



Advising the Board on **Shareholder Risk**

Reports looking at the full range of commercial risk



Risk, Resilience
and Reputation

Directors' risk report

Shareholder claims against directors are becoming increasingly prevalent with directors serving on the boards of publicly listed companies most exposed. The availability of litigation funding is making it easier for shareholders to obtain finance for such claims. There are a growing number of law firms actively seeking out such claims. There has been a greater emphasis on individual accountability for directors following the global financial crisis in 2008.

Directors are required to act in good faith and with loyalty to their companies, and to take care not to allow misleading statements to be made in share offering prospectuses. Directors on boards that breach these duties or approve misleading prospectuses risk claims against them and the prospect that any damages payable by them as individuals may not be indemnifiable. This makes it crucial that boards take care when making decisions and approving prospectuses and maintain a paper trail demonstrating they acted honestly and reasonably.

Shareholder claims

Shareholder claims against directors in the UK are usually brought in the form of a derivative claim or a securities claim. Directors can also find themselves party to unfair prejudice petitions brought by shareholders.

The issues that can give rise to shareholder claims are many and varied, and are ever changing. Financial misstatements are a cause of many complaints, particularly those involving publicly listed companies. Failures to report on the effect of climate change risks on a company's business could be a significant source of claims in the years ahead.

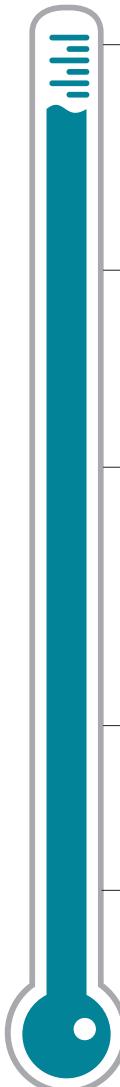
Derivative claims

Derivative claims can be brought by shareholders in private and publicly listed companies. Section 260 of the Companies Act provides that any shareholder may bring a claim against a director on behalf of a company, for negligence, default, breach of duty or breach of trust. This includes claims that a director has acted negligently even where the director has acted in good faith throughout and has not benefited personally in any way.

Derivative claims cannot proceed without the courts' permission. A court will dismiss a claim where:

- no reasonably independent board having regard to the company's interests would seek to pursue it; or
- the company has already ratified the alleged wrongdoing.

Stakeholder risk thermometer



Board

- Directors who breach their duties or allow misleading statements to be made in offering prospectuses risk shareholder claims.

Directors

- May not be able to call on indemnities provided by the companies, particularly in respect of derivative claims.

Shareholders

- Payments made or indemnified by companies on account of shareholder claims could have an adverse impact on the companies' finances which could affect their share price.

Creditors

- Low risk of debts owed to them being impacted by shareholder claims.

Customers

- No material risk for a company's clients or customers.



A court will take account of various factors in deciding whether to allow a derivative claim to proceed, including:

- whether the shareholders are acting in good faith (honestly and with no ulterior motive);
- the importance a director is likely to attach to pursuing the action;
- whether authorisation or ratification of the directors' alleged wrongdoing is likely to occur; and
- whether the shareholders would have the legal standing and capacity to bring the claim in their own right (there are only some limited circumstances in which shareholders can sue directors in their own right).

A court may also seek evidence from other shareholders in deciding whether to allow a derivative claim to continue.

If permission to pursue a derivative claim is granted, a court is likely to order the company to indemnify the shareholders who have brought the claim in respect of their past and future costs.

Securities claims

Securities claims can be brought by shareholders who suffer losses as a result of misleading statements or non-disclosure in a company's financial statements or reports or share offering documentation.

Public offerings of shares on a market regulated by the Financial Conduct Authority, such as the London Stock Exchange, are governed by the Financial Services and Markets Act 2000. Under that act, shareholders who suffer loss can bring claims against:

- A company and its directors due to any untrue or misleading statements in an offering prospectus.
- A company, not the directors, as a result of any untrue or misleading statements in a company's financial reports and statements.

Directors will not be found liable in respect of claims concerning share offerings if they are able to demonstrate that they reasonably believed, having

made such enquiries as were reasonable, that the statements made in the offering documentation were true and not misleading.

It is possible for shareholders in respect of public offerings of shares on non-regulated markets to pursue claims against directors if they can establish that the directors assumed personal responsibility for any misleading or untrue statements in share offering documentation.

Unfair prejudice petitions

Shareholders can petition the court under Section 994 of the Companies Act where they consider their rights have been unfairly prejudiced by the company. This includes circumstances where there has been:

- Breaches of the company directors' fiduciary duties;
- Serious mismanagement of the company;
- Breaches of the company's articles of association or the terms of shareholder agreements.

Petitions are unlikely to succeed where the petitioners have refused a fair offer to purchase their shares, engaged in misconduct or have acquiesced in the allegedly unfair prejudicial conduct.

If the court considers the petition is well founded it can issue an order that:

- Restrains the company from carrying out certain actions;
- Requires the petitioners' shares to be bought out by other shareholders or the company at a price and on terms to be determined by the court;
- Authorises proceedings to be commenced in the company's name including derivative actions.

Directors can be named as respondents to such petitions in their capacity as officers of a company or as shareholders in their own right. The court can make orders against directors where it is just to sanction them having regard to the involvement in the allegedly unfair prejudicial conduct. Such orders can include an obligation to purchase the petitioners' shares.

The expert's perspective



Ed Smerdon

Executive Director – Financial & Professional Services, Aon

What in your view are the key matters to consider in assessing the adequacy of directors' deeds of indemnity and insurance?

Shareholder claims have been increasing. They have been arising from alleged failings by boards to address: bad employment practices, vulnerabilities in data security, and routine bribery and corruption. In the future, we can expect to add climate change to the list. There have also been "event" driven claims, where a business has been impacted by a crisis it had failed to predict/prevent, or the risk of which it had not disclosed to investors.

Directors should ensure they have sufficient insurance coverage and indemnification in place for such claims. The indemnification should be provided by a contract that ensures there is an enforceable right even after employment ends. It should provide an indemnity to the extent permitted by law, and not be conditional upon the insurance not paying. Some shareholder claims are not indemnifiable (e.g. where there is a liability to the company itself). Insurance is therefore needed to fully

cover directors when the company does not indemnify (for whatever reason). The company can buy cover for where it does indemnify the directors and for where it is sued in securities claims (subject to an excess).

What do you consider are the most important steps that should be taken by directors when a shareholder claim is made?

Although some directors are famously well paid, most generally can't afford to defend themselves (and pay any settlement or award) in a shareholder claim. Therefore, it will be necessary to engage the protections by:

1. Providing details of the claim to the insurance broker who will notify the relevant insurers;
2. Dusting off the deed of indemnity and notifying the General Counsel's department of a request for indemnity;
3. Consider, in conjunction with the company and insurers, the appropriate lawyers to appoint.





Recent shareholder claims

Derivative claims

- **Shangold** – Derivative claim by majority shareholder against the company's chief executive. The shareholder alleged the chief executive breached his contractual and director's duties in failing to supervise adequately the design and construction of two ships. High Court granted permission for the claim to proceed.
- **Montgold** – Derivative action by largest shareholder against two directors of a company, including its finance director, and an alleged de facto director, concerning the company's pre-pack sale. The shareholder claimed the sale price was an undervalue and was the result of an unlawful means conspiracy. High Court granted permission for the claim to proceed.

Securities claims

- **RBS** – Shareholder action against RBS and its former directors in relation to its 2008 rights issue which certain shareholders alleged was not accurate or complete. Action backed by litigation funders. Large settlements were agreed in 2017.
- **Lloyds** – Shareholder claims against Lloyds Bank and its former directors in respect of Lloyds' takeover of HBOS in the Autumn of 2008. Shareholders alleged the directors breached the duties owed them in recommending that they approve the acquisition, and in failing to disclose material information. This

information included HBOS' receipt of emergency funding from the Bank of England and a £10bn loan facility from Lloyds itself. Action backed by litigation funders. High Court held that it was reasonable for the directors to recommend the HBOS acquisition but that HBOS' use of emergency funding and the Lloyds' facility should have been disclosed. No damages were awarded as a result of this as it had not been established that the disclosure of these matters would have led to Lloyds' shareholders rejecting the HBOS acquisition.

Unfair prejudice petitions

- **AMT Coffee** – Unfair prejudice petition issued by minority shareholders in respect of the directors' remuneration and the non-payment of dividends. High Court found the directors had received excessive remuneration and had unfairly determined not to pay dividends to shareholders. High Court ordered the directors to buy the petitioners' shares.
- **Edwardian Group** – Unfair prejudice petition brought by shareholders in relation to the managing director's conduct and remuneration. High Court held the managing director had breached his fiduciary duties in failing to disclose investment opportunities and his interest in such investments, and that the company had improperly distributed profits to him. High Court ordered the managing director and the company to purchase the petitioners' shares.



Managing risks

Role of the Board

The Board should:

- Ensure decisions are clearly documented, including the rationale for, and the factors contributing to, the decisions.
- Obtain professional advice before seeking shareholder approval for material or contentious transactions.
- Have a clear understanding of the views of shareholders, including those with a minority interest.
- Engage with shareholders on contentious issues.

Role of Directors

Directors should:

- Ensure they have a good understanding of their statutory and fiduciary duties.
- Check their deeds of indemnity as the precise scope of the indemnity provided by the company depends on how the deeds have been drafted.
- Seek prior board authorisation for contentious actions and, where appropriate ratification by shareholder resolution for breaches of duty.

Role of Risk Managers

Risk Managers should:

- Critically analyse the amount of directors' & officers' liability insurance cover required.
- Check whether the directors' & officers' liability insurance cover requires insurers to reimburse the company for the amount of any indemnity it is ordered to provide to shareholders pursuing derivative claims.
- Pre-plan for potential shareholder claims, including the possibility of conflicts of interest between directors necessitating the need for separate legal representation.

Summary: practical risk management

Boards, directors and risk managers should actively manage shareholder risk through:



Engagement regular communication with shareholders, particularly in respect of contentious issues;



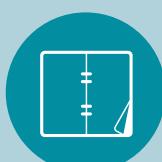
Training: adequate and regular training (typically yearly) on directors' duties;



Decision making: clearly documenting decisions taken by the board, the factors contributing to the decisions, and any professional advice obtained;



Reviewing: regular reviews of directors' indemnities and the amount and scope of directors' and officers' liability cover; and



Pre-planning: prepare for the possibility of shareholder claims, and the potential issues that may arise.



Protect: protect privilege in any investigations conducted into potential claims.

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