

Michael P Hammond

Marsh UK Ltd
No. 1, The Marsh Centre
London
E1 8DX

MARSH
An **MMC** Company

Mr Derek Higgs
Non-Executive Directors Review
Room 2142
1 Victoria Street
London
SW1H 0ET

15th August 2002

Dear Mr Higgs

Subject: Review of the Role and Effectiveness of Non-Executive Directors

I have read with interest the consultation paper that you have sent out on the role and effectiveness of non-executives. To position my comments correctly, Marsh is a leading international insurance broker, one of whose strengths is in the design and placement of directors' and officers' liability insurance. In your consultation paper, question 15, under the heading of 'Attracting and appointing non-executives' relates to insurance:

15. Do you have comments on the issue of risks or insurance provision for non-executive directors?

We believe that the rapidly accelerating litigation involving directors and officers, initially litigation arising from the involvement of directors in the affairs of US and other overseas subsidiaries, but now becoming more general with regard to the UK, makes the issue of insurance critical to the appointment of effective non-executives.

While the UK stills lags behind the USA in terms of size and frequency of claims against directors and officers, it is important to watch what is happening there. For example, there were 487 federal securities class actions filed in the USA in 2001, more than the combined total of 1999 and 2000. There are still about 2,000 federal class action securities cases pending – and this is seen as being the tip of the iceberg. At the same time, the average payment to shareholder claimants rose from US\$9.62M in 2000 to US\$17.18M in 2001.

Many of the 2001 claims were for 'laddering' by investment houses in connection with dotcom companies' initial private offerings, which are not classic directors' and officers' liability (D&O) claims. However, they will affect costs of coverage, as the claims payments will come out of the same premium pool, and they demonstrate the innovation used to broaden the scope of liability insurance. In addition, there is a regularly increasing burden of discrimination claims – shareholder actions in the USA are only 9.2% of total D&O claims, whereas discrimination represents 26.8% of all claims, and 46.1% of employee claims.

An article in USA Today by James Cox on 31st July 2002 highlights the difficulties in recruiting directors, executive and non-executive. It makes the point that post-Enron, headhunters are having to approach four times the number of candidates to identify people who wish to serve on the boards of even the most prestigious companies. CEOs, who used to have an average of three outside directorships at the start of the 1990s, are now averaging just over one. It cites a McKinsey & Co. survey in May of this year, which found that of almost 200 directors, 25% had turned down or quit a board seat in the past year at least partly out of concern for personal legal liability.

I have used US examples in this submission, not only because the trends started in the US courts often pass across to the UK, nor because the statistics are more robust than the UK figures, but because directors and officers, whether executive or non-executive, should assess their potential liability on the basis of the worst case, which is the US exposure. A growing number of companies have ADRs or other listings on the US stock markets or have parents or subsidiaries in the USA. For these reasons, it is always important to pay attention to US trends.

In the wake of the Enron and World.com scandals, and also following on from the massive rate adjustments that occurred after the tragedies of the 11th September, Directors' and Officers' Liability insurance rates have gone up dramatically – increases of 300% to 700% are quite common, as are similar increases in the deductibles required by insurers. At exactly the time when it has been demonstrated that there is most need to have a free and open market for non-executive directors – in order to gain their independence and their aggressive monitoring of corporate activity – one of the vital elements is under pressure. It is obvious that some companies will reduce the amount of D&O coverage, or be forced to accept restrictions in wordings that will make the coverage less acceptable or unacceptable to the sensible and practical non-executive.

It is also important to recognise that a key role of D&O insurance is to provide for the costs of defending a claim against a director, which costs alone can exceed £1 million and thus be beyond the financial resources of most directors. We are aware of two recent D&O claims arising under UK law where the combined defence costs for all of the directors involved have exceeded £16 million.

It could be argued that providing directors with an indemnity in respect of (some of) their actions and decisions creates an environment where poor decisions can be made without fear of the consequences. To an extent this is true, but if a non-executive is going to push against the accepted and act as the grit in the oyster, then to get talented people to fulfil this role will require the reassurance of directors' and officers' liability insurance.

This leads me to an issue that should be of even greater concern to the directors, executive or non-executive, of any company to which the UK Companies Act 1985 applies. It is something that does not appear to be specifically referenced in your consultation paper, but it is one that causes directors deep concern, and that is the uncertainty surrounding a company's ability to advance defence costs and indemnify its own directors.

I must preface my remarks by saying that Marsh is not a qualified legal adviser, and that therefore these comments are made from our understanding of the effect of the law on insurance markets. If you decide that this issue is of significance to your consultation, I would urge you to obtain professional legal advice on our interpretation of the law and on its consequences.

Our concern is over the interpretation of Section 310 of the Act, which appear to render void:

...any provision, whether contained in a company's articles or in any contract with the company or otherwise, for exempting any officer of the company or any person (whether an officer or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company.

Exemptions

Section 310(3)(b) provides two exemptions to this general prohibition:

- directors are entitled to an indemnity against liability which is limited to their legal costs incurred in civil or criminal proceedings brought against them, (so long as they successfully resist those proceedings); and
- if a director is found liable, he can recover his costs on a successful application for relief under Section 727 of CA 1985. In proceedings involving negligence, default, breach of duty or breach of trust, Section 727 gives the court power to grant relief, provided that the director in question acted honestly and reasonably, and the circumstances of the case mean that it would be fair to excuse him.

Our concern is over the interpretation of this section and its exemptions. For example, while it is possible for a company to indemnify an innocent director, it appears unclear whether or not it can advance defence costs to help the innocent director to rebut any accusation or whether it has to wait until the case is closed, when the director may have reached or passed the point of bankruptcy. Also, the section uses the words 'in relation to the Company' in the definition of the indemnities it prohibits. However, this is a very imprecise phrase and its effects are unclear. Does it mean that it is only a claim against the director by the company itself for which indemnity is restricted by Section 310? Does it mean that a claim by a third party is not subject to the Section 310 limitation?

There are a number of consequences of the way in which the section has been drafted, in the absence of any clarifying case law. Firstly, the lack of clarity slows down any finally allowable indemnification, which can cause considerable distress to the parties involved. Secondly, it complicates and inflates the cost of claims. Thirdly, and probably most significantly, as a result, most companies provide directors and officers with insurance with no deductible or very low deductibles, geared to the financial means of the individuals. This has a substantial effect on the premiums charged. If corporations could elect to provide a clear indemnity as an alternative to insurance, then they could gear the deductibles under the policy to their own financial means rather than the individual directors' means, and thus buy insurance above possibly very much higher deductible levels, generating considerable cost benefits.

We are fully supportive of this consultation and review and hope that the vital outputs include:

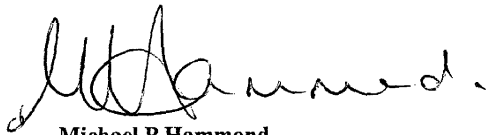
1. a greater knowledge and understanding of the role and importance of directors' and officers' liability insurance in attracting and keeping good non-executive directors, from government, the companies and the non-executives themselves,

Page 4
11 June 2002

2. clarity as to the application of Section 310 of the Companies Act 1985.

We would be happy to clarify any part of this submission or to work with you in implementing these outputs.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M Hammond', with a stylized flourish at the end.

Michael P Hammond
Chief Executive Officer
Marsh UK Ltd