MARSH

Activist Short Selling and the Mining Sector: Implications for Directors and Officers Liability Insurance Programs

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INTRODUCTION

Short selling divides opinion: Is it a balanced response to market excess that improves price discovery and market liquidity, or an ethically contentious and difficult to regulate practice, which can expose markets to abuse or deliberate manipulation?

Recent years have seen an increase in activist short selling, in which both the short position and the rationale behind it are made public – or even publicized. The negative sentiment this generates places companies and their directors and officers under even closer scrutiny.

In this report we consider the factors that can make mining companies particularly exposed to this risk, how management liability insurance might respond in such an event, and some important insurance policy considerations.

THE RISE OF THE ACTIVIST SHORT SELLER

Increasingly, short sellers are choosing to voluntarily disclose their short positions, leveraging a variety of media channels to publicly speculate about the potential over-valuation of a target company. These "activist" short sellers often issue extensive due diligence, ranging in tone between balanced to highly emotive.

While this has most often been observed in the US, this practice is increasing in other regions, particularly across Asia-Pacific and Europe, as short sellers expand their physical office network into new geographies.

IMPACT OF A SHORT-SELLING CAMPAIGN

A short-selling campaign can be highly damaging to the target company, with effects ranging from a fall in share price and initial reputational damage to longer-term, broader-ranging implications from which recovery can be protracted. While a broad-brush statement from the target company may not be sufficient to allay investor fears, a line-by-line rejection of the short-sell thesis may require further disclosure, which may in turn be examined for adequacy and any inconsistency with prior disclosures.

Proactive defenses via the courts or regulatory bodies have historically had limited success, hampered by the burden of proof that courts and regulators need to pursue charges against the short sellers.

Any corporate reaction will, therefore, be scrutinized closely by investors, the markets, and regulators, and, if not managed appropriately, could inadvertently expose the company to further regulatory investigations, redress, punitive action, or litigation. Against a backdrop of heightened expectations of conduct, directors and officers will need to be aware that they may be held personally liable – with all the attendant financial consequences – for the decisions and acts of other directors and officers, as well as their own.

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EXACERBATING FACTORS FOR THE MINING SECTOR

The cyclicality of the mining industry and the strong correlation of valuation to commodity price cycles provide a particular source of risk exposure for mining companies. If a short seller's ideal target is a vulnerable company in an underperforming sector, mining companies may meet one of these criteria simply by virtue of commodity price movement.

A significant number of mining companies also have valuations driven by a small pool of projects or assets or, in some cases, by a single project or asset. The significance of the perceived viability or value of an individual project to overall market valuation for smaller mining companies in particular creates the potential for outsize share price volatility for such organizations.

Operational complexities create further risk factors. The international nature of both mining operations and capital raising can create complexity in respect of multi-jurisdiction reporting and compliance. In addition, mining operations are increasingly exposed to enhanced transparency requirements, such as payments to host governments, which may be used to challenge the fundamentals of license awards and ownership.

Meanwhile, project feasibility, cost estimation, and scheduling are complex modeling challenges and are materially vulnerable to new information, changes in assumption, and wholly external exigencies.

SHORT SELLING IN CONTEXT

39 short attacks on

29 mining companies globally since 2010.[1]

74% of public short campaigns against miners have targeted US-traded stocks[2], this is an increasingly global phenomenon.

1/3 of short attacks primarily attributed to business and accounting fraud, misleading activity, or other illegal activity.[3]

1 Source: Activist Insight Online as at 14 September 2017 and where a mining company is defined as a company that engages in the exploration and extraction of ores and minerals.

2 Where a company is dual-listed the exchange of the listed stock shorted by the activist is used.

3 As per 1. 33% of all short attacks attributed to accounting fraud, major business fraud, misleading accounting, or other illegal activities as defined by Activist Insight.

THE CHRONOLOGY OF AN ACTIVIST SHORT-SELLING CAMPAIGN

The way in which a short-selling campaign plays out may be defined by how the company reacts as much as by the short thesis itself. Other actors – such as regulators, the courts, investors, and other interested parties – will also influence the recovery timeline. In order to minimize both the financial and reputational damage a short-selling campaign may cause, management will need to be prepared to respond to each stage of the attack.

THE ATTACK

This can be direct or anonymous and often occurs via multiple channels, such as the public issuance of the short thesis, letters to the company or regulators alleging areas of concern, and the use of social and traditional media channels. The company may be targeted by multiple short sellers, who may or may not be colluding with each other, and the attacks could occur in multiple waves.

THE TARGET'S INITIAL REACTION

Directly following the attack, an investigative committee may be set up with internal and external representation to understand the source and intent of the allegations, and legal, financial, audit, and PR advisers may be retained. Shares will often rally in the first 48 hours, minimizing immediate losses, as the investor community awaits a response from the company. Companies can choose to remain silent on the allegations, but many undertake either a broad-brush rebuttal or a line-by-line counter-argument, either publicly or directly to shareholders and other invested parties.

Regardless of the communication strategy a company takes following such an attack, it should be mindful of public and/or continuous disclosure requirements in any response, with actions taken in the best interests of the company and its shareholders, rather than from an emotional standpoint.

TRADING

Regulators may intervene and suspend the trading of shares; the company can also request a trading halt. Companies and/or directors may choose to repurchase shares in the coming days, weeks, and months to show confidence in their company, and in order to bolster share price, trading, and capitalization.

INVESTORS'/SHAREHOLDERS' RESPONSE

A short-selling campaign will trigger a sell or hold decision, and there is likely to be a keen desire from investors for additional information to inform this. Should investors' losses crystalize, the potential to seek financial redress through litigation against the company and its management presents a significant exposure for individual directors and officers.

LEGAL AND REGULATORY ACTION

While a target company may wish to pursue regulatory or legal action against the short seller if they believe they have grounds for action, the potential costs and risk associated with additional disclosure and litigation may outweigh the benefits.

MAINTAINING OPERATIONS

While minimizing the impact on "business-as-usual", operational performance and strategic delivery is crucial; management could be distracted by allegations, or, at worst, operations may be curtailed by factors such as restrictions to capital or counterparty concerns.

IMPLICATIONS FOR DIRECTORS AND OFFICERS

Given the heightened risk of shareholder loss associated with an activist short-selling campaign, it is important that companies and their executives are comfortable that their directors and officers (D&O) insurance programs will respond suitably in such an environment, and understand what will – and won't – fall within the scope of coverage.

In the moment of crisis following a publicized short-selling campaign, it is unlikely that a formal proceeding or a formal investigation will exist to immediately trigger D&O policy coverage. Mitigation and crisis costs coverage may, however, provide immediate support.

CORE COVERAGE FOR LEGAL LIABILITIES

One common trigger for the core coverage provided by a D&O policy – a formal claim that a wrongful act has been committed – may never occur for the management of a target company following a short-selling campaign against it. However, if such a claim arises, a D&O policy may cover potential liabilities of directors and officers – and the costs incurred in defense against allegations of breach of such duties. Liabilities may arise to the company, its shareholders, or other third parties, and common circumstances and events that might give rise to a claim are highlighted below – notably, many align closely with "red flags" that short sellers may seek to identify in corporate activity:

- A material fall in share price that appears to result from an error of managerial judgement.
- Negligent misstatement, whereby a director or officer misleads investors, perhaps inadvertently.
- Perceived conflicts of interest coloring the interpretation of senior executives' actions.
- Breaches of warranty of authority (with directors and/or officers acting beyond authority).
- Allegations of corruption or bribery, or the failure to prevent corruption or bribery.
- Merger, acquisition, or divestitures where executives are perceived to have failed to maximize value for shareholders, have personally profited, or have misled investors.
- Insolvency.
- A general failure to manage the business effectively.

Should a short-selling campaign proceed to the extent that it generates such claims, directors and officers will be keenly interested in the extent to which coverage applies, and minimizing risks at the stage of policy design and placement will be important.

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INVESTIGATION EXPENSES

A short-selling campaign is more likely to trigger an external or internal investigation into the conduct of company personnel than to result in litigation. However, individual directors and officers may still require substantial support to ensure they do not damage their own positions or that of the company during such instances. The associated costs, including legal expenses, can be included under the D&O coverage and can provide important support to an individual if no formal claim or litigation has commenced.

Furthermore, the increasing regulatory emphasis on self-reporting may pose important questions as to whether it is appropriate for an organization to self-report if a potential irregularity becomes evident. Coverage for costs in relation to the assessment of whether self-reporting is required can also be included within the scope of any extensions to coverage.

COVERAGE EXTENSIONS

Fees and costs may be incurred prior to an actual investigation or claim. Coverage extensions may therefore provide early support for the target company:

- **A mitigation costs extension** may fund fees, costs, or payments made to plan the defense of, investigate, prevent, settle, compromise any potential investigation, claim, or crisis, subject to insurer's consent. Early engagement with insurers is vital to secure support for expenses in relation to mitigating actions to be undertaken to reduce further risk of loss.

- **A company crisis loss extension** will fund fees, costs, or expenses incurred by PR consultants retained by the directors, officers, and/or the company in respect of a "crisis", again subject to insurer consent. The policy definition of a "crisis" is an important variable that may restrict access to cover. This term may include a limited list of events likely to cause a fall in a company's share price by a defined percentage within a defined time. Examples include:

  - Company's past/future earnings or sales are substantially less favorable than its prior public statements/projections for the period, or an outside securities analyst has published an estimate of its earnings or sales.

  - Intention to write off a material amount of its assets.

  - Default, or intention to default, on its debt or intention to engage in a debt restructuring.

Prompt engagement with insurers will be essential to secure coverage for a planned crisis management campaign.

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THE ESSENTIAL MECHANICS OF A D&O POLICY

KEY D&O INSURANCE DRIVERS

- Unlimited personal liability for actual or alleged breach of duty; personal assets at risk.
- Claims brought by the company itself or by third parties: investors/shareholders, creditors/liquidators, bondholders, listing authorities/regulators, governmental authorities, competitors, customers, etc.

- Claims may arise in one or more jurisdictions.
- Defending allegations can be expensive.
- Increased regulatory activity and a focus on fighting corruption since the 2008 financial crisis.

- Increasingly litigious environment; enhanced focus on accountability for corporate wrongdoing in both criminal and civil cases.
- The company may not be able to advance or reimburse executives for legal expenses due to lack (or prohibition) of indemnification provisions under law or statute.

THREE SECTIONS OF COVER

SIDE A
PERSONAL LIABILITY

- Covers the **individual** director or officer in the event that the company cannot fund their legal costs, or indemnify them, for the amount he/she may be obligated to pay arising from claims of a wrongful act committed (alleged or actual) in their executive/non-executive management capacity, and including defense costs.
- No retention applies to this coverage.

SIDE B
COMPANY REIMBURSEMENT

- Protects the **company** where it has indemnified a director or officer as a result of claims made against them because of any actual or alleged wrongful act committed by them in such a capacity.
- Self-insured retentions typically apply to this coverage, for which the company is solely responsible.

SIDE C
SECURITIES CLAIMS

- Protects the **company** when named as a defendant in a securities claim by shareholders or bondholders.
- Self-insured retentions apply to this coverage for which the company is responsible.

Often complemented by adding a Side A-only layer at the top of the program, which may include a difference in conditions (DIC) element, allowing broader coverage and/or protection of the insured against insurer insolvency.

STRESS-TESTING POLICIES AGAINST A SHORT-SELLING CAMPAIGN

Organizations should regularly review their indemnity provision and D&O insurance coverage against both existing and emerging exposures, seeking specialist risk management advice to ensure adequate cover and limits of liability, avoid duplication of cover, and close coverage gaps. Specific factors to consider in the context of an activist short-selling campaign include:

SUFFICIENCY OF LIMITS

The losses from a short-selling campaign will depend on a company's size and investors' losses. The likelihood of an investigation or claim in multiple jurisdictions – amplified for companies with dual listings – also increases the potential legal costs and overall losses that can be incurred by the company and its directors and officers.

D&O limits should be benchmarked against market capitalization and asset size to ensure they are sufficient. Companies should also check whether an any single claim limit is available to provide access to fresh limits for new, unrelated claims made during the same period of insurance to avoid the distressed purchase of additional policy limits mid-term.

PROGRAM DESIGN

Companies should review who is covered – directors, officers and/or the company, directors and officers only, or all employees – and what is covered – claims not indemnified by the company, the company for indemnified claims, and the company itself if a respondent to a claim. Program structure should be aligned to the company's risk management philosophy in this regard.

Consider whether priority of cover should be given to the directors, officers, and defined executives, or to all employees. Review whether to dedicate a portion of the limits to directors and officers only (in opposition to the company) or to the main board only (in opposition to all directors and officers).

PERSONAL ASSET PROTECTION

In most cases, companies will purchase a Side-A difference in conditions (DIC) policy. Such a policy provides several advantages including, but not limited to:

- Dedication of limits solely for the protection of directors and officers, covering personal liability for non-indemnifiable loss only.
- Broader terms and conditions than a conventional D&O program.
- A policy that will "drop down" to cover directors' and officers' personal liability if an underlying insurer fails to respond, becomes insolvent, or rescinds its policy.
- Prevention of limits from being construed as an asset of the company that may be frozen by the court in the event of bankruptcy and depriving directors and officers from access to the policy.

COMPLIANCE

Ensure the D&O program can respond to claims in various jurisdictions. It should encompass local admitted policies for territories where there are local directors and non-admitted insurance is not allowed - such as Brazil, Russia, India, and China - and particularly for territories where indemnification and advancement costs are prohibited. Companies should also review the design of the international program against their D&O purchasing philosophy.

MULTIPLE JURISDICTIONS

Companies should review how their retention limits would apply in the event of investigations or claims in multiple jurisdictions. Under most policies, if several retentions are applicable then the highest retention will apply. This usually means US retention levels being applied to non-US investigations or proceedings.

OTHER COVERAGE CONSIDERATIONS

It is important that companies consider whether investigation and pre-investigation covers are fit for purpose in the current environment they face.

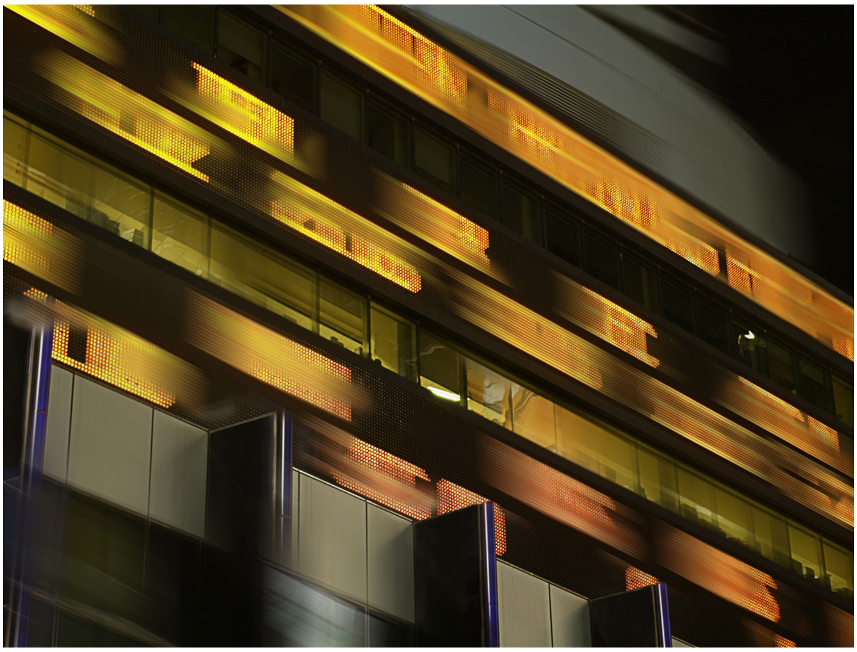
In the case of allegations of fraud, policies may provide for narrow conduct exclusions and contain language whereby investigation costs and defense costs will be advanced by the insurer up to the point when it is admitted or proven by final adjudication that a fraud has actually been committed.

It is advisable to check that policies do not include a pollution exclusion or bodily injury and property damage exclusion (or that it provides the appropriate carve-backs), as these may restrict cover under the policy in the event of a securities class action or a regulatory investigation following a corporate event.

Policies should provide a strict time-limit for insurers to confirm their coverage position and advance defense costs, or to pay a loss under the policy once the relevant information and invoices have been submitted to them.

These should also include cover for past directors and officers and automatic run-off provisions for directors and officers in the event of non-renewal of the policy.

Finally, including extensions such as mitigation costs (at least for directors and officers), company crisis loss, and an emergency costs extension in policies, allow covered costs to be incurred without the insurer's prior consent, when it has not been possible to obtain it.



Directors and officers may be held personally liable for decisions made by other directors and officers, as well as for any wrongful acts they may have committed, and their personal assets could be at risk.

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