DIRECTORS & OFFICERS NEWS UPDATE

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We have pulled together Francis's blogs from the last quarter and put them in to this easy to read bulletin.

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THE BATTLE OVER LEGAL PRIVILEGE INTENSIFIES

It’s not just the question of whether the privilege belongs to a company or a director that matters but whether it exists at all.

Not for the first time David Green, the head of the UK’s Serious Fraud Office (SFO) has fired a warning cannon shot over the bows of big business, saying in a recent Times article that he “is prepared to challenge head-on the claims of privilege that we believe are ill-founded”.

His gripe is that companies are using the cloak of privilege as it attaches both to advice given at the relevant time by in-house counsel and more particularly to internal investigations conducted after the event to withhold material from the SFO which they consider should be disclosed. Ominously, Green is talking about finding a suitable claim for privilege to challenge.

CHALLENGE TO PRIVILEGE IN THE US

At the same time comes a recent and successful challenge to the scope of legal privilege attaching to internal reports in the United States. I am grateful to Hebert Smith Freehills for bringing this to my attention in their briefing note. The case (Wultz v. Bank of China, 2015 WL 362667) was heard in The US District Court for the Southern District of New York in January 2015.

In the case, the Court rejected a claim made on behalf of the Bank of China that documents gathered during an internal investigation were privileged either under client attorney privilege or (as we would recognize it in the UK) under litigation privilege.

In January 2008, Bank of China had received a demand letter relating to allegations that the Bank had executed wire transfers on behalf of a terrorist organisation. The letter contained an express threat of proceedings. Some eight months later in August 2008, proceedings were duly served. In the interim, the bank had carried out an internal investigation—but, crucially, this had not been directed or supervised by a lawyer.

The Court held that a mere expectation that the work product would be provided to a lawyer for legal advice was insufficient. That would surely have been the result in the UK as well.

The Court went on, though, to reject what the bank must have felt was its stronger ground, i.e. that the internal report had been prepared “in anticipation of litigation” and should therefore attract privilege for that reason. After all, a specific threat of litigation had been made in this case. By some fairly tortuous logic the Court asked itself whether the bank might not have commissioned such an internal report even in the absence of the threat of litigation. Having concluded that it might very well have done so (for example with reference to its obligation to report the allegations to its regulator), the Court decided to reject the claim for privilege.

LESSON FOR THE REST OF US

The moral here, as the authors of the briefing note (themselves lawyers!) make clear, is to ensure that all internal reports are properly commissioned and supervised by lawyers so as to attract privilege. Yet, it is precisely this “good practice” which David Green is criticising in cases where he considers it is being used to obstruct the SFO’s pursuit of justice. Expect more fireworks here.
We all think we know the difference between an executive and a non-executive director – right? After all, an executive director has executive powers and functions and usually a contract of employment whereas a non-executive director does not.

It turns out, based on a decision of the Court of Appeal of Victoria *AIG Australia Limited v Jacques* [2014] VSCA 332, that things may not be that simple. Not only that, but the amount of case law – Australian or English – on the point is (until this AIG case) very limited and inconclusive.

I suppose part of the reason is that, in the eyes of the common law, all company directors are subject to the same duties and judged against the same standards so the need for judicial pronouncement in this area has been limited.

This is where a certain freebie add-on, which has become commonplace in D&O insurance comes into the story.

**SPECIAL PROTECTIONS FOR NON-EXECUTIVE DIRECTORS**

Insurers have in recent years offered special ring-fenced additional protection to non-executive directors. This was the case in Jacques, where AIG had sold a D&O policy to Australian Property Custodian Holdings Ltd. (APCH) with an aggregate limit of $5 million and an additional $1 million for non-executive directors.

APCH was responsible for a property unit trust dedicated to retirement and aged care facilities. Following the collapse of the underlying trust, the directors of APCH were sued and quickly used up the full $5 million limit of cover in defence costs. Mr Jacques contended he was entitled to the additional $1 million of cover as a non-executive director. AIG disputed this. They lost at first instance and appealed.

**WAS JACQUES REALLY AN EXECUTIVE DIRECTOR?**

AIG relied on eight separate grounds of appeal, including that the court had failed to take due account of the way Mr Jacques:

— was represented to the public;
— was regarded by the company itself; and
— himself thought about the question.

On all these grounds (and others) AIG claimed he should be treated as having been an executive director in the relevant period.

**WHY THE COURT SAID NO**

There were indeed some underlying facts to support these arguments. But the Victoria Court of Appeal, in a careful judgment which runs to some 40 pages, rejected AIG’s appeal. Here are some useful pointers as to the approach they adopted:

... we accept that in the absence of some further authority conferred upon a director by the company, be it under a contract of employment, a services agreement, or via an express delegation or acquiescence in a director’s exercise of executive powers, the director should generally be treated as a non-executive director. **The starting position must be that the mere fact of appointment does not normally give a director any executive powers.**
At one level this is a proposition it seems difficult to argue with. In other words, the Court is saying that executive powers have to come from somewhere. Having said that, I suppose many might simply assume that the appointment does itself confer the powers.

On the basis of the authorities to which we have referred, we are satisfied that the essential element of the distinction for the purposes of construing the term non-executive director in the policy, is whether the director is performing executive functions in the management and administration of the company.

In other words, it’s really a question of fact. And:

...whilst being independent of key management personnel and guiding and monitoring management may well be desirable attributes for a non-executive director to bring to his position, a finding that these attributes were not present would be insufficient to alter a conclusion based on a finding that the director performed executive functions for the company and that the company gave the director the authority to do so.

It is worth unravelling the double negative here. The court is in effect saying that just because a director thinks he’s independent and acts in that fashion, it doesn’t necessarily mean he is.

**DOCUMENT, DOCUMENT, DOCUMENT**

The reason why the Court had to look in such detail at the underlying facts is that, whilst Mr Jacques’ duties changed and evolved during his ten-year service as director of APCH, at no stage did he have a contract of employment or anything else which clearly delegated executive function to him. In smaller companies, that may not be as unusual as it sounds but even in larger companies it is important to ensure that any transition from executive to non-executive function or vice versa is carefully and accurately reflected in the company documentation.

In the APCH case it was accepted by both parties that Mr Jacques had started service as a non-executive director and finished as an executive director. The whole case centred around precisely when he made that transition.
WHEN IS A DIRECTOR ENTITLED TO INDEMNIFICATION OR ADVANCEMENT FROM HIS COMPANY?

In the UK, the answer to this question under the Companies Act is reasonably straightforward. Indeed there is a useful summary which can be accessed in our 2014 survey report conducted with Allen & Overy of the situations in which companies (and insurers for that matter) can (and cannot) provide protection to directors. Having said that, the number of decided cases in this area under English law could probably be counted on the fingers of one hand.

By contrast, in the US and especially in Delaware, where very many US-domiciled companies are incorporated, this important question seems to provoke more activity, as the recent case of Holley v Nipro Diagnostics demonstrates.

In this case, Mr. Holley was charged in 2011 by federal prosecutors in New Jersey with insider trading. The Securities and Exchange Commission brought parallel civil proceedings against him. Whilst Mr. Holley won the dismissal of several criminal counts, he nevertheless agreed to plead guilty to two counts of insider trading during his trial in 2012. During the SEC investigation leading to the civil proceedings, Mr Holley was indemnified by his company Nipro Diagnostics.

Following Mr. Holley’s plea of guilty, Nipro filed claims against him seeking repayment of the funds advanced to him on the basis that he had pleaded guilty to insider trading and therefore could not be entitled to indemnification or advancement. For his part, Mr. Holley asserted that Nipro remained under an obligation to advance on the basis that Delaware Law required indemnification for officers who were successful “on the merits or otherwise” in defending any actions.

The Court first addressed Nipro’s argument that there could be no advancement where indemnification was not permissible. It concluded that there was clear Delaware Supreme Court authority for the proposition that the two concepts were “separate and distinct legal actions” and that: “the right to advancement is not dependent on indemnification.”

The Court then went on to consider Mr Holley’s claim to indemnity based on his contractual entitlement within the context of Delaware law. It concluded that:

...The only reasonable interpretation of the indemnity agreement... is that it prohibits indemnification for actual insider trading violations but not for all claimed or alleged insider trading violations...

This sounds reasonable as far as it goes but the true significance of this finding for Mr. Holley related to Nipro’s argument that that his guilty plea in the criminal action must relieve it of the obligation to advance costs in the civil action. The Court concluded that it was by no means apparent that Mr Holley could not be “successful on the merits or otherwise” as required by Delaware law despite his guilty plea. For example the SEC might terminate the action or Mr Holley could prevail on procedural grounds. As the judge put it:

Any fees or expenses later found to have been advanced for matters as to which Holley is not entitled can be recouped at the indemnity stage

To cap it all, Nipro had also to pay Mr. Holley’s legal costs in relation to the lawsuit brought against Nipro. I cannot be sure but my instinct is that an English Commercial Court judge applying English law would not come up with such a favourable ruling for a director who had pleaded guilty – albeit not to all counts. As for D&O insurers, well that’s a subject for another day!
When I blogged recently about cyber threats and the insurance response particularly from the standpoint of D&O insurance, I said:

The steps directors take to inform themselves of the risks posed to their companies and to mitigate these risks form the main planks of both their individual and their collective defences when (rather than if) something bad happens. If they do nothing, they will have little or no defence or excuse...

I’m not sure whether I can count HM Government among the loyal followers of my blog so it is probably just a coincidence that in December 2014 it published some really valuable guidance aimed at non-executive directors to help them assessing the measures taken to enhance cyber security in the companies on whose boards they sit.

Organised into easy bite-sized chunks, it lists useful questions under headings such as:

— Do I really understand the cyber risks my company faces?
— Questions I should ask myself
— Questions I should ask board colleagues
— Questions I should ask at audit or risk committee

It is a useful summary of good practice. It also contains some links to a variety of helpful resources:

— Ten Steps to Cyber Security
— The Cyber Essentials Scheme
— Cyber Incident Response
— UK National Computer Emergency Response Team (CERT UK)
— Cyber-Security Information Sharing Partnership (CISP)
— The National Cyber Crime Unit (NCCU)
— Action Fraud
— Centre for the Protection of National Infrastructure (CPNI)

All of this is of course good news for directors who avail themselves of these or similar resources to inform themselves of the risks and thus to build their defences in the event of a personal liability attack. It’s less good news for those who don’t pay any heed to this material.

One piece of advice which you won’t find in the guidance is that it is not enough simply to rely on your recollection that you have asked and received answers to relevant questions. Chances are that your memory will not be good enough. Instead, you need as a director to create a documentary trail of some kind. Formal board minutes may be overdoing it. A straightforward email chain between you and relevant members of the management team should suffice.

Think of it this way. Just as you should never send an email you would be embarrassed to see published in the public domain (not least as a result of cyber-attack!), there is no reason why you should not create an email which may positively help you in the future should it be disclosed to regulators or claimants.
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