prior year’s policy. The judge held that the retroactive date clause did not apply in the circumstances. The judge also held that a letter from the third party was not a “Claim” for the purposes of the cover but, even if it was, it was clear that the terms of the notification clause did “not take effect to nullify the effect of the Continuity of Cover Clause.” Therefore, insurers would not be afforded this defence. The whole point of the clause was to extend cover to claims where there had been a breach of the notification condition precedent in the prior year; any breach of the condition precedent would preclude the insured from recovering under the prior year (and, if insurers did not renew, there would be no cover later on either). Where insurers did renew on terms which included the clause, there would be cover for claims which should have been notified under the prior year.

US-Style damages awarded in Dubai: *Al Khorafi v. Bank Sarasin-Alpen and Bank Sarasin* (2015)

On 7 October 2015, the DIFC Court of First Instance issued its judgment on quantum issues, awarding multiple (or punitive) damages based on the deliberate conduct of Sarasin-Alpen, confirming that it will follow the US, rather than the English, approach to such damages.

Liability had been determined in August 2014, with the defendants being held jointly liable for regulatory breaches and breaches of duty (currently under appeal). Briefly, the defendants had recommended structured financial products totalling c.USD 200m as well as loans to finance/leverage some of the investments. Following the financial crisis, the investments dropped dramatically resulting in margin calls for extra capital to be provided to prop up the investments. Unable to meet these, Bank Sarasin liquidated the investments resulting in huge losses for the claimants.

The court held that this was: “a clear case of mis-selling unsuitable investments to an unsophisticated investor...” Bank Sarasin had also carried out financial services in or

from the DIFC in breach of the general prohibition under the Regulatory Law.

Whilst a proportion of the claimants’ losses had already been quantified and awarded as part of the liability judgment, the claimants sought to recover further losses under Article 40(2) DIFC Law of Damages and Remedies which grants the DIFC Court discretion to “where warranted in the circumstances, award damages to an aggrieved party in an amount no greater than three (3) times the actual damages where it appears to the Court that the defendant’s conduct producing actual damages was deliberate and particularly egregious or offensive”.

The court disapproved of the defendants’ conduct and its deliberate breach of regulatory law and made it clear that, instead of being constrained by English law principles, its discretion “reflects the intention to depart from that law in favour of the law in the United States of America.”

This claim is one of the largest successful mis-selling claims seen in the region with damages of nearly USD 60m (in addition to interim payments of USD 11.5m) awarded. The claim was originally backed by professional litigation funders and the prospect of multiple damages awards may lead to an increased willingness by third party funders to fund such claims and result in an increase in negligent advice/mis-selling claims in the DIFC.

Illegality defence still uncertain: (1) *Top Brands Ltd* (2) *Lemione Services Ltd v Gagen Dulari Sharma (as former liquidator of Mama Milla Ltd)* (“MML”) and *Another* (2015)

MML supplied toiletry products until entering creditors’ voluntary liquidation in 2011. The business conducted through the company involved VAT acquisition fraud. The claimant creditors delivered goods to the company but had not been paid. A few weeks before liquidation, MML sent invoices for the goods which had been delivered to its onward purchaser, SERT. Over GBP 500,000 was paid by SERT into MML’s account. The account was subsequently frozen and the liquidator (Ms Sharma) appointed. The sum was transferred to her and she authorised the transfer of the sum to different recipients, wrongly believing that the money was supposed to be returned to SERT as a result

of being an advance payment for goods that were never delivered.

The High Court concluded that Ms Sharma owed a duty of care, had acted in breach of her duties under the Insolvency Act 1986 and was liable in negligence by acting below the standard of care expected of an ordinary, skilled practitioner.

It refused to grant Ms Sharma relief and found that she could not rely on the illegality defence as a bar to the claim. Accordingly, she was ordered to pay nearly GBP 550,000 to MML by way of compensation. Ms Sharma appealed.

The Court discussed the alternative approaches adopted in previous case law to the illegality defence, but ultimately found that (whichever test was applied) the illegality defence could not succeed as the illegality had no causative relationship to the loss claimed as, by the time of her involvement, MML's business had entirely ceased and the monies paid into MML (and paid away by Ms Sharma) could never have actually been employed in a VAT fraud.

It is notable that the decisions reached by the courts in cases requiring consideration of the illegality defence are highly fact specific. The courts will, in general, attempt to consider the defence in a sensible manner which achieves a just and fair result but there is uncertainty as to the parameters of the defence. The Court concluded that the illegality defence was ripe for consideration by the Supreme Court.

Collective Investment Schemes: *Asset Land Investment Plc and another v The Financial Conduct Authority* (2016)

The Supreme Court considered whether the activities carried out by Asset Land were collective investment schemes ("CIS") under section 235 Financial Services and Markets Act 2000 ("FSMA"). If they were, then the company would fall foul of section 19 FSMA, which prohibits anyone carrying on a regulated activity unless authorised or exempt (the company being neither).

The company purchased land which they divided and

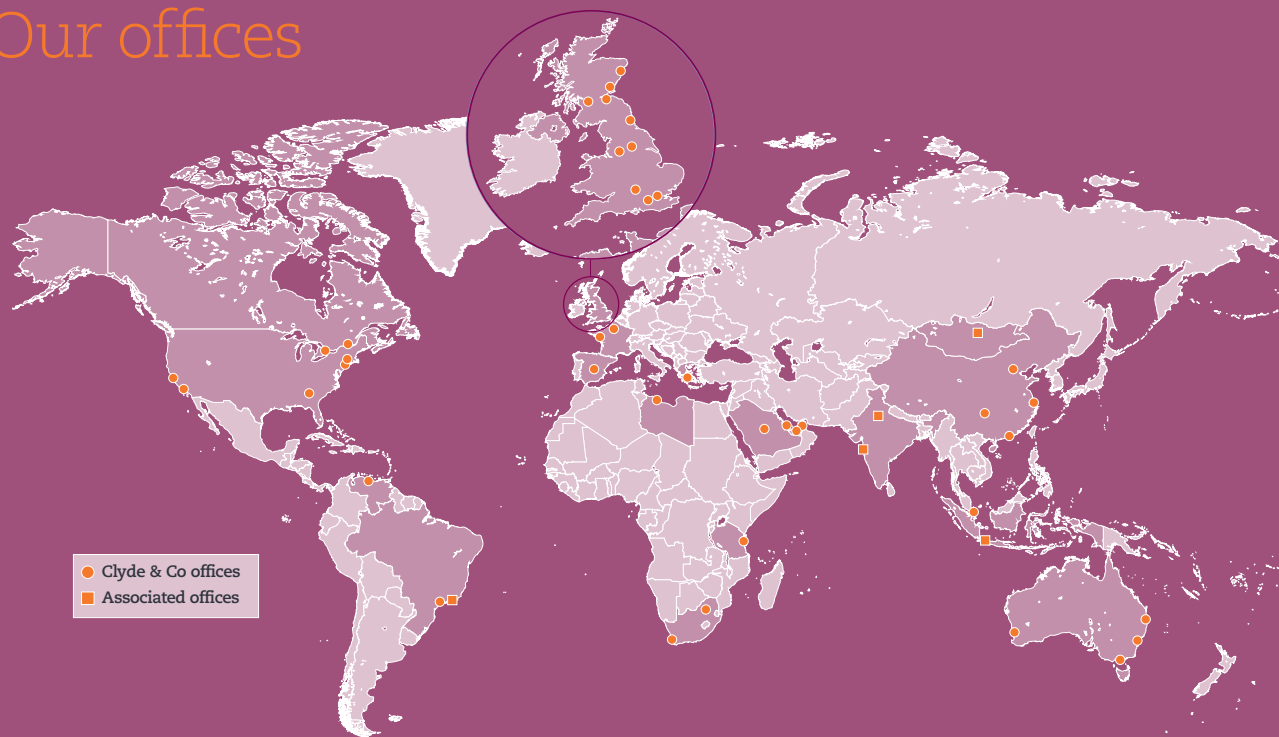
sold to investors, promising significant profits when the land was granted planning permission and sold on to a developer. These arrangements are often referred to as 'land banking' schemes. The FSA (as it was then) brought proceedings against the company and the individuals involved, arguing that it operated an illegal CIS. Asset Land responded that the investors were the legal owners of the land so the transaction was not a CIS requiring authorisation.

The Supreme Court held that Asset Land was the central operator of the scheme; the individual investors did not have control over their investments, despite being the legal owners of the individual plots. Referring to section 235 FSMA, the Supreme Court found that the words to "have control" are not necessarily limited to the legal control of the investment; one should look at "the reality" of how the arrangements are to be operated and what was intended from the outset. The judge correctly found that the management of the property as a whole comprised obtaining planning permission and securing a sale to a developer; this being within the company's remit and not the investors' giving the company effective control.

Asset Land therefore operated a CIS that required approval and they are required to pay GBP 21m back to investors. However, a recent FCA press release indicates that the assets subject to freezing injunctions will be insufficient to cover anything but a very small proportion of that amount.

The decision brings some clarity to the question of what amounts to a CIS and what will be taken into account by the court.

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