

# Newsletter

November 2011

## Areas of concern for Directors

In my opinion, there are 4 key risk exposures that Directors need to be aware of. Some, like Centro, are well known and others, like Steigrad v BFSL 2007 Ltd, not so much.

1. **Class Actions and Litigation Funders:** the rise and rise of litigation funders and class actions. A Litigation funder like IMF (Australia) Ltd is now a permanent fixture on the litigation scene (since October 2001 to June 2011, IMF have been involved in 123 cases, of which they have settled or won 93). There are around half a dozen or so litigation funders in Australia and I expect this to grow. Their presence increases the chance of claims being made against directors.

One major unresolved issue in class actions is the question of 'fraud on the market'. In the US a shareholder does not have to prove they were misled by the misleading information or the non-disclosure, but rather they simply owned stock during the period when the fraud (i.e. misleading information / failure in disclosure) occurred. In Australia shareholders still have to prove they were actually misled. If the concept of "fraud on the market" is accepted in Australia, it will be far easier for class actions to succeed.

2. **Access to defence costs:** A recent case in the New Zealand High Court, Steigrad v BFSL 2007 Ltd, has potential to cause Australian Boards significant concern. This is because we share the same law (at least in NSW), so technically what happened there can happen here.

A D&O policy covers two things: the defence costs of the director and the actual damages payable to the third party (for example the shareholder). So, what happens if both the third party (damages) and directors (defence costs) are entitled to access the D&O policy limit – whose claim has precedence?

The NZ High Court ruled that third party claimants have priority under section 9 of the Law Reform Act 1936, which meant directors were stopped from accessing the policy for their own defence costs! This will put a scare into every Board director in Australia (certainly those subject to NSW law – and most D&O policies are) as they need to assess the adequacy of their policy limit.

3. **Centro – skill set of Directors:** Directors are not required to have infinite knowledge or ability, and can rely on experts to inform them. However, it is clear that they cannot substitute reliance upon this advice for their own attention and examination. The big question is, how much are directors expected to know and understand, and how skilled are they meant to be, particularly in relation to financial statements?

As an aside, what role do shareholders and other stakeholders (e.g. insurance companies) play in ensuring Boards are appropriately skilled?

4. **Liability to creditors:** A director's duty is to the company. However, a recent case in Qld found a director, Mr Jarrod McCracken, liable to a creditor under a seldom used clause of the Corporations Act Section 1324. This dramatically increases the scope of liability a director faces. In addition, depending on the nature of the breach of Section 1324 it may be considered to be fraudulent & dishonest and therefore fall within the D&O policy exclusion. The case is on appeal, but should it succeed, director liability increases considerably.

## Ever wondered where your premiums go?

Each Insurer aggregates risk into 'premium pools' - they collect the premium from 'the many' to pay the losses of 'the few'. Different risks are assigned to different pools. These pools are assessed and negotiated on separately when it comes to actuarial analysis and treaty negotiations (i.e. reinsurance discussion). As an Investment Manager you are part of the 'Financial Institutions' premium pool, and share this pool with a myriad of risk types: Banks; Superannuation Funds; Investment Banks; Custodians etc.

So, when you are told there are losses in the Financial Institutions pool and should expect prices to rise; coverage to reduce etc, you might wonder why? Well, here is an example of where your premium gets chewed up (just think about the defence costs alone!):

1. ANZ vs Primebroker (Mr Catalano and Mr Pattison);
2. Mr Catalano and Mr Pattison accuse ANZ of misleading and deceptive conduct, which ultimately caused them to lose a business valued at \$100 million (Chimaera Capital).
3. They are seeking damages, interest, costs, declarations, the removal of the receivers and managers and, basically a return to where they were beforehand;
4. ANZ denies all the allegations;
5. There are six cases being heard at the same time and 38 days have been set aside for hearing!;
6. The court will hear from dozens of witnesses including Mr Catalano and Mr Pattison, lawyer Nick Stretch, Ben Steinberg (head of lending services for ANZ's corporate clients), Mr Mentha, (KordaMentha co-founder and principal), plus ANZ staff and expert witnesses including insolvency specialist Laurie Fitzgerald of BDO.

However, don't feel too hard done by. I'd guesstimate that the premium pool from just Investment Managers alone (excluding some of the larger players) would be in the vicinity of \$15m per annum. Even if you had your own dedicated premium pool it's barely enough to cover one limit loss. The danger is by going it alone, you actually increase your volatility – you could go a few good years and then have one Fund Manager take the whole pool – given there is no other group to 'share' your losses with, your premium would ratchet up. This is sort of what happens with Financial Planners – many Insurers treat them in their own pool, so they often experience dramatic price changes (i.e. 30% swings).