Risk, Resilience and Reputation

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What do you want from me?

Understanding risks to directors and what is expected of them

Risk, Resilience and Reputation Webinar Series

The latest webinar in our ***Focus on Funds | Risk, Resilience and Reputation*** *series saw CMS partners Andrea Arcangeli, David Bridge and Tristan Hall discuss the latest developments covering directors' risks and their implications. The full recording is available here.*

Anyone who reads the financial press will be familiar with instances of directors in court – often pursued by investors unhappy with decisions made or following regulatory investigations in the aftermath of liquidated funds.

The recent demise of the Woodford Fund or limited partner challenges to the likes of then fund manager Henderson a decade previously are just two of many examples. Today, directors of investment funds or companies can face not only the court of public opinion but also the very real prospect of lengthy incarceration and /or unlimited personal liability for misfeasance and other causes of action.

Three risk categories

The risks run by directors of investment companies or funds are many. But they ultimately fall under one of three 'L's:

- Liability

We are seeing an uptick in insolvency situations. The regulatory investigations that follow can be a real source of defence cost exposure for directors. Such costs may well continue rising as regulators continue their focus on instances where they believe directors have not done the right thing.

- Liberty

Over the years, we have seen multiple occasions of directors arrested or extradited. The latter is particularly prevalent in the UK, with directors ending up in the US even when the connection with the latter jurisdiction is not immediately apparent or obvious.

- Livelihood

There is a significant human element to directors' risk. The time spent responding to investigations, the impact on human mental wellbeing, and on corporate and personal reputations can be hard to overstate.

The direction of travel remains more – and bigger – claims

In the UK at least, two items of legislation are often the source of significant directors' risks: the 2010 Bribery Act and the Company Directors Disqualification Act 1986, following an insolvency event.

The former has extra territorial reach. It can see directors potentially exposed to severe penalties, with a maximum of 10 years' imprisonment and/or an unlimited fine for individuals (as well as unlimited fines for any corporate involved in committing a corporate offence). The latter can give rise to the risk of director disqualification for up to 15 years.

In addition, unhappy investors often seek to pursue civil claims against those decision-makers involved in the corporate governance and management of funds. Often those investors face challenges in that regard because of the unusual nature of investment industry structures. For instance, the directors of an investment fund or company are very unlikely to have day-to-day responsibility for managing client money. It is almost always delegated to portfolio managers at another legal entity in the value chain. And yet the ultimate responsibility for management rests with the board of directors.

Of course, convoluted structures make it hard for investors taking legal action. In the high profile 2012 Henderson case[1], investors although permitted to pursue claims against the third party manager of the limited partnership could only do so at the price of the investors' limited liability for the duration of the action. In practice this meant no such claims were pursued, largely because the investors were unwilling to give up their limited partner status.

That said, the trend is most certainly for more, and bigger ticket, claims against individual directors. Since the financial crisis there have been incrementally more attempts by regulators and prosecution authorities trying to hold individuals to account. Many of these are for alleged breaches of fiduciary duty, or mistakes or omissions in listing particulars.

Weavering (2011)[2] is emblematic. This Grand Cayman ruling made clear that directors can be liable for a fund's losses. Here, a case of wilful neglect saw two directors compelled to pay $111m *each*. Neither could prove they had adequately questioned the fund's portfolio or financial arrangements.

Wind the tape forward a decade and there have been numerous commercial private criminal prosecutions against directors. The largest so far, R (DAS UK Holdings) v Asplin, saw DAS successfully achieve prosecutions against former directors who secretly withheld profits, amongst other matters. The former CEO and other individuals concerned went to prison and were ordered to make good the company's losses.

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[1] Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) & Others [2012] EWHC 3259 (Comm)

[2] Weavering Macro Fixed Income Fund Limited (in liquidation) v Stefan Peterson and Hans Ekstrom, 26 August 2011, unreported

Protections: devil in the detail

Indemnities can, on occasion, provide directors with some protections. But we would never counsel relying on them solely.

Many directors seek to rely on the Company's ability to indemnify as set out in their articles of association or other constitutional documents. However, these provisions are – on close examination – often not enforceable by directors as against the company as the relevant provisions are only applicable to the contractual relationship between shareholders and the company or fund and not between the latter and its directors. In any case, there are restrictions as to what companies and funds can indemnify and they are of little value in an insolvency situation.

Best practice is for directors to all have separate deeds of indemnity.

Even better practice is for individual directors to have adequate directors' and officers' (D&O) insurance. Such policies differ widely but, in the main, they offer more robust protection than deeds of indemnity.

This should be on an individual basis. Directors should not assume a group policy will cover them adequately. For example, a €10m policy across five directors will not mean €2m each. Rather, it is paid on a first come, first served basis and we know of many examples in which have had to cover their own defence costs because their policy's limit of liability has been exhausted.

This a complex, fast changing and, increasingly, a high stakes issue.

However, if directors can fully understand their deeds of indemnity, critically analyse their D&O cover, have a detailed knowledge of their duties and document all factors contributing to decisions, then they have done just about everything possible to mitigate the considerable and growing directors' risks in the investment space.