

'IN THE LINE OF FIRE' - DIRECTORS' LIABILITIES IN AN ECONOMIC DOWNTURN

There has never been a more daunting time to be a director. When the economy flattens and there is less scope for moneymaking, parties turn their attentions to seeking redress.

For some months now, in the US the economic crisis has given rise to a number of claims by companies against directors due to their management decisions. Can we expect to see similar claims against directors in the English courts?

This article recommends some practical steps that directors, and those guiding them, can take to ensure they fulfil their duties and protect themselves.

Directors' duties

Directors owe their duties to their companies. The nature and scope of these obligations under English law are now set out and codified under the Companies Act 2006 (**2006 Act**). A director owes the following duties to his company:

- To promote the long-term financial success of the company for the benefit of its members;
- To exercise reasonable care, skill and diligence;
- To act within the powers conferred by a company's constitution;
- To exercise independent judgment;
- To avoid conflicts of interest;
- Not to accept benefits from third parties; and
- To declare an interest in a proposed transaction or arrangement.

The new duty to promote the long-term financial success of the company for the benefit of its shareholders has a particular resonance given the current climate, in which directors of many high-profile companies are being viewed as having milked those companies for their own short-term gain.

Particularly during this economic downturn, companies will wish to take practical steps to ensure that (i) directors are aware of their duties (in particular, their obligation to promote their company's long-term financial success for the benefit of its shareholders), (ii) can be seen to be considering them and complying with them - the more important the decision, the more important the thinking and the paper trail, (iii) are suitably trained, (iv) have adequate directors' and officers' insurance (**D&O Insurance**) for the benefit of the company's directors, and (v) directors review and align company strategy, policies and processes with shareholder concerns.

Claims by companies against directors

Where a company is performing badly in the current climate, there is an increased likelihood that there will be major changes to the composition of the board, potentially as the result of public outcry or shareholder pressure. In these circumstances, there is clearly the potential for directors of old boards to become the target of the criticism and, potentially, claims by new boards, even where the directors of the

old board may have left and their involvement in the company has entirely ceased.

In certain limited instances, a company's shareholders may bring proceedings to enforce the obligations of a director to his company. The route available to such disgruntled shareholders is the "shareholder derivative action" which is now provided for under the 2006 Act. Because the director owes his duties to the company, this involves the shareholder bringing an action against a director on the company's behalf, which the company itself has not chosen to pursue.

Crucially, however, before proceeding with his claim, a shareholder must first seek the permission of the court. The court will decide, by reference to a number of factors, whether to grant the shareholder permission to continue with his claim.

Whilst the current economic crisis has given rise to numerous class actions in the US class actions have not, to date, been a prominent feature of our legal landscape. A major factor in the lack of appetite for using class actions in the English courts is that, under our current legal system (unlike that in the US), the losing party is generally liable to pay the winning party's costs, which, at present, serves as an effective deterrent.

Indemnities and D&O Insurance

Among the most valuable protections for a director faced with claims against him will be an indemnity from his company and/or insurance.

The 2006 Act provides, in broad terms, that provisions purporting to exempt a director from his liabilities in respect of his company are void. Exceptions to this general rule are that in certain circumstances, a company can indemnify its directors, and that a company can purchase D&O insurance.

It is particularly important in the current climate that companies and their directors give careful thought to the issue of whether the company will indemnify its directors and, if so, on what terms, and whether D&O insurance will be bought by the company.

Indemnities

A company may indemnify its directors in respect of proceedings brought by third parties, including certain legal costs and certain judgments against the director. A company may also pay directors' defence costs (even in an action brought by the company itself, provided that the director will be liable to repay these costs to the company if the defence is unsuccessful).

Importantly, however, a company will only be able to provide its directors with an indemnity within the rules if:

- Its memorandum and articles of association permit this.
- The indemnity is evidenced in a written agreement between the director and his company.
- The agreement for indemnity does not contravene what is allowed by the 2006 Act.

D&O Insurance

Many claims against directors arise on insolvency, and the company will be in no position to protect its director by an indemnity in those circumstances. This is one area, therefore, where the availability of D&O insurance may be particularly important.

The D&O policy is, in a sense, an unusual form of insurance because, whilst it is bought by the company it is the director who benefits from it. Claims against directors are often very costly to defend and, if made out, frequently lead to sanctions other than damages, such as fines, disqualification and even loss of liberty.

Most D&O insurance policies provide cover for former and current directors of companies. There is no obligation on a company to provide D&O insurance for its directors, although many will consider it best practice to do so.

The effect of this is that directors, particularly retired directors, will not be in a position to influence whether insurance is obtained, and may well not even know if there is D&O insurance available to protect them. Directors would therefore be well-advised to acquaint themselves fully with the D&O provision

obtained by their companies, and retiring directors may wish to explore the potential for agreement that D&O cover will be maintained for the future.

Should you have any questions on issues reported here or on other areas of law, please contact any one of our Corporate Partners:

David Salisbury on +44 207 611 2335, d.salisbury@teacherstern.com

Martine Nathan on +44 207 611 2362, m.nathan@teacherstern.com

James McVeigh on +44 207 611 2304, j.mcveigh@teacherstern.com

Marc Sosnow on +44 207 611 2391, m.sosnow@teacherstern.com

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice.

Teacher Stern LLP 37-41 Bedford Row London WC1R 4JH

t+44 (0)20 7242 3191 dx177 Chancery Lane w www.teacherstern.com

Regulated by the Solicitors Regulation Authority

Teacher Stern is a limited liability partnership registered in England No. OC332605

© Teacher Stern LLP 2008. All rights reserved.