INSIGHT

SEMINAR: September 2009 **Philippa Fee**

D&O INSURANCE—Who Needs It?

A seminar given by Philippa Fee to the Lumley Liability Symposium, September 2009.

In this paper I will address three issues of relevance to brokers selling D&O Insurance in the New Zealand market at the moment:

(a) What's going on in the World and New Zealand at the moment?

(b) What is D&O Insurance?

(c) Who is it for and why should you buy it?

What's Going on in the World and New Zealand?

Unless you have been living on another planet for the last 18 months, you will be familiar with the economic restructure that has occurred around the world. It was triggered by a cascade of defaults by US homeowners. This led to $US750 trillion of write downs. Any securities valued by the performance of pools of subprime mortgages have plummeted in value, leading to huge losses for investors. Hundreds of banks in US have failed.

Inevitably, this has led to a ballooning of litigation in the US. In 2008, 210 securities class action law suits were filed, a 19% increase on 2007[1] The loss to D&O insurers is currently estimated to be US$6billion[2]. This loss has primarily hit the D&O insurers which insure the financial and real estate markets.

In New Zealand, our banking system has fared much better. Of the top 11 banks in the world 4 are Australasian[3]. As the Governor of the Reserve Bank has observed:

"Our less complex [banking system] came through well, helped by sound parent banks, good regulations here and in Australia, good management, and a little luck" [4]

However, New Zealand has shared the pain with the rest of the world. Cash has become illiquid. The median house price has dropped and unemployment has increased. Across the board there has been a significant reduction in company profitability and a worsening government debt.

A unique feature of the New Zealand environment has been the preceding decimation of the finance sector. The statistics are sobering:

- 30 failed finance companies (receivership; liquidation or debt moratorium)

  2006 3 (eg Western Bay; Provincial; National)

  2007 11 (eg Five Star; Nathans; Bridgecorp)

  2008 10 (eg Dorchester; St Laurence; Lombard)

- Billions of dollars of investors' funds lost

One of the consequences of this pain has been considerable pressure, both politically and socially, for solutions and accountability. It can be seen in the recent announcement of a Commerce Select Committee Inquiry into the finance sector collapse.

It is also my opinion that this pain has resulted in a cultural change in the attitude of society to litigation. To some degree, the template was provided by the considerable activity associated with employment claims, and the ease with which such claims can be brought. The leaky building crisis has led to specialist plaintiff firms prepared to take on significant actions for groups of affected homeowners.

Another interesting development is the emergence of collective action groups such as the ING/ANZ Frozen Funds Group and EUFA. There has been much publicity given to representative/class actions associated with

[1] Towers Perrin & Cornerstone Research, US
[2] Financial Times 23/06/09
[3] Jane Diplock, Commerce Commission Speech to Rotary 22/06/09
[4] Alan Bollard NZ Herald 29/08/09

Level 13, WHK Gosling Chapman Tower, 51–53 Shortland Street, PO Box 1801, Auckland 1140, New Zealand. T: 64 9 373 0050 F: 64 9 379 3679 W: jonesfee.com

the collapse of Blue Chip. Whether there are any more remains to be seen.

One of the most significant developments over the last few years has been the massive increase in receiverships/liquidations:

	2005/06	2006/07	2007/08
Receiverships	238	291	626
Liquidations	3893	3991	7715

Perhaps responding to greater need or political will, there has also been a significant increase in the regulatory legal costs spend.

	2005/06	2006/07	2007/08
Commerce Commission Litigation Fund	238	291	626
Securities Commission Litigation Fund	0.780m	0.292m	2.0m

What is D&O Insurance?

D&O Insurance is a species of liability cover which has two aspects:

(i) Individual cover to director for "Loss" arising from "Wrongful Act" (where the director/officer is not indemnified by the company);

(ii) Company cover where the company indemnifies the director.

These two mesh together to form a united whole intending to cover the cost to either the director personally or the company resulting from the director's wrongful acts.

It is a "Claims Made" cover like Professional Indemnity policy. Liability has to arise from a "Wrongful Act". This is frequently broadly defined to include errors or omissions, negligence, breach of duty in the capacity as a director/officer. But an important point to note is that the modern D&O policy is much more than indemnity from civil claims.

It is common for D&O policies to include the following:

(a) Cover for employees and deemed directors;

.

(b) Limited Employment Practices Cover, i.e. director/officer's liability to employee;

(c) Outside Directors Extension;

(d) Defence costs associated with:

(i) Attendance at an official investigation, examination or inquiry into the affairs of the company (e.g. coroner's inquests; disciplinary tribunals)
(ii) **Successful** defence of a criminal prosecution
(iii) Health and Safety prosecution
(iv) Pollution Claims

Who Is It For? Why Should You Buy It?

Who should buy D&O Insurance? To answer this question it is important to look at the essence of the director's position.

Because the director was acting for the benefit of the company, and, except in the case of acts which are in breach of its duty to the company itself, when a director/officer is sued the director/officer's first line of defence is the company itself. So, in reality, the director/officer's personal wealth is at the mercy of the company's fortunes.

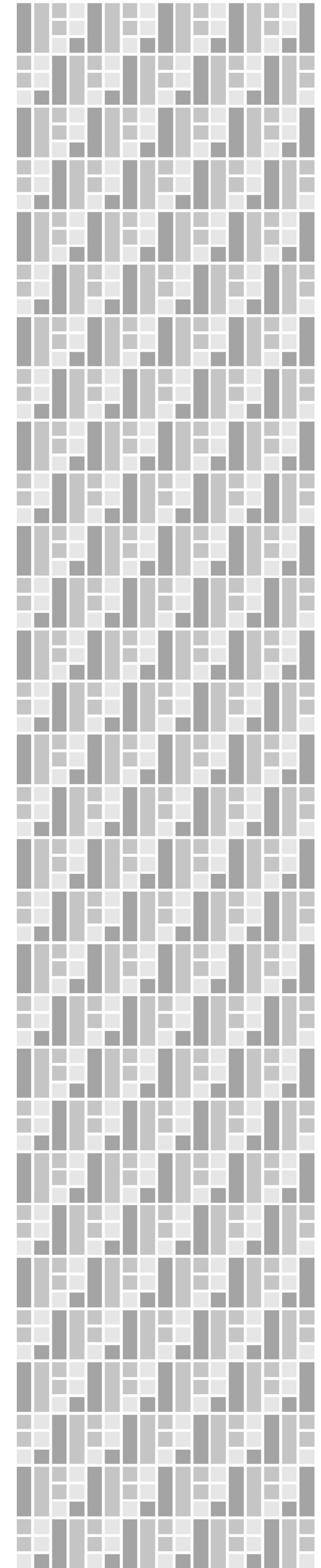
In the case of SMEs, when the director/officer owns the company then the director/officer's indemnity is circular i.e. it is coming from his/her own pocket. This is not the case when a director of a large corporation is sued. In that case, the corporate will have capital resources of its own which the director can tap into. Logically, this should mean that SMEs should have a **higher** not lower rate of take up of D&O insurance than large corporations.

In periods of economic stress, it pays to be a little paranoid. This is because in times of economic stress the chances of being at the receiving end of a suit are higher.

Insolvent Trading

One of the principal exposures a director can have is to a liquidator/receiver for insolvent trading (ss 135 &136 Companies Act 1993). Proceedings by a receiver/liquidator are an exception to the "Insured v Insured" exclusion.

The greater the risk of corporate failure the greater the need for D&O cover. Liquidators pursue directors of big **and** small companies.



INSIGHT

Case Study—*Goatlands Limited v Parsons & Kennedy*[5]

The Borrells farmed goats in the Waikato on two blocks of land. They began a subdivision of the two blocks into five smaller blocks. In 2001 the Borrells decided to buy a block of land in Horotiu. They formed a company to buy the property, signed an unconditional sale and purchase agreement and received a GST refund in respect of that sale, notwithstanding that settlement of the purchase was not to take place for a year.

During this year they needed to sell one of the larger blocks of land in order to be able to settle the purchase. They were confident that they could do so, but unfortunately that was not to be. The company had to default on the purchase, and eventually the company was put in liquidation by the IRD.

The liquidator, funded by the IRD, began an action against the Borrells for insolvent trading. The court found that the Borrells ran an unacceptably high risk when signing the contract to buy. The court assessed that risk as being 25% (which of course meant that the chance of success was a fairly respectable 75%).

Shareholder Derivative Actions

Another important source of litigation against directors is Shareholder Derivative Actions. Like insolvent trading, they are another exception to the "Insured v Insured" exclusion. These actions are brought in the company's name against the director for breach of duties owed by the director to the company (ss165-168 Companies Act 1993). In the US 32% of D&O actions in the US are shareholder derivative actions.

While perhaps not as common in NZ, they certainly exist and when they arise can be complex and costly.

Case Study—*Thorrington v McCann*[6]

In this case, T and M were both shareholders and directors of a company which established a successful Irish bar. M was the day to day manager and T was the sleeping partner. After operating for a while M allegedly arranged for the lease, on renewal, to be taken out by another in respect of which T was not a director or shareholder, only M. T alleged that M had breached his duty of good faith owed to the company by procuring the lease for M's benefit, to the detriment of the company.

Employment Claims

Another common source of claims against directors is employment claims. Overseas this represents a very significant exposure. In US 43% of D&O claims against private companies are employment related[7]. The time is right for such claims to rear their head, given that we have come off the back of a previous period of staff shortages. This shortage led to longer duration for employment contracts and an emphasis on performance based discretionary remuneration. With the global recession, performance has fallen, redundancy and terminations have increased, giving rise to a greater risk of suit. Where an employer company is no longer trading, then clearly the director is exposed to being the only viable target.

Crossing Borders

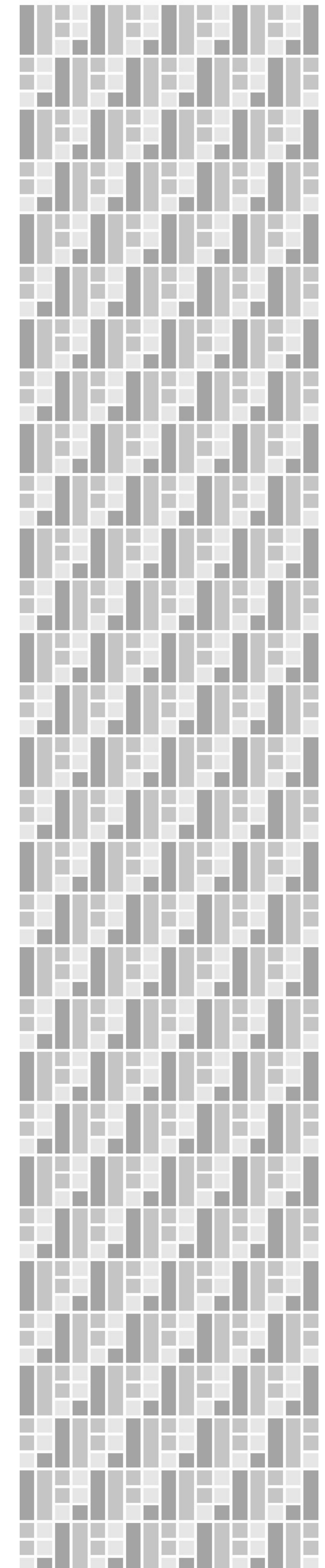
When a company crosses international borders there is an increased risk of something going wrong due to a lack of proper advice or understanding of jurisdiction-specific laws. This risk is higher when smaller companies venture out into the world without the means to engage jurisdiction specific advice.

Transactional Risks

Whenever a company enters into a transaction related to capital raising, acquisitions or refinancing there is a risk of misrepresentation, inadequate disclosure or a failure to follow proper process. Risk may be **greater** for SMEs due to lack of professional advice and informality.

Regulator Action

Regulators do not differentiate between large and small companies. Everyone, no matter how large your operation, is expected to know the law. Regulators have a statutory duty to proceed against companies, big or small, where companies breach the law in the following areas:



[5] CIV 2005-419-1643 Unreported High Court Hamilton, 14 December 2006. For a more complete summary of the case see www.jonesfee.com

[6] High Court Auckland, M1289/97 24/02/09

[7] Towers Perrin D&O Survey 2007

Level 13, WHK Gosling Chapman Tower, 51–53 Shortland Street, PO Box 1801, Auckland 1140, New Zealand. **T:** 64 9 373 0050 **F:** 64 9 379 3679 **W:** jonesfee.com

- Capital Raising. (e.g. directors may be liable to repay the allotment if there is an irregularity in the allotment of a securities or misleading advertisements)
- Misleading Statements to the public or competitors (penalties and damages)
- Anti-competitive behaviour

Criminal prosecutions can be taken against directors where the director has a duty to protect the public or its employees from harm. Prosecution of directors personally is not uncommon under the Health & Safety in Employment Act. There has even been a highly publicized prosecution of a director for manslaughter after a workplace death[8].

Fraud

Fraud on the part of management can expose innocent directors to suit either by a third party or the company itself.

> **Case Study—***FXHT Fund Managers (liq) v Oberholster*
>
> In this case, a general practitioner became involved as a director and shareholder in a company which managed client's investments in foreign exchange markets. The day to day manager of the business, H, stole in excess of US$1m of client's business. The liquidator sued O alleging that O was in breach of a number of duties he owed as a director to the company. Fortunately, the court found that O did not breach of a number of the duties he owed, but did find that he failed to insist that H provide him with regular financial reporting. This meant that H had the opportunity to steal client's funds for longer than he would otherwise have had. O was ordered to pay damages of approximately NZ$300,000.

Competitor Actions

When profitability is under pressure, competition increases. This means that there is a greater risk of directors facing actions by competitors, such as interference with business, breach of intellectual property rights, misleading/deceptive conduct or anti-competitive behaviour.

Conclusion—What does this all mean?

The current economic conditions in the world and NZ are malign. The poor economic conditions increase the risks to any business owner.

A change in NZ's attitude to litigation was already underway before recent events, but it has been given additional impetus by the collapse of the finance company sector. This collapse brought about a massive loss of investor funds, but more importantly, has contributed to cultural change.

The dramatic increase in receiverships/ liquidations, aggressive competition, deterioration in employment conditions and active regulators pose risks for SEM which equal, and in some respects exceed, that of large corporates.

D&O insurance should be regarded as an essential wealth protection device for business owners, large and small. In short, D&O is for everyone.

Philippa Fee
Partner
DDI: 09-373 0052
Email: philippa.fee@jonesfee.com

[8] R v Spencer (CA353/00 5 April 2001). The director's conviction was quashed after the Court of Appeal found a misdirection by the judge