Trends update for financial risks and professions

December 2020

Today's directors and officers have significant responsibilities not only in preserving company value and ensuring success in the future but also in responding diligently to political and environmental tensions, emerging technologies, changing regulation, and the need to promote diversity. The D&O landscape will continue to be challenging as we move into 2021.

Likewise, the professions are facing the same political and environmental tensions. Regulatory breaches are on the rise for solicitors, architects and auditors, although IFAs have welcomed the decision of *Adams v Carey Pensions UK*. However, for both the financial institutions and professions, the main impact has been COVID-19 and will continue to be for the foreseeable future.

Financial risks

COVID-19 impact

- Cybercrime and cashless payment technology will be the top priority for regulators as the financial system recovers from the shock of the COVID-19 pandemic. The existing regulatory framework will have to be adjusted to take account of the risks of new payment technologies by creating operational resilience to potential data breaches. Whilst this will mean increased stress testing for financial institutions, a revised regulatory framework will be beneficial for the finance sector and both FI and D&O insurers.

Kennedys

- COVID-19 is already leading to a rise in fidelity claims often as a result of internal controls weakening in the home working environment where it is harder to supervise more junior or less experienced members of staff. Insurers will need to ensure that appropriate procedures are in force and are suitably reflected in the policy wording.
- The number of litigation funders entering the UK market is rising, causing an increase in high value, high profile claims being instigated by large groups of claimants against both corporate defendants and D&Os. This, in turn, has caused increased defence costs and loss. The onset of insolvencies will continue to exacerbate this trend.

Related item: Coronavirus focus area

Insolvencies

- The prospect of an avalanche of insolvencies as a result of the UK Government's lockdown strategy in response to COVID-19 is now very real. This trend was already beginning at the start of 2020 as a result of a range of issues giving rise to an economic slowdown, including exchange rate fluctuations, changes in consumer/market behaviour and uncertainties surrounding Brexit. COVID-19 has accelerated that curve.
- These liquidations are leading to an increase in claims against D&Os as insolvency practitioners look to maximise recoveries for creditors alongside claims against auditors. Such actions also involve regulatory angles: not only the Financial Reporting Council examining the conduct of Chief Financial Officers at the helm when companies fail, but also the Insolvency Service looking at broad duties on all board members to oversee and ensure corporate financial health.

Related items:

- Reflective loss and the impact on claims against directors and officers
- Not so limited liability…a quiet warning on directors personal liability for company tax
- COVID-19: business as usual in the 'new normal'? A global view
- COVID-19 and your duties as a director

Cyber risks

- Advancing technology continues to present both opportunities and challenges, and cyber risks remain a concern for all businesses, no matter what their size. Data breaches have become more common and the responsibility for complying with the GDPR falls on directors. Directors need to be ever vigilant about cyber protection and ensure training and monitoring of risks is adequate, as well as having processes in place to mitigate cyber risk in the event of an attack.
- To add to this, the recent move towards remote working arrangements has led to reports of an increased risk of phishing scams on deployed devices including laptops, mobiles and tablets. We expect such malware and ransomware incidents will continue as they provide not only an opportunity to harvest personal data but also target corporate assets.
- Cyber related business interruption is an ongoing concern for all businesses. The cyber insurance market is under increasing pressure to cover BI losses stemming from intangible triggers as the frequency and severity of cyber-incidents increase. We expect this trend to continue, particularly with cyber security challenges presented by a shift towards remote working practices.
- We are also likely to see increasing claims related to reputational damage as a result of cyber related business interruption.
- In the Court of Appeal judgment in *Lloyd v Google*, handed down in October 2019, it was held that claimants could recover damages for loss of control of their data under s.13 of the DPA 1998 without proving pecuniary loss or distress, thereby removing causation defences that would otherwise have been available. The judgment is the first time a UK court has held that a uniform sum may be payable to individuals affected by a loss of control of their personal information without establishing pecuniary loss or damage and also permitted the individual to pursue his claim against Google as a representative action on behalf of four million other iPhone users.
- The decision may pave the way for US style mass 'opt out' type litigation following cyber incidents leading to data breaches. The judgment,

however, is being challenged as Google were given permission to appeal to the Supreme Court and the appeal is expected to be heard in April 2021.

Related items:

- Group litigation - into the breach - *Lloyd v Google* [02.10.19]
- Recovery from cyber fraud loss in the COVID-19 era
- Non-affirmative cyber risk: phase 2 classes of business

Data protection

- There has been a positive development following the Supreme Court decision in the *Morrison* action where it was found that Morrison would not be held liable for the action of the ex-employee. The judgment is a very welcome decision for businesses. However, the outcome will unlikely mean an end to data breach group litigation in the UK and the associated risk posed to corporates, D&Os and their insurers.

Related item: Morrisons in the Supreme Court: data breach implications for D&Os

Regulatory powers

- Regulatory bodies seek to hold corporate entities and individuals liable when things go wrong and the trend for finding individual culpability as the means to changing corporate behaviour can be expected to continue. Increasing powers are available to regulators/bodies such as the Financial Conduct Authority and Serious Fraud Office, and D&Os are faced with a plethora of potential sanctions, including criminal offences, such as bribery/failure to prevent bribery and tax evasion.
- For the past five years in the US, we have seen and continue to see significant regulatory settlements with financial institutions, as a result of more regulatory powers and increased scrutiny in the wake of the 2008 global financial crisis. More recently, Wells Fargo agreed to pay a US$3 billion monetary penalty to resolve criminal and civil investigations into its sales practices and allegedly false records.
- A recession will most likely follow the COVID-19 recovery and in those circumstances, we are likely to see the same trend here in the UK but to a lesser extent where regulators' fines tend to be lower.

Related items:

- The regulatory position of unregulated introducers and financial promotions
- Damages for late payment: will COVID-19 set the first precedent?
- Regulatory reflections: the impact of regulatory developments in the (re)insurance sector
- FCA warns insurers must be proactive in tackling non-financial misconduct

Anti-competitive conduct

- The Competition and Markets Authority continues to consider the effect of mergers and anti-competitive conduct to ensure fair deals for consumers and has not been afraid to intervene and take enforcement action.
- In a competition context, the dismissal of Mastercard's appeal on 11 December 2020 (*Merricks v Mastercard)* by the Supreme Court is a landmark decision. The judgment clarifies the test to be applied by the Competition Appeal Tribunal (CAT) in certifying collective proceedings, and indicates that the Tribunal was too strict in the way it previously approached these applications. This is likely to lead, not only to this Collective Proceedings Order being certified by the CAT, but is also likely to set the tone for future group actions in England and Wales.
- The potential is now here for the floodgates to be opened to further group actions. Claimant groups and litigation funders across the country are likely to start amassing arms to exploit this change in direction.

Related item: Collective redress: deal reached on EU-wide 'class action' regime

Brexit

- Economic volatility and/or poor Brexit planning could result in companies suffering financially, resulting in shareholder claims against entities and D&Os.
- Unforeseen and unpredictable disruptions and possible consequent financial failures may

expose companies' auditors as well as the directors. Furthermore, some businesses may be inadequately prepared for data issues post-Brexit, which may impair critical business processes and cause damage.

- The governor of the Bank of England recently told large UK financial institutions that preparations for a no-deal Brexit should be ramped up. Financial Institutions' existing difficulties in properly preparing for all eventualities in the run up to the December 2020 deadline for an EU-UK trade deal may be hampered by the impact COVID-19.

Related items:

- Brexit focus area
- EU Commission warns against complacency as the end of the Brexit transition period draws near

Climate change

- Climate change is increasingly seen as a threat to financial stability and the health of a company's balance sheet. Consumers and shareholders are increasingly demanding 'green' action and green financial products, and prudent D&Os will need to assess and manage a company's activities from an environmental perspective or face the prospect of legal action.
- Shareholder activism, as demonstrated by the climate-related shareholder resolution filed at Barclays in May, has been a powerful tool to effect change within 'carbon majors' (i.e. oil and gas companies) in terms of emissions reduction. Activists are now focussing on financial institutions who provide financial services to such companies.
- Shareholder primacy, i.e. a board's obligation to deliver value for shareholders, which forms the basis of UK corporate law is now coming under threat, with the board also needing to consider other stakeholders i.e. suppliers, employees, customers and wider community interests. Shareholders, for example fund managers, are themselves coming under pressure from their clients to ensure that the companies they invest in will deliver long-term returns, which requires them, in turn, to look at climate change issues.
- Given the rise in environmental concerns and corporates being held accountable for their corporate social responsibility, we also expect to see increasing claims related to reputational damage.
- The United Kingdom has become the first country to anticipate and plan for the necessity of mandatory disclosures related to climate change. This development comes in the form of a five year plan which seeks to implement requirements for such disclosures by 2025.
- Failure to acknowledge or prepare for these changing risk factors could result in solvency issues or regulatory intervention and penalties.
- There will also be potential for claims against firms and their directors and officers for failure to properly disclose climate risks, failure to properly assess and to take adequate action to mitigate climate risks and failure to appropriately value a company's assets and investments.

Related items:

- Asset managers are not sufficiently reporting on climate risk, TCFD consultation finds
- Insurers must consider the D&O implications of climate change
- Climate-related financial disclosure – the Bank of England report
- Financial institutions feeling direct pressure to address climate change concerns

Diversity, equality and sexual misconduct

- The spotlight on diversity and equality is having an impact on many businesses, regardless of size, nature or geographical location. The ongoing #MeToo movement is expected to continue to lead to an increased number of claims arising out of sexual misconduct allegations, whether against the perpetrator or those responsible for their appointment or management, which could impact underwriters of both D&O and employment practices liability insurance.
- As well as gender, focus is on diversity generally within all organisations; boards have to demonstrate that systems are in place and that procedures are complied with to deliver equality in terms of race, religion, disability and socio-economic status. Failure to engage with these issues may lead to liability whether from those impacted or from regulators.

- The UK Government's response to the public consultation on workplace sexual harassment was expected in Spring 2020 but is still awaited. The consultation (July-October 2019) set out to consider whether current laws protecting people from sexual harassment in the workplace are effective. A proposed change in the law is to introduce a mandatory duty on employers to protect workers from harassment and victimisation in the workplace, placing a new proactive duty on employers.

Related items:

- Potential D&O risks arising from corporate social responsibility
- Avoiding the pitfalls of employee grievances

Professions

COVID-19 impact

- At the forefront of the impacts on insurers (and brokers) are the conversations around business interruption (BI) claims. In September, the High Court handed down its detailed judgment in the Financial Conduct Authority (FCA) BI test case (BI policy wordings in the context of COVID-19 pandemic claims). The Court found in favour of policyholders on the majority of key issues, and in particular in respect of coverage triggers under most disease and 'hybrid' clauses, as well as causation and 'trends' clauses. The defendant insurers appealed this judgment, which was heard by the Supreme Court in mid-November. It is anticipated that the appeal judgment will be handed down just before Christmas or early in the New year, the outcome of which will be received with great interest, not only for COVID-related claims but in respect of all future claims under business interruption policies.
- We may see a second wave of E&O notifications by brokers for inadequate cover for losses due to the pandemic (BI claims) but much depends on the availability and cost of separate pandemic cover at time - should brokers have advised purchase of separate pandemic cover?
- The COVID-19 pandemic brought a temporary halt to travel and carbon producing industries, and increased public awareness of the benefits of 'going green'. Consequently, the UK government has committed funding of up to £350 million for the decarbonisation of heavy industry, construction, space and transport. This has encouraged the uptake of modern methods of construction (MMC) which is more sustainable and has a smaller carbon footprint than traditional construction methods. Some insurers have expressed caution in covering MMC projects as it presents new risks. As such, the continued use of MMC will require detailed interpretation of the design exclusion clause and the aggregation wording.
- Reduced construction site work as a result of COVID-19 has resulted in early commercial resolutions being sought including 'smash & grab' adjudications and this will continue into 2021.
- A recession is set to follow the COVID-19 recovery and the anticipated general trend is an increase in claims against surveyors and valuers for overvaluations. However, some commentators are predicting a short-term fall in property prices, followed by a quick recovery. Consequently, the number of claims may not rise substantially. Indeed, we have started to see fewer but significantly larger value claims arising from negligent advice relating to development potential and rental yields in addition to overvaluation.
- Solicitors' claims have increased as a result of mistakes by less experienced practitioners with reduced effective supervision due to working from home during the COVID-19 lockdowns. This will result in reputational damage to law firms and reputational management will become more important for owners of law firms and their insurers in 2021.
- Home IT systems may not have the same level of security as the office IT systems, which leads to a greater risks of data breaches for all professionals working from home.
- Following the COVID-19 recovery, a recession may also see increased claims against solicitors arising from transactions in the corporate and property fields, namely transactions with deferred consideration contingent on future events. These may include earn outs by selling shareholders and disputed beneficiary or Inheritance Act cases.
- Accountants and actuaries will face increased vulnerability to cyber attacks and GDPR claims given the large amount of data held by them.
- Going forward, there will be a clear demand for auditors and boards to consider and report on the broader range of resilience type risks issues

raised by COVID-19 (and climate change). Failure to do so will result in negligence claims against auditors.

- The onset of COVID-related insolvencies will also lead to a risk of claims against the professions which we explore further below.

Related items:

- Sharp increase in disciplinary complaints against architects
- The impact of modern methods of construction on insurers
- A rise in brokers errors and omissions premiums presents a hard market to tackle
- Law firms facing renewal test as claims rise
- COVID-19: potential claims against construction professionals and its impact on ongoing and future disputes
- Solicitors' professional indemnity – what effect will COVID-19 have on the claims profile against solicitors?
- Home working and data loss – a cautionary tale from the Solicitors Disciplinary Tribunal

Insolvencies

- The current economic crisis is likely to lead to increase in insolvencies, which could lead to a risk of claims against insolvency practitioners. In discharging their Insolvency Act 1986 functions, insolvency practitioners are often confronted with challenging situations involving a variety of stakeholder groups in which the practitioner is required to make difficult and sometimes urgent decisions, potentially leading to mistakes and negligence claims.
- There may also be claims in respect of complaints about the rationale for early sales of businesses by administrators, or allegations about independence if they have been involved in an engagement for the client, at the behest of the bank, before an insolvency order was made.
- In addition, claims by insolvency practitioners against other professionals (e.g. auditors, solicitors) alleging negligence in relation to historic matters are likely to increase.
- In a recession, the number of companies in financial difficulties will rise sharply, and in such an environment it is common for claims against accountants and auditors to increase. Following the last recession, there was a spike in claims against auditors and accountants, with claimants alleging a number of failings by auditors and accountants – for example, negligently failing to detect fraud of directors (which often increases in times of economic turmoil), negligently overvaluing assets and, in relation to tax advisers, negligently miss-selling tax schemes or failing to warn of challenges to schemes by HMRC. These claims emerged a few years after the onset of the last recession.
- Rising to the challenge in respect of client forecasts will be an issue not only for audit teams but for due diligence accountants and auditors preparing reports for banks on troubled businesses.
- In the future, there will be a clear demand for auditors and boards to consider and report on the broader range of 'resilience' type risks to which issues raised by COVID-19 and climate change alike are relevant.

Related items:

- Prioritising privilege: the importance of legal privilege in cyber incidents
- Trusts Registration Service – risk issues for professionals
- Solicitors Liability: Latest decisions August 2020

Regulatory prosecutions

- 2019 foreshadowed a new risk: regulatory breaches of the new Solicitors Codes of Conduct (the STARS). Many insurers offer regulatory costs cover in their policies and can expect that to be called upon more frequently as investigations, prosecutions and SDT hearings are likely to become more prevalent, and to deal with aspects of solicitors conduct both in and outside the office. However, in light of the Beckwith appeal judgment handed down in November, we can expect that principle to be challenged.
- Likewise, the FRC plans to increase the scope and number of audit quality reviews. We envisage that regulatory actions against audit firms is likely to rise as are the fines levied against auditors by the regulator.
- On 3 November, the FCA published a 'Dear CEO' letter, which sets out the FCA's supervision strategy for Lloyd's and London Market Intermediaries and Managing General Agents (LLMI). Brokers must now (amongst other things)

make sure they have effective supervision models in place and give examples of how their firm has mitigated risk.

- The landmark decision of *Adams v Carey Pensions UK LLP* [18.05.20] has further clarified the applicability of the FCA Handbook which should be considered in light of the contractual arrangements between the SIPP provider and its customer. The unprecedented level of claims against SIPP providers (arising from similar facts to those in *Adams v Carey*) is now likely to decrease.

Related items:

- FCA sets out supervisory focus for Lloyds and London Market
- SRA Code of Conduct: conduct outside of the office: the Beckwith case revisited
- Solicitors' regulatory roundup: September 2020
- The regulatory position of unregulated introducers and financial promotions
- SIPP providers, due diligence and contractual primacy

Brexit

- With the end of the transition period fast approaching, Brexit will continue to regain top billing, seeing a move away from the recent COVID-19 focus to which we have become accustomed.
- We have already seen the Brexit impact on supply chains in the construction industry with companies taking action to ensure they will continue to have the products they can rely on at the correct price.
- As a result, we can expect to see more professional negligence claims relating to the products used in construction projects (more so because of tax implications) and the impact this will have on construction projects, the delivery of such and the advice provided by design professionals.
- Equally, this may also see UK based companies performing roles and providing services/materials for which they have previously little or no involvement, further increasing their professional liability. In the solicitors' sphere and related to this, the negotiation of Brexit clauses and the impact of such is a new risk we expect to see.

Related item: Brexit focus area

Climate change

- Climate change is something that all companies and their boards must address. We have seen a shift towards green energy and companies being held accountable for what they are doing to help the environment. As part of this, new technology (with future unknowns) and changes to legislation are leading to claims against those professionals in the tech sphere. That includes the designers responsible for the way in which renewable energy is provided, with regard to biomass waste energy, windfarms, hydro and wave power, and in the future potentially in respect of withstanding climate related physical damages.
- The United Kingdom has become the first country to anticipate and plan for the necessity of mandatory disclosures related to climate change. This development comes in the form of a five year plan which seeks to implement requirements for such disclosures by 2025.
- The Supreme Court has granted permission for Heathrow Airport to appeal the Court of Appeal decision (February 2020) rejecting expansion proposals for disregarding legal commitments to reduce carbon emissions. This may influence the volume of climate change litigants and we may see claims against construction professionals for negligent design of buildings that are not compliant with policy on the control of climate change.
- 2020 has seen a continuation of devastating wildfires dominating news headlines. The risk of UK wildfires exists and is growing – this is not a risk that applies only to hot, dry regions. As well as the risk to life and health comes the inevitable risk of damage to property and infrastructure, and the question as to whether landowners and the construction industry are doing all they can to reduce the impact of wildfires on the community by, for example, the use of fire resistant materials and careful management of flammable material. However, the difficulty we are seeing in this area - and which will inevitably be a trend for 2021 - is the change to building regulations and construction legislation and the standard to which construction professionals must adhere.

- Likewise, the increased flooding events of 2020 has seen a significant rise in property damage and business interruption claims with an increased risk in claims against surveyors and construction professionals (for inadequate/defective design of floodproof buildings/infrastructure and delay to construction works). Climate scientists have advised that flooding events will increase in 2021. COVID-19 has exacerbated the impact by causing further delays in repairs and increasing costs to insurers. Some insurers are looking to incentivise insureds to adopt flood resistance and resilience measures to help manage their exposure to flood in line with the July revised National Flood and Coastal Erosion Risk Management Strategy.

Related items:

- The impact of transitioning to renewable energy-from-waste projects – problems for UK designers
- The growth of floating offshore wind
- Impact of the Heathrow decision on the construction industry
- London Market forecast 2020

Japanese Knotweed

- Following the government's response to the Science and Technology Committee's report entitled 'Japanese knotweed and the built environment', Defra conducted a detailed study comparing how various different countries approach the issue of Japanese knotweed. The final report was published on 1 September 2020.
- The overwhelming conclusion was that no other country takes a similar approach to Japanese knotweed in the context of property sales as the UK. It was felt that this is predominantly due to the high persistence and impact on the native ecosystem, followed by 'linguistic alarmism' that affects all areas of the housing industry.
- However, Defra remained satisfied that the legislative approach appears effective in managing the long term impact of Japanese knotweed.
- We therefore remain of the view that the presence of Japanese knotweed, even without physical damage, will continue to present as an actionable nuisance. The restrictions and extra burdens placed on an occupier because of current legislation is the key driver in such claims and we will continue to see valid claims for the cost of treatment/eradication.
- As it remains relatively straightforward to bring a claim for Japanese knotweed, we may see the emergence of claims farming and a surge in such claims.
- Should the steps suggested by Defra be implemented, it may be that in time the impact of Japanese knotweed on a property's value will be lessened. Accordingly, any anticipated claims for consequential financial loss – for example, residual diminution in value – will be less substantial.

Related item: The new claims trend spreading like Japanese knotweed

Further information

To find out more about our services and expertise, and key contacts, go to: **kennedyslaw.com**

Key contacts

John Bruce
Partner, London
t +44 20 7667 9459
e john.bruce@kennedyslaw.com

Jeremy Riley
Partner, London
t +44 20 7667 9143
e jeremy.riley@kennedyslaw.com

Ben Aram
Partner, London
t +44 20 7667 9490
e ben.aram@kennedyslaw.com

Jennifer Boldon
Partner, London
t +44 20 7667 9038
e jennifer.boldon@kennedyslaw.com

Nick Bond
Partner, Manchester
t +44 161 829 0791
e nick.bond@kennedyslaw.com

Paul Castellani
Partner, London
t +44 20 7667 9695
e paul.castellani@kennedyslaw.com

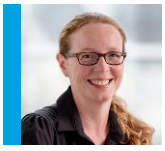
Iain Corbett
Partner, London
t +44 20 7667 9065
e iain.corbett@kennedyslaw.com

David Kupfer
Partner, Basking Ridge
t +1 908 848 1227
e david.kupfer@kennedyslaw.com

Tom Pelham
Partner, Manchester
t +44 161 829 7453
e tom.pelham@kennedyslaw.com

Eric Scheiner
Partner, Chicago
t +1 312 800 5051
e eric.scheiner@kennedyslaw.com

Kevin Yam
Partner, Hong Kong
t +852 2848 6370
e kevin.yam@kennedyslaw.com



Joanna Manthorpe
Corporate Affairs Lawyer, London
t +44 20 7667 9863
e joanna.manthorpe@kennedyslaw.com

Christopher Butler
Partner, London
t +44 20 7667 9562
e christopher.butler@kennedyslaw.com

Rudy Chung
Partner, Hong Kong
t +852 2848 6311
e rudy.chung@kennedyslaw.com

Oliver Dent
Partner, Manchester
t +44 161 829 7462
e oliver.dent@kennedyslaw.com

Dino Paganuzzi
Partner, London
t +44 20 7667 9238
e dino.paganuzzi@kennedyslaw.com

Fleur Rochester
Partner, London
t +44 20 7667 9766
e fleur.rochester@kennedyslaw.com

Barnaby Winckler
Partner, London
t +44 20 7667 9359
e barnaby.winckler@kennedyslaw.com

Ann Dingemans
Corporate Affairs Lawyer, London
t +44 20 7667 9747
e ann.dingemans@kennedyslaw.com